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April 14, 2014

Hon. Mary Jo White, Chair
Hon. Luis A. Aguilar, Commissioner
Hon. Daniel M. Gallagher, Commissioner
Hon. Kara M. Stein, Commissioner
Hon. Michael S. Piwowar, Commissioner
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Section 913 Fiduciary Rulemaking – Evidence of Investor Harm

Dear Chair White and Commissioners:

We were encouraged to hear that Chair White expects the Securities and Exchange Commission (SEC or Commission) to make a threshold decision regarding whether the Commission will move forward with a rulemaking, pursuant to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), by the end of the year. As you know, Section 913 authorized the SEC to adopt a rule to require all professionals who provide personalized investment advice to retail customers to do so under a fiduciary standard of care that is no less stringent than the existing standard under the Investment Advisers Act of 1940 (Advisers Act). The undersigned organizations continue to advocate for such a rulemaking and to urge the SEC to move forward expeditiously with a rulemaking consistent with Section 913.

When the SEC issued a Request for Information (RFI) last year seeking data related to the cost and benefits of extending a fiduciary rule to broker-dealers, each signatory of this letter submitted a response. Through those responses, the undersigned organizations provided data and stated support for extending the fiduciary standard of care as the necessary step to better protect investors. Though we will not repeat all of those arguments here, we strongly believe that in order to be meaningful and consistent with Section 913, a uniform fiduciary rule must include more than the current suitability standard supplemented by additional disclosure requirements.

Despite the broad support for rulemaking, some have questioned whether there is evidence of harm to investors that would justify the adoption of a uniform fiduciary standard. After all, they assert, the suitability standard that applies to broker-dealer recommendations affords investors significant protections. For example, it requires brokers to make recommendations that are generally appropriate for their customer based on knowledge of their customer's financial situation. Designed with a sales relationship in mind, however, the suitability standard *does not* impose the same clear obligation that exists under a fiduciary standard, which requires the adviser to put the customer's interest first. Moreover, the suitability standard does not impose an obligation on brokers to appropriately manage conflicts of interest in order to ensure that they do not influence recommendations. These are among the standards that distinguish a suitability relationship from a fiduciary relationship.

While the harm to investors of this two-tiered regulatory scheme may be difficult to quantify, it is nonetheless real and, we believe, pervasive. It directly affects the ability of many middle-income Americans to accumulate funds adequate for their retirement needs and other long-term financial goals. Evidence of the harm to investors from the lack of a uniform fiduciary standard comes in a variety of forms, including observations of industry practices, academic studies, and basic market analysis. First and foremost, however, evidence of this harm is found in the difference between recommendations that satisfy a suitability standard and those that are designed to serve the best interests of the investor. Second, evidence of investor harm is found in the adverse effect that unchecked conflicts of interest have on recommendations. And finally, evidence of harm is found in the effects of a market where investment products compete to be sold rather than bought.

By aggregating a number of examples that appear in the public record, this letter details the harm to investors under a suitability standard that a fiduciary standard consistent with Section 913 of the Dodd-Frank Act would help to ameliorate. Such a rulemaking should ensure that all those who provide personalized investment advice to retail clients have an affirmative fiduciary obligation to act in their clients' best interest and to minimize and appropriately manage conflicts of interest that could impede their ability to do so. In addition, we further explain why disclosure alone or disclosure combined with investor education does not offer an adequate solution. Finally, we provide additional evidence to counter assertions that imposition of a fiduciary standard would itself harm investors by limiting their access to affordable investment services.

Investor Harm as a Result of Investment Recommendations That Are Suitable But Not in the Investor's Best Interest

When examining the range of investment options that brokers and investment advisers might recommend to retail investors – i.e., a particular class of mutual funds or variable annuities – the vast differences in the features of these investment products becomes readily apparent. For example, otherwise similar products may impose different fees on the investor, or achieve comparable investment results with significant differences in volatility, or provide different guarantees, or, in the case of variable annuities, offer the investor a greater or lesser degree of choice among underlying investment options that are of varying quality.

Although all of the options within a particular category may be deemed suitable for a particular investor, these differences in features can profoundly impact costs, risks and overall performance. Investors are harmed when they are encouraged to pay excessive fees, receive substandard performance, or are exposed to unnecessary risks because a broker recommended an investment that, while suitable, was inferior to other available options. This harm could be remedied, or at least ameliorated, by requiring brokers to provide services under a fiduciary standard.

<u>The suitability standard allows for the sale of high-cost investments that erode investors' long-term gains</u>

The most readily observable impact of investor harm resulting from the lack of a uniform fiduciary standard arises out of the significantly different costs imposed by otherwise similar investments. Consumer Federation of America (CFA) addressed this issue in a comment letter responding to the Commission's RFI.[1] CFA examined Morningstar data for S&P 500 index funds to determine the impact of costs on otherwise similar investments. CFA chose this type of fund to analyze because it offers a clear example that any increase in investor fees comes directly out of investment performance without offering any added benefits to compensate for those increased costs. Based on its examination of the Morningstar data, CFA found evidence of thriving cost competition among direct-marketed funds, with investor assets heavily concentrated in a handful of very low-cost options. In contrast, administrative costs for broker-sold S&P 500 index funds held outside of retirement plans were often significantly higher than those of direct-sold funds, even after the cost of compensating the broker was excluded. Moreover, in several cases cited by CFA, customers of major brokerage firms paid sales loads of as much as 5.25 percent in order to purchase an S&P 500 index fund that has an expense ratio roughly ten times or even twenty times as high as the expense ratio of the lowest-cost direct-marketed fund. Far from adding value, the recommendation of a broker, in this case at least, merely added to the already excessive cost.

There is nothing inherently more expensive about operating a broker-sold S&P 500 index fund than a direct-marketed fund (other than the cost of compensating the broker, which CFA subtracted from the administrative fee for the purposes of its analysis). The logical conclusion, therefore, is that the higher fees in broker-sold funds reflect a market where competition is based primarily on factors other than cost. Given the singular role that reducing costs plays in determining performance in index funds, there is every reason to believe that this lack of cost competition has the same impact on the sale of other types of investment products that can be sold on the basis of features other than cost alone. As noted by Dr. Michael Finke in the Investment Management Consultants Association (IMCA) comment letter,[2] this lack of cost competition among broker-sold funds, as is permitted under the suitability standard, may help to explain why broker-recommended mutual funds significantly underperform direct-sold funds more commonly recommended by investment advisers operating under a fiduciary standard.

Excess fees paid by investors who invest based on the recommendation of a broker can have a significant impact on the long-term savings of investors. As the Commission warned in a

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[1] See letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to the SEC in response to the request for comments on the "Duties of Brokers, Dealers, and Investment Advisers," July 5, 2013, pp 25-25, *available at* http://www.sec.gov/comments/4-606/4606-3119.pdf.
[2] Dr. Michael Finke, "Fiduciary Standard: Findings from Academic Literature," attached to the letter from IMCA, July 5, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," *available at* http://www.sec.gov/comments/4-606/4606-3121.pdf (hereinafter "Finke Study").

recent bulletin for investors, "[o]ver time, even ongoing fees that are small can have a big impact on your investment portfolio," reducing returns, shrinking a nest egg, and preventing investors from achieving financial goals.[3] This impact was illustrated in an October 2013 Bloomberg Markets Magazine report on data filed with the SEC which showed that "89 percent of the $11.51 billion of gains in 63 managed-futures funds went to fees, commissions, and expenses during the decade from Jan. 1, 2003 to Dec. 31, 2012."[4] Brokers have an incentive to keep clients in managed-futures funds because they receive annual commissions of up to 4 percent of assets invested and investors pay as much as 9 percent in total fees each year.[5]

The Department of Labor (DOL) illustrates the harm associated with fees that accompany non-fiduciary, suitability-based advice this way: "Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent."[6] If anything, the SEC and DOL examples understate the harmful impact on investors of excessive fees, since they feature only one of the several cost differences among investments commonly sold to retail investors.

<u>The suitability standard allows brokers to sell products with other substandard features</u>

While they may be the most easily quantifiable, excessive costs are not the only concern associated with advice delivered under a suitability standard. In its comment letter, CFA used ratings of variable annuities by Weiss Ratings[7] to help illustrate how factors beyond costs could be affected by a best interest standard, such as the availability of choice and performance. In rating variable annuities, Weiss assesses a number of factors in addition to cost, including both the availability of a wide selection of mutual fund subaccounts with good performance and the financial strength of the insurance company issuing the annuity. In describing the basis for arriving at its recently issued 10-best list, Weiss explained that "mutual fund subaccount performance played an important role in the selection process. After all, a variable annuity can have low costs and a strong Financial Strength Rating, while at the same time offering only mediocre fund performance."[8]

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[3] U.S. Securities and Exchange Commission Investor Bulletin: "How Fees and Expenses Affect Your Investment Portfolio," February 19, 2014, *available at* http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-how-fees-expenses-affect-your-investment-portfolio#.UxpflfldVKg

[4] David Evans, "How Investors Lose 89 Percent of Gains from Futures Funds," Bloomberg Markets Magazine, Oct. 7, 2013, *available at* http://www.bloomberg.com/news/print/2013-10-07/how-investors-lose-89-percent-of-gains-from-futures-funds.html.

[5] *Id.*

[6] U.S. Department of Labor, "A Look at 401(k) Plan Fees," August 2013, *available at* http://www.dol.gov/ebsa/publications/401k_employee.html.

[7] See Weiss Ratings Best and Worst Variable Annuities, *available at* http://weissratings.com/ratings/best-and-worst variable-annuities.aspx.

[8] *Id*.

Lack of fund choice and high surrender fees were also significant factors in determining which annuities ended up on Weiss's 10-worst list. In its comment letter, CFA questioned how some of the funds on the 10-worst list could even exist in a truly competitive market. For example, the list includes two annuities that offer a single fund option (described by Weiss as "weak"), impose high surrender fees, and have high total expenses, including a mortality and expense risk charge (M&E fee) many times higher than other available funds. While these annuities may be deemed to be suitable for an investor, a financial professional subject to a fiduciary duty would find it difficult to defend a recommendation of one of these funds as being in the best interest of the investor.

<u>Financial advisers are more likely to target less sophisticated and less affluent investors with products that are higher-cost or otherwise substandard</u>

IMCA commissioned Dr. Michael Finke, a professor at Texas Tech University, to conduct an in-depth literature review that provides data and other information addressing specific questions related to the benefits and costs resulting from the application of a fiduciary standard of care to the conduct of brokers, dealers and investment advisers.[9] Dr. Finke reviewed a number of academic studies related to the potential benefits to consumers of a fiduciary standard, including studies showing that less sophisticated and less wealthy investors are most likely to suffer the harmful consequences of recommendations that are not based on the best interest of the investor:

- A 2012 study found that commission-compensated insurance agents "will consistently recommend higher commission products to less sophisticated consumers, leading to welfare losses that are greatest among those who can least afford to sustain them."[10]

- An earlier study similarly examined financial firms' "incentive to shroud attributes."[11] The researchers described how producers "will rationally segment the market by level of investor sophistication," with less efficient, more opaque products created to "maximize economic rents from less sophisticated consumers" while more competitive products are simultaneously offered to sophisticated consumers. "Examples of product differentiation through opaque characteristics are evident in the mutual fund market."

- Another study cited by Dr. Finke describes how fund companies use different tactics to attract "less sophisticated investors, who fund families attract through marketing, and more sophisticated, direct-channel investors who are targeted through higher performance."[12]

[9] See Finke Study.
[10] Finke Study at 6 (citing S. Anagol, S. and H.H. Kim, 2012, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market," American Economic Review, 102(1): 576-593).
[11] Finke Study at 7 (citing X. Gabaix and D. Laibson, 2006, "Shrouded attributes, consumer myopia, and information suppression in competitive markets," Quarterly Journal of Economics, 121(2), 505-540).
[12] Finke Study at 7 (citing N.M. Stoughton, Y. Wu and J. Zechner, 2011, "Intermediated investment management," The Journal of Finance, 66(3), 947-980).

- This is consistent, Dr. Finke suggests, with evidence from a separate academic study "that successful mutual funds appear either to gain market share through lower expenses or by increasing opaque fees which are then used to incent advisor recommendations."[13]

- Finally, Dr. Finke cites research suggesting that the "latitude of recommendation quality allowed in a suitability model is particularly troubling when clients are older and have experienced cognitive decline that may reduce their ability to perceive self-serving recommendations."[14]

In other words, while opposition to fiduciary rulemaking is often presented as being motivated by concern over the well-being of middle-income investors, the academic literature strongly suggests that it is precisely these less wealthy, often less sophisticated investors who are most at risk from harmful practices permitted under a suitability standard.

<u>A fiduciary standard affords investors legal protections not available under a suitability standard with regard to an adviser's ongoing duty of care</u>

Under a suitability standard, investors are harmed because a broker has no duty to monitor or revise a recommendation, even when the client's circumstances have changed. In its response to the SEC's RFI, the Public Investors Arbitration Bar Association (PIABA), whose members represent individual investors in resolving complaints with brokers, highlighted several examples of the how the fiduciary standard protects investors seeking recourse in ways that a simple suitability standard does not.[15]

Using specific examples, PIABA illustrates how investors can be better protected with a fiduciary standard that requires advisers to: (i) update investment recommendations when a client's personal circumstances change, (ii) review existing investments when a customer changes advisers and provide advice regarding the appropriateness of the investments, and (iii) inform investors of new information that comes to the adviser's attention that impacts that investment's risk profile.

Among the most significant differences in the legal accountability for brokers and advisers is that investment advisers are held to an ongoing fiduciary duty to act in the best interests of their clients. By contrast, most brokers contend, and courts generally agree, that their duties begin and end with the securities transaction.[16] Imposing a fiduciary duty on broker-dealers would better protect investors by limiting the circumstances in which brokers' can argue that, among other things, the investor was negligent or was sophisticated enough to understand

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[13] Finke Study at 7 (citing A. Khorana and H. Servaes, 2012, "What drives market share in the mutual fund industry?" Review of Finance, 16, 81-113).
[14] Finke Study at 6 (citing M.S. Finke and T. Langdon, 2012, "The impact of a broker-dealer fiduciary standard on financial advice," Journal of Financial Planning, 25(7), 28-37).
[15] See letter from Scott C. Ilgenfritz, President, Public Investors Arbitration Bar Association, July 3, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," *available at* http://www.sec.gov/comments/4-606/4606-3107.pdf.
[16] *See In de Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1303 (2d Cir. 2002). Whether imposition of a fiduciary duty on broker-dealers would address this difference will turn on how the Commission applies the ongoing duty of care in instances where the broker is providing ongoing advice.

the transaction(s) or had ratified the transaction(s) or was estopped from bringing claims or had failed to mitigate his or her damages.

Financial Incentives Often Cause Brokers to Make Recommendations That Are Not in the Customer's Best Interest

Under the suitability standard, a broker-dealer is free to recommend the security that pays the broker-dealer the highest compensation, so long as it is otherwise appropriate for the investor. As the Financial Industry Regulatory Authority (FINRA) noted in its October 2013 Report on Conflicts of Interest, such conflicts "are widespread across the financial services industry."[17] The report goes on to state, "[w]hile the existence of a conflict does not, per se, imply that harm to one party's interests will occur, the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly."[18] In a comment letter to the Commission, Massachusetts Secretary of the Commonwealth William Galvin, the state securities regulator, suggested he was stating the obvious when he pointed out that a broker's recommendations can be influenced by how they are compensated:

> "It is a truism that many of the riskiest investments pay the highest selling compensation. Too often, brokers, who are subject to sharp conflicts of interest, recommend high-commission alternative products that carry inappropriate levels of investment risk, detrimentally high costs, and/or expose investors to factors such as illiquidity or price volatility."[19]

It is significant that those who are on the front line of enforcing the securities laws see a direct connection between conflict-inducing broker-dealer compensation and practices that result in harm to investors. This occurs because broker-dealers are not required to place their client's interest above their own.

Recent media accounts also provide evidence of the significant pressure brokers may be under from their employers to sell proprietary products regardless of the investor's best interests. This is illustrated, for example, by a recent *New York Times* article on J.P. Morgan's aggressive tactics aimed at pushing the sale of in-house products.[20] According to the article, several advisers who resisted the pressure to sell the firm's proprietary products said "they were told to change their tactics or be pushed out." As the article notes, while the promotion of in-house products is not illegal, the concern is that, "driven by fees, banks will push their own products over lower-cost options with stronger returns." Moreover, at least one former J.P. Morgan broker

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[17] FINRA, "Report on Conflicts of Interest," October 2013, available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf
[18] *Id.*
[19] See letter from William F. Galvin, Secretary of the Commonwealth of Massachusetts, Boston, Massachusetts, June 27, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," available at http://www.sec.gov/comments/4-606/4606-3088.pdf.
[20] Susanne Craig and Jessica Silver-Greenberg, "Selling the Home Brand: A Look Inside an Elite JPMorgan Unit," The New York Times, March 2, 2013, accessed at http://dealbook.nytimes.com/2013/03/02/selling-the-home-brand-a-look-inside-an-elite-jpmorgan-unit-

left the firm because he did not feel that the firm's policy on selling in-house products allowed him to do what was best for his customers.

Similarly, a recent *Investment News* article noted that MetLife had increased both its minimum production limits for its sales force (by 50 percent) and the percentage of that minimum that must come from the sale of proprietary products (two-thirds).[21] Although the sale of proprietary products or a limited range of products may not, in and of itself, violate a fiduciary duty, it can create a clear conflict of interest with the potential to inflict considerable harm on investors.

This potential harm to investors is evidenced in a Government Accountability Office (GAO) analysis of 401(k) roll-over recommendations by the major call centers. GAO found considerable evidence of questionable practices that appear to be the result, at least in part, of conflicts of interest.[22] Among other things, GAO found that call centers (i) provided questionable information to investors about the benefits of various options available to them and (ii) directly undercut their own 401(k) plans in order to move individuals into Individual Retirement Accounts (IRA). The financial incentives for firms to undercut their own 401(k) plans are significant since roll-overs provide the primary source of money flowing into IRAs. Among its more specific findings, the GAO study noted:

- Financial advisors "encouraged rolling 401(k) plan savings into an IRA even with only minimal knowledge of a caller's financial situation."

- Representatives claimed that 401(k) plans had extra fees and that IRAs "had no fees," or argued that IRAs were always less expensive, notwithstanding the fact that opposite is generally true. IRAs are more expensive for investors, on average, than 401(k) plans.

- Misleading statements made it difficult for investors to understand IRA fees. For example, a GAO investigator called a number of 401(k) plan service providers, most of which offer IRA products, and found that 7 of 30 call center representatives (representing firms administering at least 34 percent of IRA assets at the end of the 1st quarter of 2011) said that their IRAs were 'free or had no fees with a minimum balance,' without clearly explaining that investment, transaction, and other fees could still apply, depending on investment decisions. In the GAO's review of 10 IRA websites, investigators found 5 providers that made similar claims, often with certain conditions such as a $50,000 minimum balance or consent to receive electronic statements explained separately in footnotes.

Numerous additional examples exist in academic research illustrating the pernicious effect that conflicts of interest can and do have on the recommendations of transaction-

[21] Darla Mercado," Under new structure, fewer MetLife advisers pushed to produce more," October 25, 2013, accessed at http://www.investmentnews.com/article/20131025/FREE/131029914?utm_source=issuealert-20131027&utm_medium=in-newsletter&utm_campaign=investmentnews&utm_term=text#

[22] Labor and IRS Could Improve the Rollover Process for Participants, Government Accountability Office, GAO-13-30 (March 2013) ("GAO Report") available at http://www.gao.gov/assets/660/653506.txt.

compensated salespeople. For example, in 2009, Professors Michael Finke and Sandra Huston[23] designed a study to measure the adequacy of life insurance coverage for consumers who used a financial planner versus those who used a broker.[24] The study found that "[c]onsistent with agency theory, the use of financial intermediaries who have the strongest fiduciary duty toward a household is associated with holding life insurance at or above the adequacy threshold. Even though households who employ brokers are demographically similar to those who rely on financial planners, the lack of contracting incentive among brokers … may reduce their willingness to recommend financial products that are substitutes for those that provide direct compensation. In other words, households that obtain life insurance using intermediaries who operate under a fiduciary duty (i.e., financial planners) tend to have a more adequate level of insurance than households that use non-fiduciary intermediaries (i.e., broker-dealers).

A 2012 study by the National Bureau of Economic Research sent mock investors with one of four different portfolios (all cash, index funds, a large position in company stock, and a large position in sector funds) to get portfolio recommendations from financial advisors compensated through product sales.[25] The study found that, because these financial professionals were compensated through product sales, they favored recommendations that provided greater remuneration over recommendations that "were objectively optimal." When advisers mentioned fees, they did so in a way that downplayed them without lying. For example, they often used arguments such as, "[t]his fund has 2% fee but that is not much above industry average."

Despite the data demonstrating the harm to investors as a result of higher fees in connection with transaction-compensated salespeople, one might expect that investors who rely on financial professionals would be less prone than those investing on their own to engage in self-destructive practices, such as chasing returns. On the contrary, Dr. Finke's analysis of the academic literature suggests that the "lack of a fiduciary standard of care coupled with contracting incentives can also encourage advisers to cater to, and perhaps amplify, welfare-reducing investor biases."[26]

Dr. Finke cites research that shows investors' tendency to chase returns in mutual funds leads them to underperform average market returns by 1.56% per year, since they tend to buy overvalued sectors after prices have risen and to sell following a market decline. Researchers found that "this underperformance was significantly greater in commission funds, perhaps because advisors benefitted from acceding to investor demands to buy and sell funds at a greater frequency."[27] A separate, more recent study finds that "commission-compensated insurance

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[23] Associate Professors with the Division of Personal Financial Planning, Texas Tech University.
[24] Dr. Michael Finke, Dr. Sandra Huston, and William Waller, "Do Contracts Impact Comprehensive Financial Advice,?" Working Paper, July 4, 2009, available at http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1431173_code57590.pdf?abstractid=1429807&mirid=1.
[25] Sendhil Mullainathan, Markus Nöth and Antoinette Schoar, "The Market For Financial Advice: An Audit Study," March 2012, Working Paper 17929, National Bureau of Economic Research, *available at* http://www.nber.org/papers/w17929.
[26] Finke Study at 5.
[27] Finke Study at 5 (citing G.C. Friesen and T.R.A. Sapp, "Mutual fund flows and investor returns: An empirical examination of fund investor timing ability," Journal of Banking & Finance, 31(9), 2796-2816).

agents will play into a client's biases if these biases help them sell a higher commission product."[28]

A Fiduciary Standard Could Help Reduce the Harm to Investors Resulting From Market Conditions

The marketplace for investment products is among the most competitive in the world, offering investors an immense array of options designed to serve every investment need. This fact raises the question of how objectively inferior investment products (e.g., those that combine extremely high costs with poor performance) continue to exist and in some cases attract significant assets, particularly in the broker-sold marketplace. In other words, investors who invest through broker-dealers operating under a suitability standard of care do not appear to benefit from that market competition.

A key reason for this, as discussed in the previous section, is that investment products that cannot compete based on quality and cost succeed instead because those who sell them are rewarded with generous financial incentives. Brokers operating under a suitability standard are free to recommend products that reward them financially, even where better options are available, as long as their recommendation is generally suitable. Indeed, the broker-sold investment marketplace is characterized by "reverse competition," where investment products compete to be sold, not bought, and do so on terms that may actively induce brokers to ignore the best interests of their customers.

Imposition of a fiduciary standard has the potential to fundamentally change the basis on which investment products compete in the broker-sold market. As Dr. Finke concluded based on his review of the academic literature, "the majority of retail investor welfare loss from suitability standards arises from self-serving recommendations of products that are more expensive than the ideal, and reduced incentives to both create more efficient financial products and to invest in the knowledge required to make high quality recommendations. To the extent that fiduciary standards help align the interests of the agent and retail investor, it is possible that a combination of improved price disclosure and more effective disincentives to make self-serving recommendations will have little impact on the supply of advice while improving investor outcomes." [29]

Adoption of a fiduciary standard for broker-dealers' retail investment advice would promote market competition on pro-investor terms. This would be done not by eliminating all conflicts of interest, but by applying an over-arching best interest obligation on broker-dealer recommendations and by requiring brokers to appropriately manage their conflicts of interest. If brokers were required to have and document a reasonable basis for believing their recommendations are in the best interest of the investor, investment products would face increased pressure to compete based on features that promote client interests. That one change has the potential to deliver dramatic benefits to investors in the form of reduced costs, reduced exposure to unnecessary risks, and improved long-term performance.

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[28] Finke Study at 5 (citing S. Anagol and H.H. Kim, 2012, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market," American Economic Review, 102(1): 576-593).
[29] Finke Study at 17.

There is No Evidence to Support the Contention That a Fiduciary Standard of Care Will Harm Investors

Some opponents of fiduciary rulemaking have argued that investors, particularly middle-income investors, could be harmed if brokers stop serving this market, thereby leaving middle-income investors without access to affordable financial advice. In advancing this argument, critics make an inaccurate comparison between brokers and investment advisers. These critics draw a false conclusion that, because investment advisers tend to serve higher income clients than brokers that, therefore, brokers practicing under a fiduciary standard would be compelled to serve higher income clients as well.

In addition, the argument that investors could lose access to affordable advice is based on the false assumption that adoption of a fiduciary standard for broker-dealers' investment advice would force brokers to abandon transaction-based compensation arrangements. And, it assumes that broker-dealers would face significantly higher liability risks under a fiduciary standard than they currently face under the suitability standard. Several studies have been conducted in recent years that explore the real-world impact that a fiduciary duty has on the cost of service, the availability of services to middle-income customers, and the liability risks that financial professionals face. These studies strongly refute the claim that adopting a fiduciary standard for all financial professionals who provide personalized investment advice will increase costs or cause-middle income investors to lose access to products or services.

<u>Aité Group study</u>

The Financial Planning Coalition's submission to the SEC included a study conducted by the Aité Group that supports the conclusion that a uniform fiduciary standard will benefit retail customers and their financial advisers, and will not impose significant costs.[30] The study concludes that financial advisers and broker-dealers at investment advisory firms who deliver services to their customers under a fiduciary standard experience stronger asset growth, stronger revenue growth, and obtain a greater share of client assets than their counterparts who provide services primarily under a non-fiduciary model. Notwithstanding opposition arguments that a fiduciary standard would increase compliance burdens on brokers, the study found that fiduciary financial advisers do not spend any more of their time on compliance or other back-office tasks.

Specifically, both the financial advisers associated with investment advisory firms and the fiduciary registered representatives surveyed for the study report that, since 2007, they have achieved higher customer asset and stronger revenue growth than the financial advisers at broker-dealers who primarily work on a non-fiduciary commission basis. These findings suggest that transitioning to a fiduciary model is not likely to have a negative effect on broker-dealer financial advisers. To the contrary, operating under a fiduciary standard is likely to improve both their relationships with customers, the quality of advice they provide to those customers, and their bottom-line profits.

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[30] See Attachment A, "Aité Fiduciary Study Findings," in the letter from the Financial Planning Coalition, July 5, 2013 to the SEC in in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," available at http://www.sec.gov/comments/4-606/4606-3126.pdf.

Finke/Langdon Study

Dr. Michael Finke and Thomas Langdon, professors at Texas Tech University and Roger Williams University, respectively, conducted an illuminating study that includes an analysis of the availability of financial services to investors in states that treat broker-dealers as fiduciaries as compared to states that apply a lesser standard of conduct to broker-dealers.[31] The authors identified four states that impose an unambiguous fiduciary standard on broker-dealers (the "fiduciary states"), 14 states that do not impose a fiduciary standard on broker-dealers (the "non-fiduciary states"), and 32 states that impose a limited fiduciary standard ("limited fiduciary states"). They then compared the "saturation rate" (the number of registered representatives of broker-dealers that are not dually-registered compared to the number of households) among the three types of states.

The Finke and Langdon study finds no statistically significant difference in the ratio of registered representatives to total households in states in which broker-dealers have a full fiduciary duty, a limited fiduciary duty, or no fiduciary duty to customers. This study suggests that applying a uniform fiduciary duty standard on broker-dealers will have little if any effect on the availability of investment advice to customers, including customers with moderate levels of income or assets.

The authors also surveyed registered representatives located in fiduciary and non-fiduciary states regarding the conduct of their business. The survey covered such items as: the brokers' ability to serve moderate wealth customers; the ability to offer a variety of products; the ability to provide product recommendations that are in their customers' best interest; and whether representatives experience a greater compliance burden. The difference in responses from representatives in fiduciary states and those in non-fiduciary states was not statistically significant. The authors found (i) that the percentage of clients with an income of less than $75,000 is statistically equal between both groups, and (ii) that there is no statistically significant difference in either the percentage of brokers who believe they serve the needs of high-wealth clients or in the percentage of brokers who believe they serve the needs of low and moderate-wealth clients. Nearly all respondents believe they are able to provide products and advice that meet the needs of customers.

In contrast to the speculation and conjecture that characterizes the argument that a fiduciary standard would reduce investor access to affordable services, the Finke-Langdon study provides real-world empirical evidence that the imposition of a uniform fiduciary standard would neither reduce the availability of retail advice to investors nor unduly constrain the ability of financial advisors to provide a broad range of products or tailored advice to retail investors.

[31] The Finke and Langdon study is available in the Journal of Financial Planning (July 2012) at http://www.fpanet.org/journal/TheImpactoftheBrokerDealerFiduciaryStandard/.

Cerulli Associates Data

Finally, the Cerulli Associates data[32] referenced in the Financial Planning Coalition's letter concerning the conversion of fee-based (non-fiduciary) brokerage accounts to fiduciary, non-discretionary (fiduciary) advisory accounts suggests that a fiduciary standard will impose little if any additional cost or burden on brokers. In fact, the Cerulli data show the opposite; that there is already a strong brokerage industry trend toward providing investment advice on a fiduciary basis and that the costs of such a transition will not be significant.

The industry data indicate that the number of these accounts, and their amount of assets in the accounts, have grown dramatically since the conversion. Cerulli Associates found that, even after the broad market declines of 2008, the client assets in non-discretionary advisory accounts rose by almost 75% from approximately $329.6 billion at the end of the conversion process in 2007 to $574 billion in the third quarter of 2012. Meanwhile, the level of fees charged to customers for this service model at the major national firms has stayed flat or decreased since 2007. In sum, the experience of converting fee-based (non-fiduciary) brokerage accounts to non-discretionary advisory (fiduciary) accounts demonstrates that the expense of operating under a fiduciary model has not prevented the number of accounts and level of assets in those accounts from continuing to grow substantially.

Better Disclosure and Investor Education Alone Will Not Solve the Problem

Despite the clear benefits to investors of adopting a uniform fiduciary standard, some continue to suggest that the Commission can cure the significant investor harm that currently exists by simply improving disclosures, better educating investors about the differences between brokers and advisers, and relying on investors to choose the business model that is best for them. It is in this context that the well-documented problem of investor confusion becomes relevant. Numerous studies over the years have demonstrated that investors do not understand the differences between brokers and advisers, including the differences in the legal obligations to clients. Indeed, a 2008 RAND Study found that most investors cannot identify whether their own financial adviser is a broker or investment adviser even after the differences have been explained to them.[33] Earlier Commission efforts to design effective disclosure regarding the different legal obligations of brokers and advisers proved futile, even after extensive redesign based on investor testing.[34]

We are not aware of any new research that would suggest that disclosure and education can offer an effective solution to this problem. To the contrary, the Commission's comprehensive study of financial literacy provides convincing evidence of the extreme

[32] As referenced in the Financial Planning Coalition letter to the SEC, Cerulli Associates, Cerulli Quantitative Update: Advisor Metrics, Exhibit 1.02 (2012).
[33] Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, Rand Institute for Civil Justice, "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers," released January 2008 by the SEC and available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.
[34] See Siegel & Gale, LLC and Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures, Report to the Securities and Exchange Commission, March 10, 2005.

limitations of disclosure as an effective investor protection tool.[35] Despite decades of increased attention to improving investor knowledge, the SEC staff study found that investors typically do not understand basic financial concepts, such as compound interest and inflation.

A review of studies and surveys on investor knowledge, prepared by the Library of Congress for the SEC, found that many investors do not understand key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns. Moreover, investors lack critical knowledge about investment fraud. In addition, surveys demonstrate that certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the average person in the general population.

Academic research confirms that disclosure is not enough to protect consumers. For example, in 2007, employees with low saving rates were randomly assigned to a study in which they were paid $50 each to read a short survey explaining their 401(k) plan, including a calculation of how much money they would personally gain by taking full advantage of the employer match. Relative to a control group, this group did not significantly increase its average 401(k) saving rate.[36] In a March 2009 study, researchers found that the adoption of an easy-to-read summary prospectus by the SEC, which simplifies mutual fund disclosure, seemed to have no effect on investor choices.[37]

Moreover, academic research has shown that conflicts of interest disclosures can actually have the opposite of the intended effect because investors tend to place more trust in the financial adviser's recommendations and financial advisers tend to be less concerned about acting in the customer's best interest when conflicts are disclosed. A 2005 study found that in certain situations, disclosure can sometimes lead advisers to give more biased advice by providing individuals with "moral license" to engage in self-interested behavior.[38] The results of this study were confirmed by a more sophisticated study in 2011, which found that disclosure alone lessens moral reluctance to provide biased advice.[39]

Investors who cannot distinguish between brokers and advisers, who do not understand the different legal standards that apply to their recommendations, and who do not understand the

[35] Staff of the Securities and Exchange Commission, Study Regarding Financial Literacy Among Investors (As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act), August 2012.
[36] *See* Choi, *et al*, "Are Empowerment and Education Enough? Underdiversification in 401(k) Plans," Brookings Papers on Economic Activity 2: 151–98 (2005), *available at* http://scholar.harvard.edu/files/laibson/files/are_empowerment_and_education_enough_under-diversification_in_401k_plans.pdf.
[37] *See* John Beshear, *et al*, "How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?" Kennedy School of Government Harvard University, Working Paper No. RWP09_16 (March 2009), *available at* http://www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/MRCBG_FWP_2009_02-2009_Madrian_Mutual_Fund.pdf.
[38] Daylian M. Cain, *et al*, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. Legal Stud. 1 (2005).
[39] Daylian M. Cain, *et al*, *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest*, 37 J. CONSUMER RES. 836 (2011).

ramifications of disclosed conflicts of interest cannot be expected to make an informed decision about which business model would best serve their interests.[40] Certainly, there is no reasonable basis for believing that a disclosure and education-based approach would promote informed decisions by investors unless brokers were also prohibited from using titles and marketing their services in ways that are designed to portray them as trusted and expert financial advisers.

Conclusion

The bifurcated approach to regulating investment advice offered by broker-dealers and investment advisers reflects the failure of regulatory policy to keep pace with changes in market practices. There is no justification for applying different standards of care to financial professionals who are offering the same services to investors. Over the years, broker-dealers have not only identified themselves as financial advisers, but they have offered virtually identical services to investors in order to compete. The Commission has permitted, at least tacitly, this evolution by failing to apply the appropriate regulatory standard.

[40] Dr. Sunita Sah, *et al*, "The Burden of Disclosure: Increased Compliance with Distrusted Advice," Working Paper, Dec. 2011, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615025&download=yes (The study reflected that eliminating conflicts of interest is also key to enhancing the benefits of disclosure. The study found that the choosers were aware that their advisers had not put their interests first, but due to the pressure of the situation, the chooser was more likely to comply with the advice, even though they were less satisfied with their choice.).

Investors suffer concrete harm – in the form of higher costs and poorer performance – as a result. The Commission has an opportunity to reduce this harm to investors without imposing undue costs or regulatory burdens by applying a fiduciary standard to both broker-dealers and investment advisers when they offer personalized investment advice to retail customers. We urge the Commission to move forward expeditiously with a rulemaking, consistent with Section 913 of the Dodd-Frank Act, to achieve this goal.

Sincerely,

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