

April 26, 2019

The Honorable Jay Clayton  
Chairman  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

Dear Chairman Clayton:

Thank you for taking the time to meet with us recently to discuss our chief concerns regarding the Commission's proposed "Regulation Best Interest" regulatory package.<sup>1</sup> As we indicated in that meeting, we agree with public statements you have made suggesting that an important goal of the rulemaking should be to ensure that the standards of conduct that apply to broker-dealers and investment advisers "reflect what retail investors would reasonably expect from these types of financial professionals," while preserving investor choice with regard to the type of financial adviser they hire, the scope of services they receive, and how they pay for those services. Unfortunately, while we believe it would be possible to adopt standards that meet investors' reasonable expectations under the Commission's chosen regulatory approach, the regulatory package as currently drafted does not achieve that goal.

On the contrary, unless the standards for brokers and advisers alike are strengthened and clarified, they will fall well short of investors' reasonable expectations because:

- They won't require brokers or advisers to recommend the investments they reasonably believe are the best available match for the investor.
- They won't prevent brokers or advisers from placing their own interests ahead of their customers' interests.
- They won't prevent firms from continuing to create incentives that encourage and reward advice that is not in customers' best interests.
- They will, in some important ways, weaken protections that investors currently receive under state common law fiduciary standards.
- And they won't even provide investors with the information they need, in a form they can understand, to determine which type of relationship or account would best suit their needs.

Our purpose in meeting with you was to explain the basis for these concerns and to identify the key fixes needed to address them.

These proposed fixes do not represent the full range of changes we believe can and should be adopted to improve the rule. Rather, we view these fixes as the minimum necessary to ensure that the proposal meaningfully raises the bar on investor protection. All of them can be adopted working within the Commission's chosen regulatory approach. As a result, they would

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<sup>1</sup> Participants in the meeting included representatives of AFL-CIO, Americans for Financial Reform, Better Markets, Consumer Action, Consumer Federation of America, Consumer Reports, and PIABA.

not require the Commission to go back to the drawing board or restart its regulatory process from scratch.

Unfortunately, despite your allocation of an hour for the meeting, we were not able to discuss all of the concerns we had hoped to cover. The purpose of this letter is to provide additional content and context regarding both the points we made and those we were not able to discuss. As always, we stand ready to discuss any of these issues in greater detail with members of the Commission and the rule-writing team.

**1. Adopt a true best interest standard for brokers that enhances, rather than simply codifies, FINRA’s interpretation and enforcement of its suitability standard.**

Investors reasonably expect that the investment professionals they turn to for advice will recommend the investments and investment strategies they reasonably believe would best meet the investor’s needs. Calling the standard that applies to brokers’ recommendations a “best interest” standard reinforces that reasonable expectation. But Reg BI, as drafted and interpreted in the proposing release, imposes no such obligation. Instead, the Release suggests that the intent of the rulemaking is to codify, rather than enhance, protections investors currently receive under FINRA’s suitability standard, which can be satisfied by recommending any of a potentially large number of “suitable” investments. Indeed, the Release explicitly states, in footnote 7, that the proposed rule’s information collection requirement, the fact that the duty can’t be satisfied through disclosure alone, and the requirement to make recommendations that are consistent with the customers’ best interests all “reflect obligations that already exist under the FINRA suitability rule or have been articulated in related FINRA interpretations and case law.”

The impression that Reg BI is intended to codify, rather than enhance, the existing suitability standard is reinforced by the Commission’s failure to provide any concrete examples of how Reg BI would raise the bar over FINRA suitability. Instead, examples provided in the Release of how brokers would be required to weigh a variety of factors and, in particular, how they would be required to consider costs when determining what to recommend, are all consistent with, rather than an enhancement to, FINRA’s interpretation and enforcement of its suitability standard. For example, Reg BI suggests that brokers would have to give greater consideration to costs when determining what to recommend, but the Release suggests that this requirement would only apply when deciding between two otherwise identical securities, such as two different share classes of the same mutual fund. But FINRA has for many years brought enforcement actions against brokers who recommended higher cost options in these limited circumstances.<sup>2</sup> While there may be modest benefits to codifying this standard in federal law, it is misleading to suggest that it meaningfully raises the standard that applies to brokers’ investment recommendations.

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<sup>2</sup> See, e.g., FINRA, Improper Sales of Mutual Fund Class B and C Shares—Remediation Information for Investors, <https://bit.ly/2GsLGLG>; Press Release, NASD Fines Merrill Lynch, Wells Fargo and Linsco \$19.4 Million For Improper Sales of Class B and C Mutual Fund Shares, December 19, 2005, <https://bit.ly/2GsHr2J>; Jill Gregorie, FINRA Censures Voya Over Share Class Sales, Ignites, April 25, 2019, <https://bit.ly/2PwyJEX>.

If the Commission wants to improve protections for investors by adopting a true best interest standard for brokers' investment recommendations, the following changes to the rule text are essential to achieve that goal.

- The Commission must adopt a principles-based definition of best interest that unequivocally raises the bar over the existing suitability standard. In defining the term, it must make clear that brokers are required to recommend the investments they reasonably believe are the best match for the investor from among the reasonably available investment options.<sup>3</sup>
- If, as has been suggested, one goal is to ensure that brokers give greater consideration to costs in determining what investments to recommend, the rule should incorporate an explicit requirement to consider costs in the rule text.

In addition to clarifying the definition of best interest in the actual text of the rule, the Commission must make changes to the rule Release to clarify and strengthen its interpretation of the best interest standard. First, if the Commission is serious about wanting to raise the standard, it must delete footnote 7 and scrub the Release of similar statements suggesting that Reg BI is intended to codify, rather than enhance, the existing FINRA suitability standard. Second, the Commission must support its best interest definition with concrete examples of practices that are required under Reg BI that are not required under FINRA suitability as well as practices that are prohibited under Reg BI that are not prohibited under FINRA suitability. For example, if the intent of the Care Obligation is to impose a diligence requirement that goes beyond the existing due diligence requirement under FINRA rules, the Commission must provide clear guidance on what kind of information collection and analysis would be required to satisfy the Reg BI Care Obligation that is not required to satisfy FINRA's know your customer and suitability rules.

In order to make clear that the standard is not just procedural in nature, however, the Commission must also clarify how it would interpret the obligation to make recommendations in the best interest of the client. Currently, the Release makes clear that brokers are not expected to identify the single "best" option for the investor, but it is considerably less clear on what they *are* required to do. To rectify this problem, the Release must clearly state that, while it may often not be possible to identify a single "best" investment, the pool of investments that satisfy a best interest standard in a particular situation should be significantly narrowed beyond the large number of investments that would typically satisfy the suitability standard. Moreover, the Release should make clear that the analysis to identify the best available options would have to be based on the full range of the investments' material characteristics, including but not limited to costs, liquidity, and risks, as well as the investor's circumstances and needs. Finally, if one goal of the proposed regulation is to require brokers to give greater weight to cost in determining what to recommend, the Release must make clear that the obligation to consider costs applies broadly, when considering different investments and investment strategies to achieve a particular investment goal, and not just when comparing otherwise identical securities. While such an approach would not require brokers to always recommend the lowest cost option available, it would require that, before recommending a higher cost option, the broker would have to have a reasonable basis for doing so based on the investor's best interests.

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<sup>3</sup> The approach outlined in the [SEC Investor Advisory Committee's recommendation on Regulation Best Interest](#) offers a good model for how this could be achieved.

**Hypothetical Example 1:** A broker determines that a portion of a client’s assets should be invested in a large cap mutual fund. She can satisfy her obligation under FINRA suitability by recommending any of the large cap funds that the firm has available to sell, as long as she recommends the lowest cost share class of that particular fund. Under a true best interest standard, that same broker would be required to compare the firm’s available large cap mutual funds – considering such factors as cost, past performance, risk, and volatility – in order to identify which of the many suitable funds represent the best available option for the investor. In this case, the obligation to consider costs wouldn’t just apply in determining which share class to recommend, but would also apply to the decision regarding which particular fund to recommend.

**Hypothetical Example 2:** A client comes to a broker seeking investments to provide a steady stream of income in retirement. The broker can satisfy his obligations under FINRA suitability by recommending any of a variety of investments designed to provide income. He could, for example, recommend a variable annuity, and as long as he recommended the lowest cost share class of that annuity to the investor, he wouldn’t need to compare its costs (including surrender charges), liquidity, risks, and other material characteristics to other available annuities, let alone to other income-producing strategies. Under a true best interest standard, the broker would need to consider the costs and risks and other material characteristics of the various available strategies for producing income in order to determine which strategy is best for the investor. For example, in order to have a reasonable basis for his recommendation, he might have to weigh the costs and benefits not just of the various annuities he has available to sell, but also of a strategy based on a laddered bond portfolio or of an investment strategy that relies on a portfolio of ETFs or mutual funds to provide the potential for long-term growth and a fixed annuity to provide guaranteed income.<sup>4</sup> In this case, the broker would need to weigh the costs, risks, and advantages not just of available investment products, but of available investment strategies to achieve the customer’s goals.

As we discussed in our meeting, applying a best interest standard to brokers whose business model is based on a very limited menu of investment options poses particular challenges. However, we believe it is possible for the Commission to adopt an approach that improves protections for investors without placing the Commission in the position of dictating or banning particular product menus. Specifically, to ensure that its best interest standard can’t be satisfied by recommending the least bad of a limited list of substandard investments, the Commission must make clear in the Release that it will hold firms accountable for developing a product menu that complies with the first prong of the proposed best interest standard, which requires that the recommended investments must be in the best interest of at least some investors. Under such an approach, firms would need to periodically assess their product offerings against other products available in the marketplace in order to ensure that their offerings are competitive. Moreover, the Commission must clarify that, as part of their Care Obligation, brokers will be required to consider a diverse product mix and make sure that their recommendations represent a good faith selection from that mix that best serves the investor’s needs. Adopting this approach would create an incentive for product sponsors to improve their product offerings and for firms

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<sup>4</sup> This example assumes the broker is also licensed to sell insurance annuities, as is often the case.

to improve their product menus, which has the potential to greatly increase investor benefits from the rule, without putting the Commission in the position of dictating specific outcomes.

If the Commission is not prepared to make the above-outlined changes to its proposed standard, it should stop calling the standard a best interest standard. Continuing the use of the best interest label without strengthening the standard as outlined above is sure to mislead investors into expecting protections the rule does not provide.

**2. Revise Reg BI to prevent brokers from placing their own interests ahead of customer's interests and to prevent firms from creating harmful conflicts that would undermine compliance with the best interest standard.**

Investors don't expect financial professionals to be entirely free from conflicts of interest, but they do reasonably expect that the financial professionals they rely on for investment advice will put their interests first. That is, after all, the essential difference between advice and a mere sales recommendation. Adopting a standard that explicitly states that brokers are prohibited from placing their own interests ahead of the customer's interests reinforces that reasonable expectation. However, without changes to both the rule text and the accompanying guidance in the rule Release, Reg BI will fail to meet investors' reasonable expectation in this regard and continue to leave them vulnerable to advice that is tainted by harmful and avoidable conflicts of interest.

The proposed rule doesn't live up to its promise to prevent brokers from putting their interests ahead of customers' interests for at least two reasons:

- The rule, as drafted, is fully satisfied through compliance with three operational provisions, which effectively form a compliance safe harbor. A requirement to put the customer's interests first is not included in that safe harbor.
- The obligation to mitigate conflicts, which has the potential to give meaning to this obligation, is too vague to do so. And the discussion of this mitigation requirement in the rule Release doesn't provide the necessary clarity.

As with the best interest standard itself, these fundamental weaknesses in provisions of the rule designed to address conflicts of interest can be addressed through a combination of changes to the rule text and revisions to the supporting guidance, working within the Commission's chosen regulatory approach. Nothing in our proposed changes would impede the ability of brokers to charge transaction-based payments for their services. On the contrary, these regulatory fixes would make transaction-based services a far more attractive option for investors than is currently the case.

The following changes, which can be achieved without threatening investor access to transaction-based advice, are essential to prevent conflicts of interest from tainting brokers' investment recommendations.

- First, a requirement to place the customer's interests ahead of the brokers' interests must be included in the operational provisions of Reg BI. This could be accomplished by requiring that policies and procedures to mitigate conflicts of interest be reasonably designed to ensure that the broker-dealer and its associated persons at all times place the customer's interests ahead of the brokers' interests.

- Second, the Commission must provide supporting language in the rule Release that makes clear that the broker's obligation to place the customer's interests first applies broadly, whenever the broker is considering which investments, investment strategies, accounts, or services to recommend.
- Third, the Commission must provide greater clarity regarding how the obligation to eliminate or mitigate conflicts would apply to different types of conflicts. In particular, it must make clear that conflicts cannot be addressed through disclosure alone and that firms would be prohibited from artificially creating harmful incentives that undermine compliance with the best interest standard.

For this approach to work, the obligation to mitigate conflicts would need to apply to all material conflicts of interest, not just those arising from financial incentives. While we appreciate that the Commission has broadly defined the category of conflicts that would have to be eliminated or mitigated under Reg BI, failure to include all material conflicts under the mitigation requirement would suggest that there are certain types of conflicts where brokers would be free to place their interests ahead of customers' interests and where conflicts could be addressed through disclosure alone. That would undermine the stated intention behind the rule of requiring brokers to place their customers' interests first at all times when providing investment advice.

As we mentioned in our meeting, CFA has developed a framework for addressing conflicts of interest that could apply equally to conflicts present in the broker-dealer and investment adviser business model. (A copy of that framework is included at the end of this letter.) Under CFA's suggested approach, firms would be required to adopt conflict mitigation practices that are tailored to the nature and scope of conflicts of interest present in their particular business. Conflicts that are more likely to result in serious investor harm would be subject to more stringent mitigation requirements.

Under this approach, firms would be prohibited from adopting certain incentives that encourage advice based on the financial interests of the firm rather than the best interests of the customer. That includes such practices as:

- imposing sales quotas for the sale of proprietary products or basing bonuses on the volume of proprietary product sales;
- paying reps more to sell investments that make revenue sharing payments than they pay for the sale of comparable investments that do not make revenue sharing payments;
- adopting retroactive ratcheted payout grids that dramatically increase conflicts as the rep approaches the next rung on the grid;
- providing certain types of signing bonuses that impose severe penalties on reps who fail to meet production targets; and
- providing financial bonuses to encourage reps to steer customers toward the type of account that is most profitable for the firm, rather than the type of account that is best for the investor.

This is intended as a representative, rather than exhaustive, list of the types of harmful incentives that firms ought to be banned from creating. In each case, the conflict of interest created is both potentially harmful and entirely within the control of the firm and, thus, easily avoidable.

Adopting a framework for addressing conflicts along the lines advocated by CFA in its proposed framework would meet the Commission's goal of preserving investor access to transaction-based advice, minimize the risk that misaligned incentives present in both brokerage and advisory business models would result in investor harm, and create an incentive for brokers and investment advisers alike to adopt investor-friendly practices. We encourage the Commission to adopt this framework as part of its guidance for compliance with both Regulation Best Interest and the IA Guidance.

### **3. Reg BI must not undermine protections investors currently receive with regard to ongoing account monitoring under state common law fiduciary standards.**

While some investors may be equipped to make their own investment decisions, many turn to brokers for advice because they themselves lack the expertise to develop an investment strategy or determine whether a particular investment is in their best interests. In choosing an investment professional, they rely on advertisements and marketing claims that portray brokers as trusted advisers committed to acting in their customers' best interests.<sup>5</sup> They reasonably expect brokers to live up to the claims they make and the expectations they create when describing and marketing their services. So, when brokers describe their customer relationships as long-term relationships of trust and confidence, investors reasonably expect that the broker will be looking out for their interests, not just when recommending a particular transaction, but also between transactions. They assume, for example, that the advice to buy a particular security will be coupled with advice to sell that security at the appropriate time. Reg BI fails to meet these reasonable expectations. Worse, it actually weakens protections investors may currently receive under state common law.

State common law recognizes that brokers have a fiduciary duty to their customers under certain circumstances, including where the broker has de facto control over an account. This includes circumstances in which the investor routinely approves the broker's recommendations because the investor lacks the experience or sophistication necessary to exercise her own judgment. Given the generally low levels of financial literacy and the high degree of dependence investors place on their brokers, we believe the circumstances that give rise to a common law fiduciary duty, including a duty to monitor the account, are far more common than the Commission recognizes in this proposal.

In such cases, courts have held that the broker has a duty to manage the account in a manner directly comporting with the needs and objectives of the customer, to keep informed regarding changes in the market which affect the client's interests, and to *act responsively to protect those interests*, among other things. In contrast, the Commission proposes in Reg BI to arbitrarily limit a broker's duty to the customer to the point of transaction, regardless of the nature of the relationship and the extent of customer reliance on the broker's advice. Customers of dual registrant firms who have both brokerage and advisory accounts will be responsible for

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<sup>5</sup> Micah Hauptman and Barbara Roper, Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways, CFA and AFR, January 18, 2017, <https://bit.ly/2vgQtdY>; Joseph C. Pieffer and Christine Lazaro, Major Investor Losses due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty; Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard, Mar. 25, 2015, <https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf> .

remembering which accounts their financial advisor is responsible for monitoring, and for which accounts the customer bears that responsibility. The Commission proposes to rely on unproven disclosures to inform investors of these important differences, with no evidence to point to indicating the disclosures are likely to be effective.

Once Reg BI is adopted, courts and arbitration panels are likely to look at the rule, rather than state common law, to determine what duties a customer is owed in circumstances where the broker exercises significant control over the account. And firms are certain to point to the rule's explicit lack of any ongoing duty in disputing customer claims arising out of neglect. As a result, claims that are successful today, resulting in recoveries for harmed investors, are likely to fail if Reg BI is adopted as drafted.

Here again, this is a fixable problem, if the Commission has the will to fix it. Specifically, in order to avoid weakening the protections investors receive when they rely on brokers for investment advice, the Commission must take the following actions.

- Eliminate the provision in Reg BI that arbitrarily limits the broker's obligation to the customer to the point of transaction.
- In its place, adopt a principles-based obligation to monitor the account, where the nature and extent of the monitoring follows the contours of the relationship.

Under such an approach, whether the broker has an ongoing duty to monitor the customer account, and the nature and extent of that duty, would be appropriately tailored to match the nature of the relationship and the customer's reasonable expectations.

**Hypothetical Example 3:** A broker makes a one-time sales recommendation to a customer which is clearly recognized as such by the customer. Under both Reg BI and a true best interest standard, the broker would have no ongoing duty to monitor the customer account. In such circumstances, however, the broker would have a duty not to recommend investments or investment strategies that he knows the customer cannot independently monitor based on his understanding of the customer's investment experience and financial expertise.

**Hypothetical Example 4:** A broker works with a customer over many years, making periodic recommendations that are consistent with the customer's stated investment goals. The investor, who is not financially sophisticated, follows all of the broker's recommendations, trusting the broker's expertise and that he will act in her best interests. Under many states' common law standards, this broker would be held to a fiduciary standard, which would require the broker to manage the account in a manner directly comporting with the needs and objectives of the customer, to keep informed regarding changes in the market which affect the client's interests, and to act responsively to protect those interests, among other things. Under Reg BI, the broker has fully satisfied his obligations to the client in the context of individual transactions, and has no on-going duty to monitor the account between transactions. Under a true best interest standard, the broker would be required to review the client account at least once a year to ensure that the investments in that account continue to serve the client's best interests in light of her changing circumstances and changes in the market. If, for example, the client's asset



allocation needs to be adjusted, either because market returns have rendered it out of balance or because the client is approaching retirement and needs a more conservative allocation, the broker would have a duty to inform the client of that fact and recommend appropriate changes.

**Hypothetical Example 5:** A broker has a long-term, closer than arm's length relationship with a customer. The broker has recommended an investment strategy that is sensitive to market fluctuations. The market experiences a sudden downturn, slashing the value of a customer's investments. Under Reg BI, the broker has no obligation to notify the investor or recommend adjustments to the account in response to those events, because the broker's obligations ended when the recommendations were made. Under many states' common law standards, the broker is a fiduciary and has an obligation to act responsibly to protect the customer's interests. A true best interest standard would mirror the state common law standard.

One reason this issue arises is because of changes to the broker-dealer business model over the last several decades that have blurred the line between brokerage services and advisory services. We have on many occasions urged the Commission to address that problem by clarifying the broker-dealer exclusion from the Advisers Act. In 2005, for example, CFA wrote to the Commission suggesting a pro-investor definition of broker's "solely incidental to" exclusion from the Advisers Act, founded on the legislative history of the Act.<sup>6</sup> While we continue to believe this is the appropriate interpretation of the Advisers Act, adopting our proposed approach would cause a broad range of services routinely offered by brokers today to be captured under the Advisers Act, something you have indicated you do not wish to do. Moreover, unless the Commission strengthens its interpretation of the Advisers Act fiduciary duty, which you have repeatedly insisted is not an option, narrowing the Advisers Act exemption would have the unintended effect of more widely applying the Commission's weak, disclosure-based approach to enforcing the Advisers Act "fiduciary duty" to the conflict-ridden broker-dealer business model, to the detriment of investors.

At the same time, the Commission should *not* adopt an inaccurate and inappropriate definition of "solely incidental to" in order to achieve its regulatory goals. For example, it should not make ongoing monitoring the basis for regulatory status as an investment adviser, as some have suggested. Such an approach could discourage brokers from adopting responsible monitoring practices out of concern that doing so might trigger an unwanted change in their regulatory status. It would also make a brokerage account an unattractive option for the millions of investors who lack financial sophistication and want a long-term relationship with an investment professional. If that were to occur, firms might find it necessary to convert more customer accounts to advisory accounts in order to provide the ongoing monitoring necessary to serve the customer's best interests and make the accounts attractive to their clientele.

Instead, we urge the Commission to adopt the less disruptive approach we have outlined above, by adopting a principles-based ongoing duty that follows the contours of the customer relationship. Such an approach would meet investors' reasonable expectations based on how

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<sup>6</sup> Letter from Roper to SEC Secretary Jonathan G. Katz, Certain Broker-Dealers Deemed Not To Be Investment Advisers, CFA, February 7, 2005, <https://bit.ly/2ISPTer>, at 8-11.

brokers market and describe their services and preserve brokers' ability to offer transaction-based services on terms that are beneficial to investors.

#### **4. Reg BI must clearly cover important account-opening recommendations.**

Some of the most important decisions investors make, in terms of the impact on their long-term financial well-being, are made either before or at the time an account is being opened. That includes decisions about whether to roll over a retirement account, whether to take a lump sum pension distribution in order to invest the proceeds, whether to transfer assets from one firm to another, and what type of account to open. Because of the way Reg BI is written, it isn't clear whether or how the best interest standard would apply to these types of recommendations. And because the standards for brokerage and advisory accounts differ, it is particularly unclear what standard would apply to these types of recommendations at dual registrant firms.

We believe the Commission should clarify the rule's application to such recommendations. Specifically, the Commission should make clear that any such recommendations must be in the best interests of the potential customer, based on a careful review of the customer's situation. Firms should be required to adopt and enforce policies and procedures that are reasonably designed to ensure that these recommendations are not influenced by conflicts of interest. Under such an approach, firms should be prohibited from creating incentives that are designed to encourage account-opening recommendations based on the interests of the firm rather than on the best interests of the customer.

**Hypothetical Example 6:** An investor approaches a dual registrant firm about opening an investment account. The financial advisor, who receives a financial bonus for steering customers to fee accounts, recommends a fee account, despite the fact that the investor indicates she is a buy and hold investor who expects to do little trading in the account. It is unclear whether or how Reg BI would apply to that recommendation. The Commission should make it explicit as part of this regulatory package that the recommendation of account type must be in the best interests of the investor. Moreover, it should make clear that, as part of their obligation to mitigate or eliminate conflicts of interest, firms are prohibited from creating incentives, such as paying reps a bonus when they recommend the type of account that would be most profitable for the firm, that would undermine compliance with that standard.

**Hypothetical Example 7:** A broker recommends that a potential customer roll over his 401(k) plan and invest the proceeds in a brokerage IRA at the firm. The broker would clearly have to comply with Reg BI when recommending how to invest the proceeds of the rollover, but it is not clear that Reg BI would also cover the recommendation of *whether* to conduct the rollover. The Commission should make clear that brokers would be required to comply with Reg BI (and investment advisers would be required to comply with their fiduciary duty) when determining whether a rollover is in the best interests of the customer and would be prohibited from recommending a rollover when that is not in the customer's best interests. For example, where the investor is moving from a 401(k) with a poor selection of high-cost investment options, the rollover would likely be in the investor's best interests. However, where the investor's money is in a top notch 401(k)

with an excellent selection of high-quality, low-cost options, the broker would have a tougher case to make that the transfer is beneficial for the investor.

**Hypothetical Example 8:** A broker recommends that an investor take early retirement, cash out of their pension fund, and invest the proceeds with the broker. Here again, Reg BI would clearly apply to recommendations regarding how to invest the money once the decision to cash out is made, but it is not clear whether the recommendation to take early retirement and cash out the pension fund would also be covered. This can be vitally important to the investor's long-term financial well-being, particularly for participants in certain union pension funds who lose their health insurance coverage if they leave the pension. The Commission should make clear that the all-important initial recommendation of whether to take the cash-out would be covered by the best interest standard for brokers (and the fiduciary duty for investment advisers).

**Hypothetical Example 9:** A dually-registered financial advisor recommends that a new client open both a brokerage account and an advisory account. The financial advisor recommends that municipal bonds be purchased in the advisory account, and structured products be purchased in the brokerage account. The securities recommended are appropriate for the customer, but the financial advisor has placed the securities in different account types based on the compensation the firm would receive from each account. It is not clear whether the financial advisor's recommendation to separate assets between a brokerage and an advisory account in a manner in which it will be more profitable for the firm, will be prohibited under Reg BI. The Commission should make that clear.

**Hypothetical Example 10:** A broker that is changing firms recommends that a customer follow him to his new firm, a move that will require her to cash out her investments, potentially triggering certain penalties, such as surrender fees, as well as capital gains taxes. Here again, it is not clear whether Reg BI would apply to this recommendation. The Commission should clarify that such recommendations that occur prior to account opening are nonetheless required to be in the best interests of the customer.

Because the decisions investors make when opening an account may have an even greater impact on their long-term financial well-being than subsequent recommendations regarding how to invest their money, we urge the Commission to make crystal clear that these types of recommendations would be required to be in the investor's best interests and that firms would have to have policies and procedures in place to support compliance with that standard.

## **5. The Investment Advisers Act Guidance must be revised to better protect clients from the harmful impact of conflicted advice.**

One of the most troubling aspects of this regulatory package is the huge gap between how the Commission characterizes the Investment Advisers Act fiduciary duty and how, as a practical matter, it interprets and enforces that standard. On the one hand, the Commission states that investment advisers, as fiduciaries, are required to avoid conflicts, must always act in clients' best interests, and must never subordinate clients' interests to their own. It goes on to state that this duty cannot be disclosed or negotiated away. That is entirely consistent with investors'

reasonable expectations regarding the standard that investment advisers should be held to, as well as the legislative history of the Investment Advisers Act.<sup>7</sup> Unfortunately, the interpretation of that standard in the proposed Guidance directly contradicts every one of those statements.

Specifically, the proposed Guidance regarding investment advisers' fiduciary obligations makes clear that, in practice:

- Investment advisers aren't required to avoid conflicts or even to manage them to the benefit of the client. They must simply disclose them to be deemed by the Commission to be in compliance with their fiduciary obligations.
- Investment advisers are free to place their own interests ahead of their clients' interests and recommend the investments that pay them more, rather than those that are best for their clients, as long as they disclose that practice.

One problem is that the characterization of the Advisers Act fiduciary duty is grossly misleading; if all the Commission is prepared to do is require disclosure, it shouldn't pretend otherwise. The more pressing problem is that this approach is entirely inadequate to address harmful practices that result from an increasingly conflicted advisory business model.

The Commission's disclosure-only approach may have been adequate a few decades ago, when investment advisers were typically paid exclusively by the client and therefore didn't have a lot of complex incentives to make recommendations that weren't in their clients' best interests. Where the adviser is paid a percentage of assets under management, for example, the adviser has an incentive to gather assets, and to avoid recommending investments that would deplete those assets under management. But that's the kind of conflict that can readily be addressed through disclosure plus some basic policies and procedures to protect against reverse churning and inappropriate asset transfers. In recent years, however, that business model has completely changed with the growing dominance of dual registrant firms. These firms typically bring many of the same complex conflicts associated with brokerage accounts into their advisory accounts. That includes: favoring recommendations of investments that make revenue sharing payments; favoring recommendations of proprietary products even when better options are available; offering financial incentives to steer clients toward the account type that is most profitable for the firm rather than the account that is best for the customer; and more.

As a result of the enormous gap between how the Commission describes the Advisers Act fiduciary duty in theory, and the reality on the ground, investors are being misled into expecting protections that they badly need when dealing with conflicted advisers, but that the Commission's enforcement of the standard does not provide. This is not an easy problem to solve under the Commission's chosen regulatory approach.<sup>8</sup> Despite the challenges, there are

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<sup>7</sup> See SEC, Investment Trusts and Investment Companies: Report of the Securities and Exchange Commission Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, 28 (1939) (Representatives of investment counselors recognized that their function was the "furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments" and they could not do this "unless all conflicts of interest between the investment counsel and the client were removed.").

<sup>8</sup> Had the Commission relied on its rulemaking authority under Section 913(g) of the Dodd-Frank Act, it could have adopted an explicit requirement for investment advisers to act in the best interests of their clients, without regard to the financial interests of the firm or the individual adviser. This would have strengthened the Commission's hand in bringing enforcement actions against investment advisers who place their own interests ahead of client interests.

steps the Commission could take that, while far from a complete solution, would at least help to narrow the gap between theory and reality and, in so doing, impose a standard for investment advisers that comes somewhat closer to meeting investors' reasonable expectations.

First, the Commission must do more to ensure that investors' consent to investment advisers' conflicts of interest is truly informed. The current approach of burying conflict disclosures in a lengthy, legalistic ADV form clearly doesn't result in informed consent. We understand the Commission is placing its hopes in the CRS disclosures to resolve that problem, but the testing of the CRS makes clear that most investors did not understand either the nature or potential harmful impact of common conflicts, even after a careful review of the proposed disclosures. And it is difficult to see how firms that may fill multiple pages of an ADV form with a description of their conflicts will be able to provide meaningful disclosure of those conflicts in a CRS that is limited to four pages to cover all of the required content.

To address this problem, the Commission must require much more prominent disclosure, not only of the existence of conflicts of interest, but of their potentially harmful impact. It should test those disclosures to ensure their effectiveness. While we remain very skeptical that disclosure can offer a solution to the problem of conflicted advice, the hope is that, if advisers were required to provide the kind of stark disclosures needed to obtain truly informed consent, they would be less likely to engage in practices that are harmful to the investor.

Second, the Commission must recognize that there is an important difference between consenting to the existence of conflicts of interest and consenting to be harmed as a result of those conflicts. Simply put, reasonable investors do not consent to be harmed. Where conflicts result in advisers' placing their own interests ahead of their clients' interests – for example, by recommending the investments that pay them the most when they have options available that would be better for the client – this should be taken as prima facie evidence that the consent was not informed, and the Commission should respond accordingly. Finally, the Commission should give meaning to the requirement for investment advisers to avoid conflicts by prohibiting advisory firms from artificially creating incentives that encourage recommendations based on the financial interests of the adviser and the firm, rather than on the client's best interests. The framework for addressing conflicts of interest that accompanies this letter provides additional details on how this could be accomplished.

**Hypothetical Example 11:** An investor opens an advisory account at a dual registrant firm that includes proprietary funds on its large menu of fund offerings. Under the IA Guidance, as long as they disclose their practices, the firm would be free to impose quotas for recommendations of proprietary funds or pay advisers more when they recommend the funds, and the individual adviser would be free to recommend those proprietary funds even when other options are available with lower costs, better performance, and lower risks that clearly make them a better option for the investor. Under a true fiduciary standard that is consistent with the Commission's characterization (but not its enforcement) of the Advisers Act standard, the individual adviser would be required to recommend the investments he reasonably believes are best for the client, and firms would be prohibited from creating incentives that encourage recommendations based on the firm's financial interest rather than the investor's best interests. At the very

least, in order to ensure that consent to the conflicts of interest is informed, the adviser must be required to prominently disclose, orally and in writing, that he is recommending higher cost, lower quality proprietary funds when the firm has better options available, that he is making that recommendation because he has a quota he needs to fill, and that the investor can expect to lose out on \$X thousands in investment returns over the lifetime of the investment as a result.

If the Commission would take these limited steps, which are well within its authority and achievable within its chosen regulatory approach, it might help to rein in some of the most harmful practices among conflicted advisory firms and thus help to narrow the gap between theory and reality with regard to the Advisers Act fiduciary duty. While far from perfect, it would be a modest improvement over the Commission's deeply flawed proposed approach.

#### **6. Form CRS needs to be revised and retested to ensure that it supports an informed choice between a brokerage account and an advisory account.**

You have identified as one of your key goals for this regulatory package preserving investor choice with regard to the type of financial adviser they hire, the scope of services they receive, and how they pay for those services. But for that choice to be meaningful, investors need to understand what they are choosing between and how that choice might affect them. This regulatory package relies on the Customer Relationship Summary (CRS) to provide investors with the key information they need to make an informed choice between a brokerage account and an advisory account. The problem is that the CRS, as proposed, doesn't clearly convey the information necessary to support an informed choice. It will require extensive revisions and retesting to arrive at an approach that works.

The testing of CRS that has so far been conducted, both the qualitative interviews conducted by RAND and the separate testing conducted by AARP and others, shows that investors who review the CRS more carefully than is likely to occur in real world circumstances still don't understand:

- key differences in the services offered by brokers and advisers;
- the differences in the legal standards that apply to those services;
- how much they are likely to pay; or
- the nature or potential harmful impact of conflicts of interest.

If investors don't understand those basic differences, they can't determine which type of account or relationship would be best for them or otherwise make an informed choice.

We've seen reports that the Commission expects to extensively revise the CRS before finalizing its regulatory package. But, even if these reports are true, unless the Commission retests the revised disclosure, it won't have any way to know whether the revised version solves the problems that earlier testing has identified. When AARP engaged in a second round of testing of the CRS, for example, they found that the changes they made resulted in some improvements in investor comprehension, but didn't fully resolve other areas of confusion. Clearly conveying information about the legal standard and conflicts of interest proved especially challenging. The Commission has given disclosure too prominent a role in its

proposed regulatory approach to rely on wishful thinking, rather than rigorous testing, to determine whether its proposed regulatory approach is likely to be successful.

We have also heard reports that the Commission is likely to give firms greater “flexibility” in implementing the required disclosure. If true, this has the potential to leave investors with the worst of both worlds – a disclosure that fails to clearly convey important information (especially information on conflicts that firms prefer to obscure) that isn’t even comparable from firm to firm. We would strongly oppose such an approach.

Given the important role that the CRS plays in the Commission’s proposed regulatory approach, and the extensive changes needed to ensure the CRS serves its intended purpose, it would be irresponsible for the Commission to finalize a revised CRS without going through that revision and retesting process and making the results of that testing available for public comment.

## **Conclusion**

You have outlined an appropriate goal for Commission rulemaking in this area – to develop a standard that meets investors’ reasonable expectations while preserving investor choice. Unfortunately, your proposed regulatory package fails to achieve that goal. In attempting to understand why, one reason appears to be a reluctance on the part of Commission officials to acknowledge the degree to which the current market for investment advice does not work well for typical, financially unsophisticated investors. Another is the Commission’s apparent reluctance to disrupt even harmful aspects of the broker-dealer business model. The market in its current form is pervaded and driven by conflicts of interest that cause severe harm to investors, costing everyday Americans billions of dollars a year that they need for a secure future. A rule to protect investors needs to be built on a clear recognition of this serious problem and include sufficient specific steps to address it. We urge you to acknowledge, before it is too late, that significant improvements and clarifications are needed for the proposed regulatory package to meet the standard that you have set for it. We believe the changes outlined above are the minimum needed to meet that standard. We stand ready to work with the Commission to achieve that goal.

Respectfully submitted,

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## Consumer Federation of America

### **A Framework for Addressing Broker-Dealer and Investment Adviser Conflicts of Interest When Providing Retail Investment Advice**

Conflicts of interest are present in both the broker-dealer and investment adviser business models. Some conflicts are inherent to each business model, the natural outgrowth of commission- and fee-based compensation structures. Other conflicts result from the investment products brokers and advisers recommend and the various payments product sponsors make to encourage their sale. Still other conflicts are artificially created by firms to encourage financial professionals to recommend the products and services that are most profitable for the firm. All have the potential to inappropriately influence recommendations, to the detriment of investors, but the nature and severity of those conflicts varies greatly. How the Commission addresses conflicts of interest will largely determine whether investors benefit from the proposed Regulation Best Interest as well as the Commission's accompanying interpretation of the Investment Advisers Act fiduciary duty.

The good news is that there is a workable framework for addressing conflicts of interest that can be adapted to both brokerage and advisory business models. Under this approach, firms would be required to adopt conflict mitigation practices that are tailored to the nature and scope of conflicts of interest present in their particular business. Conflicts that are more likely to result in serious investor harm would be subject to more stringent mitigation requirements. This framework for addressing conflicts would preserve the ability of brokers to receive transaction-based compensation, minimize the risk that misaligned incentives present in both brokerage and advisory business models would result in investor harm, and create an incentive for brokers and investment advisers alike to adopt consumer-friendly practices.

#### **I. Conflicts that are inherent to the business model**

##### **A. Explanation of the problem**

Conflicts of interest are inherent to both the broker-dealer and investment adviser business models. Brokers and advisers alike have an interest in maximizing their compensation, creating incentives that may not always align with investors' interests.

- **Commission compensation creates an incentive to maximize transactions.** In the brokerage model, the firm and financial professional get paid only if a recommendation results in the completion of a transaction. Therefore, a broker-dealer has an incentive to recommend that an investor complete a transaction, regardless of whether doing so is in the best interest of the customer. This incentive can result in recommendations to roll over a 401(k) to the firm, even when that results in increased costs to the investor, or to churn an account in order to increase the number of transactions, for example.

- **AUM fees create an incentive to gather assets.** Investment advisers who charge a fee based on assets under management get paid only if they are managing a client's money. The more of the client's money they manage, the more they get paid. As with brokers, this incentive can result in recommendations to roll over a 401(k) to the firm, regardless of the benefits to the client. It can also cause advisers to avoid financial recommendations, such as paying off debts or investing in real estate, that would reduce assets under management. Because an adviser compensated through AUM fees gets paid the same amount regardless of the level of service provided, that adviser also has an incentive to do the least amount of work necessary to maintain the account (a practice known as reverse churning).
- **Other payment methods also create conflicts.** While AUM fees represent the most common compensation method among investment advisers, some advisers charge hourly fees while others charge engagement or monthly fees. Each comes with its own set of conflicts. When the client pays by the hour, for example, the adviser has an incentive to maximize the time it takes to complete the job. The opposite is true when the adviser is paid by the engagement, and the incentives associated with monthly fees resemble the incentives under AUM fees to engage in reverse churning.
- **Dual registrants have an additional layer of conflicts.** Firms that offer both brokerage and advisory accounts, or different accounts with different payment models, have an incentive to recommend the type of account that is most profitable for the firm, rather than the type of account that is best for the investor.

Conflicts of interest that are inherent to the business model are typically fairly simple and straightforward. They boil down to the fact that the firms and financial professionals have an incentive to maximize compensation, whatever their compensation structure, that may not always result in recommendations that are in investors' best interests.

#### B. Framework to appropriately address this problem

Addressing conflicts that are inherent to the business model starts with disclosure and informed consent. The disclosure must be sufficient to ensure that the investor understands the nature of the conflicts of interest associated with the particular business model and how the recommendations they receive could be affected, since without such understanding consent cannot truly be "informed." It is critically important to recognize, however, that when investors consent to the existence of conflicts, they do not consent to be harmed as a result of those conflicts. Firms and financial professionals must still have an obligation to provide advice that is in the investor's best interest, even after the conflicts have been disclosed and consented to.

To ensure that conflicts of interest that are inherent to the business model do not taint the advice they offer, firms must adopt strong policies and procedures tailored to the conflicts specific to their business model. So, for example, broker-dealers must have policies and procedures in place to ensure that their reps do not engage in excessive and unnecessary transactions. Advisers who charge AUM fees must have policies and procedures in place to ensure they do not neglect the account. To achieve this, firms must have surveillance mechanisms to identify and curtail recommendations that are the natural result of the business model's conflicts and that are not in the investor's best interest. At dual registrant firms, this should include supervisory procedures designed to ensure that their financial professionals

recommend the type of account that is best for the investor, rather than the type of account that is most profitable for the firm.

All three types of firms must have policies and procedures in place to ensure that rollover and asset transfer recommendations are in the best interests of the customer, and not just the firm. Under such an approach, firms must require rigorous analysis and documentation showing why their advice or recommendation is in the investor's best interest. For example, to ensure that any recommendation to roll over a workplace retirement account into an IRA is in the investor's best interest, a firm's policies and procedures must require that the professional undertake a rigorous analysis comparing the customer's current account with reasonably available options at the firm. This analysis would include a comparison of the relative costs, available investments, and different level of services, for example, in order to make an ultimate assessment of the value of the recommended transaction. Further, the firm's policies and procedures must require that the financial professional document this analysis so that the firm's compliance department and regulators can review whether the recommendation was in the investor's best interest and confirm that it was not inappropriately influenced by the desire to charge a commission or capture assets.

Firms that prepared to implement the Department of Labor fiduciary rule before it was over-turned in court should already have designed compliance programs that meet this standard. Moreover, numerous technological tools were brought to market in response to that rule to support such a requirement. In some cases, an objective analysis is going to demonstrate that a rollover is improper, and firms need to be prepared to refrain from recommending a rollover in such instances. For example, few firms can compete with the low costs available to participants in the Thrift Savings Plan (TSP) and thus would find it difficult to justify a rollover that could easily increase the investor's annual costs by 30 to 40 times for similar products. In other instances, the firm will be able to document the benefits to the investor of a rollover, particularly when the firm has an attractive suite of retirement account options or the 401(k) plan in question is a substandard plan. This approach has the added benefit of creating an incentive for firms to compete based on the cost and quality of their products and services, which in turn has the potential to deliver significant benefits to investors.

## **II. Investment product-related conflicts**

### **A. Explanation of the problem**

Conflicts of interest can also arise as a result of payments investment products make, and practices product manufacturers engage in, to encourage firms and financial professionals to recommend their products rather than those of their competitors. Some of those conflicts, such as payments made to get on a firm's investment menu, may be present in advisory as well as brokerage accounts, particularly at dual registrant firms. Others are directly tied to transaction payments, and thus are associated exclusively with brokerage accounts. When financial professionals' pay and firms' profits vary significantly based on what investments they recommend, conflicts of interest are multiplied and magnified, and the policies and procedures firms adopt to address those conflicts must be adjusted accordingly.

These product-specific conflicts arise because of the stiff competition that exists among product manufacturers, who seek to encourage sales of their products over their competitors' by offering the most attractive compensation arrangement to the selling brokers. Such conflicts tend to be much more complex than the basic compensation-related conflicts discussed above, making them difficult for even financially sophisticated investors to understand or guard against. To illustrate, when a product manufacturer creates an investment product, the manufacturer decides whether to embed certain distribution-related costs in the product and how those costs should be structured. With a broker-sold mutual fund, for example, the mutual fund company decides both the amount of the sales load to be charged and how to structure that load; whether and how much to charge in 12b-1 fees; whether and how much to charge for recordkeeping through sub-transfer agency fees; whether and how much the fund's adviser should pay different broker-dealers in revenue sharing arrangements; and how much to pay to brokers in gross-dealer concessions for distributing their fund. It only gets more complicated from there. Different mutual fund companies adopt different distribution cost structures and varying levels of compensation paid to brokers who sell their products. And other investment products – such as annuities, structured products, and non-traded real estate investment trusts (REITs) and business development companies (BDCs) – have different cost structures from mutual funds, typically with even higher levels of compensation paid to broker-dealers who sell them.

The result is that brokers have a strong incentive to recommend the products that pay them the most, regardless of whether they are the best option for the investor. In practice, this means, for example, that a broker-dealer has an incentive to recommend a mutual fund that pays a higher share of the load rather than an available alternative that offers a lower payout, even if the alternative has a history of better performance or is otherwise a better match for the investor. Similarly, a broker-dealer has an incentive to recommend a variable annuity or structured product instead of a mutual fund, because those products pay so much more, even if a portfolio of mutual funds would achieve the same investment goal at lower cost and with greater liquidity and fewer risks.

Conflicts such as these are a major source of investor harm. Because costs associated with product-specific incentives are ultimately born either directly or indirectly by the investor, the products that are most lucrative for the broker are also typically those that are most expensive for the investor. Similarly, products that are hardest to sell, because they are less liquid or higher risk or suboptimal for other reasons, can overcome those disadvantages by offering higher compensation. As a result, these incentives can expose investors not just to higher costs, but also to higher risks or inferior performance. Because of the complexity of such conflicts, and the potential for investor harm, particularly rigorous policies and procedures are needed to reduce the likelihood that these incentives will taint recommendations.

#### B. Framework to appropriately address this problem

It should be patently obvious that conflicts of interest of this complexity cannot adequately be addressed through disclosure alone. Experience, and disclosure testing, tell us that most investors will never gain a sufficient understanding of such conflicts to give informed consent. And brokers who have strong incentives to act against their customers' interests are less likely to comply with a best interest standard. More rigorous policies and procedures are needed to ensure that these product-specific conflicts do not taint investment recommendations.

The good news here is that, while firms do not create these product-specific conflicts of interest, it is possible for them to eliminate or at least significantly reduce such conflicts. Some firms had begun that process in response to the DOL rule through the adoption of “clean shares” and other more product-neutral approaches to broker compensation. By removing all distribution-related costs from the products, clean shares in particular have the potential to eliminate incentives for broker-dealer reps to recommend funds based on their own financial interests rather than the investor’s best interest. (Though some clean shares appear to be “cleaner” than others.) Other approaches to levelizing compensation across products, and basing broker compensation on the nature and extent of services provided rather than on the products sold, have the potential to provide a similar benefit at the individual rep level, though firms may continue to face compensation-related conflicts.

- **Levelizing compensation for similar products can better align interests of brokers and investors.** Where investment products have similar features and serve similar functions, broker-dealer firms could reduce product-specific conflicts by taking steps to ensure that the compensation that flows to the individual rep does not depend on the product recommended. For example, a broker-dealer would ensure that there is no incentive for the rep to recommend one mutual fund over another by providing level compensation for all mutual fund recommendations. One option would be to apply a level commission to load-waived A shares, as LPL announced it planned to do with its Mutual Fund Only Platform, an approach that reduces conflict-related incentives at both the firm and individual rep level. Another option is for firms to continue to distribute products that offer variable compensation, but to offer level compensation at the individual rep level for all similar products. In such cases, the firm neutralizes the conflict at the rep level but retains the conflict at the firm level, as well as the differences in cost to the investor. This approach to levelizing compensation for similar investments would apply equally to recommendations of annuities, for example, or any other class of investments. If firms are required to design policies and procedures to mitigate conflicts that are reasonably designed to ensure that the customer’s interests come first, they may come up with additional approaches that achieve the same objective of minimizing product-specific conflicts.
- **Ensuring that variations in compensation are justified based on an objective analysis can help to reduce compensation-related conflicts of interest across different product lines.** While levelizing compensation for similar products can reduce incentives to recommend one mutual fund over another or one annuity over another based on compensation considerations, it doesn’t eliminate the incentive to recommend those classes of investment products (e.g., variable annuities, non-traded REITs, and structured products) that offer the most generous compensation. Brokers have argued that differences in compensation are warranted by differences in the time it takes to analyze the products and explain their features to investors. But it is unquestionably the case that the higher compensation provided by these products largely explains why they feature so prominently in stories of abusive sales practices. To counteract this problem, broker-dealer firms should take steps to ensure that any variations in the level of compensation for different types of investments that flow to the individual representative are justified based on an objective analysis, in writing.

- **To the extent firms do not eliminate compensation-related conflicts, recommendations of higher compensating products must be backed by rigorous analysis documenting the basis for concluding that such recommendations are in the customer’s best interest.** Firms that retain significant variations in compensation at the individual rep level will need to adopt particularly rigorous policies and procedures to ensure those conflicts don’t inappropriately influence recommendations. Where the rep recommends higher paying products, particularly when those products also impose additional costs on the investor, this must include written documentation of the basis on which the rep determined that a particular recommendation is in the customer’s best interest. The rep should have to explain, for example, how the particular product meets the investor’s goals and needs, why the imposition of any additional costs provides value to the investor, and why the same objective cannot be accomplished more efficiently through other reasonably available investment products or strategies. For example, if a broker-dealer recommends that an investor purchase a variable annuity or a non-traded REIT, the broker-dealer should be required to provide an objective analysis documenting the investor’s need for that particular type of investment and why it is a better option for the investor than other reasonably available investment products and strategies. If the rep can’t support the recommendation, including why any added costs are justified, he should not be permitted to make the recommendation. And the firm should adopt supervisory procedures to ensure compliance.

The benefits to investors of a more product-neutral approach to broker compensation are obvious. If investment products were forced to compete based on their own merits (cost and quality), rather than by compensating the broker, the best products would thrive, to investors’ benefit. And, in a commission account based on clean shares, for example, the costs of brokerage services would be transparent and subject to market forces. These factors have historically led to much lower costs for investors, which likely explains why firms have been so reluctant to adopt clean shares now that the DOL rule no longer provides them with an incentive to do so. But there are benefits to firms as well from approaches that reduce product-specific conflicts. Firms that adopt such approaches are likely to face fewer compliance headaches under a best interest standard if incentives for non-compliance are reduced or eliminated. And firms that minimize product-specific conflicts should find it easier to justify their recommendations and easier to defend against claims that their reps placed their own financial interests ahead of the customer’s best interests.

### **C. Conflicts that firms artificially create to drive specific conduct**

#### **A. Explanation of the problem**

Conflicts of interest also arise when firms themselves create incentives to encourage and reward very specific behavior that is profitable to the firm, but harmful to investors. These types of conflicts aren’t inherent to the broker-dealer or investment adviser business models, nor are they created by outside parties, as product-specific conflicts typically are. Rather, these conflicts arise when firms make a conscious decision to inject a variety of perverse incentives into a business model that, in all too many cases, is already rife with conflicts of interest in order to maximize their profits at customers’ expense.

Artificially created incentives include, but are certainly not limited to, contests, quotas, bonuses, trips, or other special awards that firms use to reward individual reps for meeting certain sales targets. Such incentives may be used, for example, to encourage financial professionals to sell proprietary products over non-proprietary products or, at dual registrant firms, to steer prospective clients to high-cost managed accounts when they would be better served by a brokerage account. Artificially created incentives also include retroactive ratcheted payout grids, which disproportionately increase compensation for incremental increases in sales, creating enhanced risks for investors when reps approach the next level on the grid. What these incentives have in common is that none exist naturally or inevitably within the broker-dealer business model, and all are fully within the control of the firm. While not every such incentive is harmful, these incentives create problems for investors when the conduct that is most profitable for the firm is not in investors' best interest, because it inappropriately increases their costs, for example, or exposes them to unnecessary risks.

Moreover, these types of incentives are not limited to the broker-dealer business model. They may also arise in advisory accounts in the dual registrant context, where investment adviser affiliates often artificially create many of the same conflicts that are so prevalent in the broker-dealer space. In such cases, the investment adviser affiliate typically buries their various conflict disclosures deep in their Form ADV in legalese that few if any investors will read and even fewer will understand. As discussed above, that type of disclosure does not lead to informed consent and cannot substitute for a true best interest obligation.

#### B. Framework to appropriately address this problem

As with product-specific conflicts, an approach to these artificially created incentives that relies on disclosure alone would be totally ineffective at protecting retail investors from harm. Research has shown that simply disclosing conflicts does not enable investors to protect themselves from the harmful impact of those conflicts, particularly when the conflicts are complex and opaque, as is often the case here. Moreover, the whole point of many of these incentives is to drive specific behavior that benefits the firm, regardless of whether it harms investors. Where that is the case, the easy, logical solution is simply to eliminate the incentive.

The specific standard that the SEC should adopt to guide firms when deciding what artificially created incentives they must eliminate is whether the incentive would reasonably be expected to encourage recommendations based on factors other than the customer's best interest. If an objective analysis shows that an incentive would reasonably be expected to encourage recommendations that are not in the customer's best interest, it must be eliminated. The good news is that, because these incentives are not intrinsic to either the broker-dealer or investment adviser business models, they are the easiest of conflicts to eliminate. All it takes is the will to do so.

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In conclusion, the only way to ensure compliance with a meaningful best interest standard is to rein in harmful incentives that would otherwise taint advice. This requires firms to adopt strong anti-conflict policies and procedures that are tailored to the specific risks that different types of conflicts pose to investors' well-being. This framework for addressing

common conflicts of interest among both broker-dealers and investment advisers is rigorous enough to protect investors' interests and flexible enough to work across a variety of business models.