Consumer Federation of America

April 19, 2021

The Honorable Gary Gensler
Chairman
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington, DC 20549-1090

Dear Chairman Gensler,

Congratulations on your confirmation as Securities and Exchange Commission Chair. Your regulatory experience, market expertise, and commitment to the public interest make you uniquely qualified to lead the agency at this time. At Consumer Federation of America (CFA)[1] we look forward to working with you to advance an ambitious agenda to protect investors, facilitate capital formation, and promote fair, orderly, and efficient markets. Toward that end, there are a wide range of important issues on which we expect to communicate with you as you settle into your new role.

My immediate purpose in writing is more targeted. Since we first wrote to Arthur Levitt on this topic in 1999,[2] CFA has greeted each new SEC Chair with a plea to reform the regulation of broker-dealers and investment advisers. We have warned them that regulatory reform is needed to keep pace with changes in the marketplace and to ensure that investor protections match investors' reasonable expectations of the investment professionals they rely on in making decisions that are critical to their financial wellbeing.[3] Time and again we have noted that this should be a top priority because it affects the most vulnerable investors – those who must rely on financial professionals for advice and recommendations because they do not feel equipped to make investment decisions on their own, but who have limited ability to judge, or even distinguish between, the financial professionals who compete for their business.

Unfortunately, despite the extensive attention this issue received in the previous administration, the need for a fresh approach to this issue remains undiminished.

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[1] CFA is a non-profit association of more than 250 national, state, and local pro-consumer organizations. It was formed in 1968 to advance the consumer interest through research, advocacy, and education.
[2] Letter from CFA Director of Protection Barbara Roper to SEC Chairman Arthur Levitt (Oct. 26, 1999), https://consumerfed.org/_archives/elements/www.consumerfed.org/file/LEVITTLT.pdf.
[3] See, e.g., Letter from CFA Director of Investor Protection Barbara Roper to SEC Chairman Harvey L. Pitt (Dec. 13, 2001), https://consumerfed.org/pdfs/Pitt_Letter_121301.pdf.

- Regulation Best Interest (Reg. BI), at least as initially interpreted by the Commission, is too weak and undefined to deliver the promised protections of a true best interest standard backed by meaningful restrictions on harmful incentives.
- The new guidance on the Investment Advisers Act fiduciary standard is similarly flawed. Its fiduciary duty as enforced is more theoretical than real, as it continues to over-rely on disclosure without any evidence that the required disclosures are effective in protecting investors' interests.
- The new Customer Relationship Summary (Form CRS) does more to obscure than to clarify important differences between brokers and advisers and thus does not support an informed selection among different types of investment professionals.

That's the bad news. The good news is that we do not believe it will be necessary to scrap these rules and start from scratch in order to deliver the protections investors expect and deserve when they turn to financial professionals for help with their investments.

Despite their many flaws, these regulations can provide a framework on which to build a more robust regulatory approach, as the Department of Labor (DOL) recently demonstrated with its new guidance on its own advice rule.[4] As you are probably aware, the DOL based its advice rule on Reg. BI. Like Reg. BI, it includes an obligation to act in the best interests of the customer and to have policies and procedures to mitigate conflicts of interest. With its new guidance, the DOL makes clear that these obligations, properly implemented, can have an impact. The guidance makes clear, for example, that superficial conflict mitigation will not suffice; DOL expects firms to take meaningful steps to rein in conflicts present in their business model and not to create harmful incentives that are likely to undermine compliance. It also makes clear that determinations that rollover recommendations are in the best interest of the retirement investor must be based on a thorough analysis, including the long-term impact of any increased costs that may result. While much work remains to be done, DOL has shown that it is possible to bring real rigor to these requirements where regulators have the interests of investors at heart and the will to face down industry opposition.

As you move forward with implementation of the SEC's related rules, we urge you to adopt a similarly rigorous approach. The primary goal should be to ensure that all investors who choose to work with an investment professional – whether that professional is a broker-dealer or an investment adviser – are protected by strong regulatory standards that require those financial professionals to place the customer's interests first at all times. In keeping with that standard, investment advisers must be required to provide the advice and brokers must be required to recommend the investments that they reasonably believe are the best option for the investor from among those they have available to recommend. In order to promote compliance with that high standard, both brokers and advisers must be required to adopt stringent policies and procedures to ensure that the conflicts of interest present in their business model are not allowed to influence their recommendations in ways that would reasonably be expected to result in harm to the investor. As is the case under the DOL guidance, conflicts that can't be mitigated sufficiently to achieve that goal should be required to be eliminated. The current regulations give lip service to

[4] U.S. Department of Labor, Employee Benefits Security Administration, New Fiduciary Advice Exemption: PTE 2020-02, Improving Investment Advice for Workers & Retirees, Frequently Asked Questions (April 2021), https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/faqs/new-fiduciary-advice-exemption.pdf.

those principles, but do not achieve them. The purpose of this letter is to outline the comprehensive approach we believe the Commission can and should adopt to achieve that goal.

Let me start, however, with a warning. It is essentially the same warning CFA delivered to your predecessor, but that he chose to ignore.[5] First, success in this effort is far from guaranteed, not just because of the predictable opposition of financial services firms to anything that requires more than superficial adjustments to their practices, but because the SEC itself has proven to be resistant to change in its approach to this issue over the years. Indeed, it is the SEC that is largely responsible for creating the problems these regulations are intended to resolve. For decades it has permitted brokers to market themselves as advisers while it continued to regulate them exclusively as salespeople, leading not just to investor confusion, but to investors' being actively misled. Ignoring overwhelming evidence to the contrary, the Commission has continued to maintain that disclosure in documents, such as ADV forms or the Reg. BI conflict disclosures, that few investors read and fewer still are likely to understand leads to "informed consent" to harmful conflicts and conduct. On that basis, it has permitted fiduciary advisers to engage in avoidable conflicts and harmful practices at the expense of their unwitting clients. In developing its regulatory approach, it has appeared to worry more about "disrupting" the industry than it has about inadequacies in investor protections. For this reason, it will take a firm hand at the top – not just in the Chairman's office, but also in the division director roles – to overcome this deep-seated institutional resistance to reform and deliver the protections investors need and deserve.

Second, because of the constant threat of an industry legal challenge, any action the Commission takes to strengthen the regulations will need to be based on credible evidence of a market failure and sound economic analysis to identify the best available solutions to that failure. That assumption is built into the approach outlined below for moving forward on this issue. Fortunately, there is already an abundance of evidence to support that analysis in the decades-old comment file, including evidence that: conflicts of interest have a harmful impact on investors, disclosures are ineffective in addressing those conflicts, and measures to rein in conflicts result in better outcomes for investors – evidence that was largely ignored in the Reg. BI rulemaking.[6] Supplemented by additional research, as outlined below, this evidence can form the basis for a more rigorous regulatory approach that truly puts investors' interests first.

1) Clarify the Standards to Deliver Promised Investor Protections

When DOL adopted its conflict of interest rule in 2016, the news was full of reports of firms taking dramatic steps to reduce conflicts of interest in retirement accounts. These included plans to adopt so-called clean shares, which have the potential to dramatically reduce commission-based conflicts of interest, or to otherwise reduce differential compensation within

[5] Letter from Barbara Roper, CFA Director of Investor Protection, and Micah Hauptman, CFA Financial Services Counsel, to SEC Chairman Jay Clayton, Regarding the Standard of Conduct for Investment Advisers and Broker Dealers (Sep. 14, 2017), https://consumerfed.org/wp-content/uploads/2017/09/cfa-letter-to-sec-on-standard-of-conduct-rfi.pdf at 2-4

[6] Some of that evidence can be found in the many letters CFA has written to the agency on this topic over the past two decades. Links to many of those letters can be found in the Appendix to this letter. Additional evidence can be found in the comment file and economic analysis for the Department of Labor's 2016 conflict of interest rule.

and across product lines.[7] With the exception of some adjustments firms made to their product menus, however, these promising developments quickly evaporated when the Trump Administration stopped defending the DOL's conflict of interest rule in court.

We've seen no evidence of even remotely comparable changes since Reg. BI took effect. Instead, most firms seem content to make minor tweaks to their practices, confirming our suspicion that industry viewed Reg. BI as doing little more than codify existing requirements under FINRA rules. This is a predictable result of the Commission's failure to define key requirements of the rule and its not so subtle message that it wanted to avoid doing anything that might disrupt the broker-dealer business model, even at the cost of investor protection. An important first step for the Commission, therefore, is to provide the necessary clarification of these core requirements of the rule, and to do so in a way that delivers on the promise of a true best interest standard backed by real mitigation of conflicts.

a. Adopt a principles-based definition of "best interest"

The requirement to act in the customer's best interest that lies at the heart of both Reg. BI and the Advisers Act fiduciary duty has no generally accepted meaning under the securities laws.[8] For these standards to have any impact, therefore, the Commission must adopt a principles-based definition of best interest either through guidance or, if necessary to give the requirement greater weight and permanence, through rulemaking. In an April 2019 letter to then Chairman Clayton, we described what such a definition should entail.[9] We noted, for example, that while the Commission had made clear in its Rule Release that brokers were not expected to identify the single "best" option for the investor, it had failed to make clear what they *were* required to do to comply with their best interest obligations. That problem has yet to be rectified.

To correct this central failure of the rule, the Commission must emphasize, first, that the best interest obligation applies, not just to the recommendation of individual securities, but also to recommendations of investment strategies, accounts, and services.[10] Second, the Commission must make clear that, to satisfy the best interest standard, brokers must recommend the investments, investment strategies, accounts, and services that they reasonably believe are the best option for the investor from among those they have reasonably available to recommend. Furthermore, while it may often not be possible to identify a single "best" option for the customer, the pool of investments that satisfy a best interest standard in a particular situation

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[7] CFA Fact Sheet, The Department of Labor Conflict of Interest Rule is Already Delivering Benefits to Workers and Retirees: Delay Puts Those Benefits at Risk (Jan. 31, 2017), https://consumerfed.org/wp-content/uploads/2017/01/1-31-17-DOL-Rule-Delivering-Benefits_Fact-Sheet.pdf.

[8] The recently released DOL guidance provides only limited clarification on this point, though what clarification it does provides sends a generally pro-investor message. It states, for example, that "the advice must be based on the interests of the customer, rather than the competing financial interest of the investment professional or financial institution. This means, for example, that in choosing between two investments equally available to the investor, it is not permissible for the investment professional to advise investing in the one that is worse for the retirement investor because it is better for the investment professional's or the financial institution's bottom line." (p8)

[9] Letter from AFL-CIO, Americans for Financial Reform, Better Markets, Consumer Action, CFA, and PIABA to SEC Chairman Jay Clayton (Apr. 26, 2019), https://consumerfed.org/wp-content/uploads/2019/04/Clayton-Meeting-Follow-up-Letter.pdf.

[10] The Commission should apply a similar interpretation of best interest in the context of investment advice under the Advisers Act fiduciary standard, as we discuss further below.

should be significantly narrower than the large number of investments that would typically satisfy the FINRA suitability standard replaced by Reg. BI. [11]

Toward this end, the Commission should emphasize that recommendations must be based on a robust analytical process. For example, the analysis required 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. Furthermore, the Commission should 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 recommend the lowest cost option available, it would require that, before recommending a higher cost option, particularly one that pays them more, the broker would have to have a reasonable basis for doing so.[12]

The Commission will also need to further clarify how the best interest standard applies to firms that offer a more limited menu of investment options. As we discussed in our April 2020 letter to Chairman Clayton, the Commission should make clear that brokers at such firms cannot satisfy their best interest obligations by recommending the least bad option from an investment menu where all the options are poorly suited for the investor. Second, it must hold firms accountable for developing a product menu that complies with the first prong of the best interest standard, which requires that the recommended investments 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. Adopting this approach would create an incentive for product sponsors to improve their product offerings and for firms to improve their product menus, which has the potential to greatly increase investor benefits from the rule.

If the Commission were to adopt a clarification of the best interest standard along these lines, for brokers and advisers alike, we do not believe it should be necessary for the Commission to scrap Reg. BI and start from scratch with rulemaking under Section 913(g) of the Dodd-Frank Act. If, on the other hand, the Commission were to conclude that it cannot achieve the necessary clarification under either Reg. BI or the Advisers Act fiduciary standard, we would weigh these issues differently. In that case, rulemaking under Section 913(g) might be the only viable option to deliver the true best interest standard and restrictions on conflicts that investors reasonably expect when they turn to financial professionals for help with their investments.

b. Clarify how the Commission will assess the adequacy of firms' policies and procedures to mitigate conflicts of interest

The obligation under Reg. BI for firms to "mitigate" certain representative-level conflicts of interest has the potential to deliver meaningful and much needed protections against conflict-

[11] For the sake of convenience, we use the term "investments," but it should be read throughout this section to refer to investments, investment strategies, accounts and services.

[12] This approach is similar to the approach outlined in a recommendation of the SEC Investor Advisory Committee regarding proposed Regulation Best Interest. (https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-on-proposed-reg-bi.pdf)

driven recommendations, but only if the Commission is willing to enforce it effectively. Because this provision, like the best interest standard itself, is vague and undefined, the Commission will need to begin by clarifying how it will assess whether firms have adequately mitigated such conflicts. The rule requires only that firms' policies and procedures be "reasonably designed," but it doesn't provide any indication of how the Commission will determine whether firms' practices meet that standard.[13] Furthermore, we've seen no indication that, in thinking about this issue, the Commission has drawn clear distinctions among the vast array of conflicts of interest present in the broker-dealer business model – conflicts that pose very different degrees of risk to the investor and thus require very different approaches to mitigation.[14] As a result, it is not clear whether, how, or to what extent, firms will be required to make meaningful changes in their incentive and compensation practices to comply with the mitigation requirement. This is of particular concern in light of the attitude prevalent in large swaths of the industry that anything that isn't explicitly prohibited in rules is permitted.[15]

The recently released guidance from the Department of Labor provides a roadmap that the Commission can use to tackle this issue. If the SEC were to follow DOL's lead, industry would get the benefits of consistency across different account types, while investors would reap the benefits of long-overdue constraints on the toxic incentives that pervade the broker-dealer business model. As a first step, the Commission needs to be crystal clear that policies and procedures to mitigate conflicts must be reasonably designed to ensure that the broker-dealer and its associated persons at all times place the customer's interests ahead of the broker's interests.[16] For any but the most basic, unavoidable conflicts – e.g., the conflicts inherent to being compensated on a transaction-by-transaction basis – the Commission must make clear that disclosure and supervision alone would not be sufficient to satisfy the standard.[17] The more significant, complex, or opaque the conflict, the more robust those policies and procedures would need to be.

We repeatedly urged the Commission, in adopting Reg. BI and updating the Advisers Act guidance, to prohibit firms from artificially creating incentives that would reasonably be expected to undermine compliance with the best interest standard. Ideally, the Commission would now follow DOL's lead and take that step. To the extent that at least some such practices continue to be permitted, however, the burden of proof must be on the firm to show that the mitigation is sufficient to prevent the conflict from influencing recommendations in ways that would cause the investor to receive sub-optimum advice. Anything less would make a mockery of the best interest obligation that the mitigation requirement is designed to support.

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[13] The limited guidance the SEC has provided suggests that firms will be given significant discretion to determine what conflicts to mitigate and how, with little concern that the SEC will second-guess those choices.

[14] *See,* CFA, A Framework for Addressing Broker-Dealer and Investment Adviser Conflicts of Interest When Providing Retail Investment Advice, https://consumerfed.org/wp-content/uploads/2019/04/CFA-Conflict-of-Interest-Framework.pdf.

[15] See, e.g., Letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Vanessa A. Countryman regarding File No. 4-761, Rulemaking Petition to End the Commission's "Backdoor" Regulation of 12b-1 Fees (Jun. 15, 2020), https://bit.ly/3g6Jjip.

[16] The Commission should adopt a similar approach under the Advisers Act fiduciary duty, making clear that advisers are expected to avoid or mitigate conflicts that cannot adequately be addressed through disclosure alone.

[17] See the CFA Conflict Framework for examples of the limited types of conflicts that could reasonably be addressed in this manner for brokers and advisers alike.

Once it has provided clear guidance on how it will interpret the standard, the Commission, FINRA, and state securities regulators should incorporate that approach into their examinations of firms and bring enforcement actions where they find violations. We appreciate that SEC and FINRA have indicated that they will be focusing on compliance with Reg. BI in their 2021 examinations, including with regard to conflict mitigation, but we are concerned that such examinations may be focused more on whether firms are meeting the letter of the law to create policies and procedures, and less on whether, as a practical matter, they are resulting in changes in industry practices sufficient to rein in conflicts and prevent harm to investors. In determining whether practices are "harmful," the Commission should not limit its focus to practices that rise to the level of fraud, as has too often been the case in the past. It should instead focus on whether the policies and procedures truly promote recommendations that are in the best interests of the customer, as defined above. Absent such an approach, the best interest standard will remain theoretical rather than real and will only serve to mislead investors about the protections they are actually receiving.

Both because changing incentives is, in our view, the key to changing harmful conduct, and because we believe the mitigation requirement is more enforceable as a practical matter than the best interest standard itself, this may well be the most important thing the Commission can do to significantly improve the protections investors receive under Reg. BI.

c. Consider whether rulemaking is needed to provide this clarification

Our hope is that guidance would be sufficient to provide the necessary clarification, since it can be adopted more quickly than formal rulemaking. Moreover, we believe there is ample evidence to support such guidance in the existing comment file. In theory, such an approach should be supported by industry, which would benefit from clearer messages from the Commission about what is needed to comply with the standard. We are not naïve, however, and we recognize that industry support for greater regulatory clarity often only manifests itself when "clarifications" serve to weaken the regulatory requirements. We recognize, moreover, that there are additional arguments in favor of adopting any such clarification through rulemaking. In making that decision about the best procedural approach, the Commission will need to balance the need to act quickly to deliver the protections investors reasonably expect from a best interest standard against the need to ensure that the standard is enforceable and provides lasting benefits to investors. We look forward to discussing with you how to achieve the best outcome for investors.

2) Gather Evidence in Support of Additional Regulatory Changes

While issuing guidance could help to strengthen Reg. BI's protections, significant short-comings in the rules remain which clearly cannot be addressed through guidance alone. These shortcomings will require rulemaking. Some of those changes could be undertaken relatively quickly, based on the existing comment file, while others would likely require more extensive additional study to support the case for regulatory change. There are two areas, in particular, where we believe additional study would be beneficial. Regardless of any other decisions the Commission makes about how to sequence its work in this area, we urge you to set these studies

in motion immediately, as they have the potential to provide critically important evidence in support of further regulatory action.

a. Study compensation, sales, and incentive practices among broker-dealers and investment advisers

Section 913(g) of the Dodd-Frank Act directs the Commission to "examine and, where appropriate promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors." Since that law was enacted, the Commission has never conducted a comprehensive examination of these critically important issues. Although the topic was addressed peripherally in the Reg. BI rulemaking, the Commission never put the issue front and center in developing its regulatory approach.[18] Even as it gave lip service to the notion that brokers and investment advisers alike should always put the customer's interests first, the Commission refused to confront how common industry practices might conflict with that standard and undermine compliance.[19]

Working closely with FINRA and the state securities regulators, the Commission should move quickly to undertake that long-delayed comprehensive review. Particularly careful scrutiny should be given to:

- conflicts of interest that the firms themselves create to reward conduct that is profitable for the firm but that may not be in the best interests of the customer;
- conflicts of interest associated with differential compensation both within and across product lines and evidence that it may inappropriately influence recommendations;
- conflicts of interest that are particularly opaque or complex and thus difficult for investors to understand; and
- the conflicts of interest that exist both within advisory accounts at dual registrant firms and when firms have multiple account types available to recommend.

As part of this study, the Commission should also look at business models among broker-dealers and investment advisers that minimize conflicts, as well as best practices to reduce or mitigate the harmful impact of conflicts. This should go beyond the review of steps firms are taking to comply with Reg. BI, though those findings should certainly be incorporated in the Commission's analysis.

The findings of the study should inform Commission decisions about whether there are particular sales practices, conflicts of interest, or compensation schemes that should be limited or prohibited as inherently inconsistent with a best interest standard or fiduciary duty. Those decisions will inevitably be influenced by evidence that common practices to address the conflicts, including disclosure, do not adequately protect investors from the harmful impact of those conflicts. Toward that end, we also encourage the Commission to conduct a comprehensive study of disclosure effectiveness.

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[18] The Commission used this authority for its ban on product-specific, time-limited sales contests, under Reg. BI.

[19] Ultimately, the Commission adopted a watered down requirement in both Reg. BI and the Advisers Act fiduciary guidance not to place the firm's or the financial professional's interests ahead of the client's interests, all the while adamantly insisting that its intention was *not* to adopt a weaker standard.

b. Test the effectiveness of Form CRS, the ADV Form, and Reg. BI disclosures

The regulation of broker-dealers and investment advisers relies heavily on disclosure to protect investors. Between them, Form CRS, the ADV Form, and Reg. BI disclosures are supposed to enable investors: 1) to make an informed choice among different investment professionals and 2) to arm them with important facts, including information about costs and conflicts of interest, they need to protect themselves when working with an investment professional. In implementing these standards, the Commission generally assumes that disclosure in these documents results in informed consent on the part of the investor, such that practices that are not in investors' best interests, if disclosed, may nonetheless be permissible. Only rarely, for example, does the Commission bring enforcement actions against investment advisers for conduct that is not in their clients' best interests, rather than for violations of their disclosure obligations.[20]

The Commission gives all this weight to disclosure in its regulation of brokers and advisers despite overwhelming evidence, including in studies that the Commission itself initiated, that these disclosures are not effective either in supporting an informed selection among investment professionals or in arming investors to protect themselves against harmful practices.[21] The Commission ignored that evidence in developing its regulatory approach under Reg. BI. To rectify that analytical failure, the Commission should now undertake an in-depth project to test the effectiveness of these three disclosures. That research should, on the one hand, seek to determine whether and how the disclosures can be made more effective. In addition, however, and perhaps even more importantly, the testing should seek to determine the limits of disclosure as an investor protection tool. If, as we expect, the Commission identifies areas where disclosures, no matter how well designed, do not lead to informed consent, it will need to factor that evidence into its regulatory policies. That would likely require a significant rethinking of its approach to both broker-dealer and investment adviser regulation and more extensive restrictions on harmful incentives.

Such testing could, for example, provide compelling evidence of the need to limit or ban practices that are inconsistent with either the Advisers Act fiduciary duty, Reg. BI's best interest standard, or both. For example, the Commission could follow the DOL's lead by prohibiting firms from using incentive practices that artificially create conflicts of interest that wouldn't otherwise exist, such as imposing sales quotas for the sale of proprietary products or basing bonuses on the volume of proprietary products sold, paying more or otherwise providing rewards for the sale of investments that make revenue sharing payments, adopting retroactive, ratcheted

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[20] We are encouraged that some of the more recent cases brought as part of the Commission's Share Class Disclosure Initiative cited firms for best execution violations as well as disclosure violations, where the firm recommended higher-cost share classes when they had lower-cost options available. While this is an encouraging development, it would need to be greatly expanded beyond the share class context to deliver meaningful benefits.

[21] The most recent example is the RAND Corporation study on the proposed Form CRS. Although the limited testing conducted as a part of that study showed that key aspects of the disclosures were not well understood by investors, the Commission chose to ignore those findings and finalize the rule largely as is. *See,* Letter from CFA Director of Investor Protection Barbara Roper and CFA Financial Services Counsel Micah Hauptman to SEC Secretary Brent J. Fields regarding File No. S7-08-18, Form CRS Relationship Summary (Dec. 7, 2018), https://consumerfed.org/wp-content/uploads/2018/12/cfa-letter-to-sec-on-rand-crs-testing-study.pdf.

payout grids that dramatically increase conflicts as the sales representative approaches the next rung on the grid, and more. Short of an outright ban, the Commission could consider requiring far more rigorous conflict mitigation practices with regard to such conflicts, with the burden of proof on firms to demonstrate that the mitigation is adequate to prevent the conflict from tainting recommendations. In short, testing can help the Commission to determine when disclosure is effective and when a more rigorous regulatory approach is needed to protect investors.

3) Correct Weaknesses in the Rules and Guidance

There are a number of areas where we believe additional rulemaking will be needed to correct glaring shortcomings in the rules and guidance. As noted above, these include some where we believe the Commission already has all the evidence it needs to support additional rulemaking, and others where further study would be advisable to lay the groundwork for rulemaking. If you were to determine that clarification of the best interest and mitigation requirements is best addressed through rulemaking rather than guidance, as discussed above, these would clearly be our top priorities for Commission action. The following are additional areas that we view as priorities for further rulemaking.

a. Fix the Reg. BI rule provisions and Advisers Act guidance that discourage brokers from monitoring customer accounts in ongoing relationships

By categorically stating that brokers have no ongoing duty to monitor customer accounts after a recommendation is made, Reg. BI materially weakened the protections certain particularly vulnerable investors previously received in court and arbitration under state common law fiduciary standards. 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. 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 – in other words, to provide ongoing monitoring and management of the account.

In contrast, Reg. BI arbitrarily limits a broker's duty to the customer to the point of the transaction, regardless of the nature of the relationship and the extent of customer reliance on the broker's advice. With the Commission having staked out this position, courts and arbitration panels are likely to look to the rule, rather than the state common law fiduciary standard, to determine the duties a customer is owed in circumstances where the broker exercises significant control over the account. Meanwhile, 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 were successful in the past, resulting in recoveries for harmed investors, are likely to fail.

In addition to the problems with Reg. BI itself, the Investment Advisers Act guidance on "solely incidental to" at best muddies the waters and at worst actively discourages brokers from monitoring accounts in long-term relationships. Under that guidance, brokers who voluntarily

monitor customer accounts must worry about whether their activities would be deemed by the SEC to cross the line into advisory activities that are not "solely incidental to" their brokerage activities. Brokers who cross that line trigger obligations under the Investment Advisers Act. The broker remains relatively safe from regulatory consequences if they do not enter into an agreement with the customer to provide monitoring services. If they do enter into such an agreement, however, they must be careful to ensure that they do not "agree to monitor a customer account in a manner that in effect results in the provision of advisory services that are not in connection with or reasonably related to the broker-dealer's primary business of effecting securities transactions, such as providing continuous monitoring." The Commission declined "to delineate every circumstance where agreed-upon monitoring is and is not solely incidental to a broker-dealer's brokerage business," or even to provide illustrative examples.

The guidance may be motivated by a legitimate desire to ensure that brokers can't, in the guise of monitoring, cross the line into clearly advisory services without being regulated accordingly. It is ironic, however, that the Commission, which has all but erased the functional distinction between brokers and advisers in other contexts where the risks customers will be misled are far greater, would now choose to draw the line here. As we warned in our April 2019 letter to Chairman Clayton, this approach "could discourage brokers from adopting responsible monitoring practices out of concern that doing so might trigger an unwanted change in their regulatory status." Unfortunately, that warning fell on deaf ears. Since the rule was finalized, we have heard anecdotal evidence from several firms that this guidance language has had the predicted effect of discouraging firms from entering into customer agreements to provide any service to long-term customers that could reasonably be viewed as account monitoring. While it could be argued that those firms are being overly conservative in their interpretation, the guidance presents an unnecessary complication.

Fortunately, there is a straightforward fix to this problem. The Commission should undertake rulemaking to adopt a streamlined monitoring obligation for brokers that provide periodic or episodic advice in the context of an ongoing customer relationship. In developing such an approach, the Commission should draw a clear distinction between the type of continuous monitoring that is required of investment advisers who are engaged in ongoing portfolio management and the type of periodic monitoring that should be not just permitted, but required of brokers who provide periodic or episodic recommendations. In other words, the nature and extent of the broker's duty to monitor should be appropriately tailored to match the nature of the relationship and the customer's reasonable expectations. Under such an approach, brokers in long-term relationships of trust and reliance should be required to periodically (e.g., twice a year or quarterly) review the customer's account not just to determine whether additional transactions are warranted, but to make sure that the investments in the account continue to perform as intended and continue to be in the customer's best interests.

As part of the rulemaking, the Commission should also either clarify or withdraw the language in the "solely incidental to" guidance that raises the specter of Advisers Act obligations on brokers that voluntarily provide periodic account monitoring. Instead, it should make clear that it views account monitoring as a best practice that brokers are encouraged to adopt, while rulemaking is pending, in instances where the broker has de facto control over the account and state common law fiduciary standards would therefore impose an obligation to manage the

account in the best interests of the customer. In the interim, the Commission should also make clear that brokers that do not provide account monitoring cannot, consistent with Reg. BI's best interest standard, recommend products that require ongoing monitoring that the broker knows or reasonably should know the customer is not able to provide on their own.

b. Fix the Advisers Act guidance

One of the negative consequences of the Commission's decision to engage in rulemaking under Section 913(f) of the Dodd-Frank Act instead of 913(g) is that it missed the opportunity to adopt an explicit fiduciary obligation under the Advisers Act to act in the best interests of the client and without regard to the adviser's own interests. We have over the years often heard SEC officials cite the fact that the fiduciary duty under the Advisers Act is implied rather than explicit as a key reason the Commission focuses so heavily on disclosure, rather than best interests of the client or elimination of avoidable conflicts, in its enforcement actions against investment advisers. Instead of acting to address that weakness, the Commission adopted new guidance regarding the Advisers Act fiduciary duty that arguably weakens a standard that, as enforced, already fell well short of what investors have been led to expect.[22] It is essential, therefore, that in acting to shore up weaknesses in the regulation of investment professionals, the Commission focus not just on Reg. BI, but also on fixing weaknesses in its guidance regarding the Advisers Act fiduciary duty. If it acts to strengthen Reg. BI without taking comparable actions to strengthen the Advisers Act fiduciary duty, it risks creating an opportunity for regulatory arbitrage that would drive the most problematic conduct to the weakest regulatory regime.

This should start, first and foremost, with clarification that investment advisers, as fiduciaries, are required to act in their clients' best interests at all times, using a principles-based definition of best interest that parallels that discussed above for brokers under Reg. BI. In support of a standard that is designed to ensure that the client's interest always comes first, the Commission should also require investment advisers to take steps to prevent any conflicts of interest present in their business model from inappropriately influencing the advice they give in ways that would be harmful to the client. To the extent that the Commission's study of disclosure effectiveness, discussed above, demonstrates that ADV disclosure does not lead to informed consent with regard to certain more opaque or complex conflicts or other potentially harmful practices, the Commission should clarify that disclosure alone would not be sufficient to address such conflicts or permit such practices. The conflict would need to be either eliminated or subject to mitigation sufficient to prevent the conflict from inappropriately influencing the advice. As discussed above, the Commission should seriously consider, based on the findings of its study,

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[22] *See, e.g.,* Commissioner Robert J. Jackson Jr., Statement on Final Rules Governing Investment Advice (Jun. 5, 2019), https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd. ("As to investment advisers, the final guidance the majority approves today removes language from last year's proposal stating that the law 'requires an investment adviser to put its client's interests first.' The guidance suggests that a careful reading of decades-old cases reveals that we were wrong last year to say that this is the law. I disagree. Thousands of advisers who have taken pride in putting clients first for decades will be surprised to learn that, all along, the SEC has had lower expectations for their work.") See, also, Statement of Concerned Securities Law Professors Regarding Investment Advisers and Fiduciary Obligations, The CLS Blue Ski Blog (Jun. 25, 2019), https://clsbluesky.law.columbia.edu/2019/06/25/statement-of-concerned-securities-law-professors-regarding-investment-advisers-and-fiduciary-obligations/.

whether certain practices are inherently inconsistent with a fiduciary duty and initiate rulemaking to limit or ban any such practices.

We are also concerned that guidance adopted by the Commission made it too easy for investment advisers to contract out of their fiduciary obligations in ways that deprive investors of protections they reasonably expect. Here again, we doubt that disclosure of these limitations reliably leads to informed consent. We encourage you to revisit that approach in updating the standard.

We are not, at this time, recommending that the Commission completely withdraw its guidance on the solely incidental to exclusion from the Advisers Act, even though we continue to believe it is based on an erroneous interpretation of the statute.[23] Solely incidental to does not mean "in connection with and reasonably related to," as the Commission has suggested, and the Commission's adoption of this incorrect interpretation has over the years been responsible for a harmful blurring of regulatory lines between investment advisers and broker-dealers. On the other hand, unless the Commission were to dramatically strengthen its interpretation and enforcement of the Advisers Act fiduciary duty, narrowing the Advisers Act exemption could have the perverse effect of weakening requirements that apply to conflicts of interest. Properly implemented, Reg. BI's mitigation requirement actually has the potential to provide more meaningful limits on conflicts of interest than the Commission has traditionally been willing to impose on investment advisers. Instead of focusing on narrowing the solely incidental to exception, therefore, we believe the Commission's time would be better spent working to ensure that both Reg. BI and the Advisers Act fiduciary standard meet investors' reasonable expectations by incorporating a true best interest standard and meaningful limits on conflicts.

c. Fix the disclosures

Both Form CRS and the Reg. BI conflict disclosures are in need of a major overhaul if they are to meet the most basic requirements of effective disclosure – providing the information investors need, in a form they can understand, at a time when that information is useful to them. The disclosures currently fail on all three counts. We believe that, by engaging in disclosure effectiveness testing and working with plain English disclosure experts, the Form CRS could be turned into an at least moderately useful document. The same cannot be said for the Reg. BI cost and conflict disclosures, in our opinion. While we will withhold final judgment until testing can be conducted, our strong impression is that an honest appraisal of the Reg. BI disclosures will force the Commission to confront the impossibility of developing disclosures that effectively convey information about conflicts in a way that typical investors can and will put to good use. At the very least, if the goal is for the Reg. BI disclosures to be read and understood, we believe it would require an entirely different approach to content, format, timing, and delivery than the Commission has adopted under the current rules. The ADV Form, meanwhile, falls somewhere in the middle, functioning reasonably well for advisory firms with relatively straightforward business models and a commitment to clear disclosure, but all but useless when it comes to firms with more complex and pervasive conflicts which they wish to obscure.

[23] The one exception, as we noted above, is that we strongly urge the Commission to withdraw the harmful language in the "solely incidental to" guidance regarding the potential for brokers who voluntarily provide account monitoring to trigger obligations under the Advisers Act.

Though it is deeply flawed, we do not believe Form CRS is a completely hopeless case. Moreover, we still believe an abbreviated, plain English disclosure document for brokers and advisers has the potential to deliver at least modest investor benefits. While disclosure testing and work with a plain English disclosure expert is necessary to identify all the ways in which the Form CRS could be improved, the need for certain types of changes is, in our view, already evident.

- Timing: Form CRS is supposed to assist investors in making an informed choice among different types of investment professionals. But brokers can delay providing the document until account opening – after the relevant decision about who to work with has already been made. To serve the intended purpose, Form CRS should have to be provided at or immediately following the earliest point of contact with a prospective client.
- Format: Because the Commission imposed an arbitrary page limit on the forms, even firms that want to make the CRS visually appealing may struggle to do so. Many of those we've reviewed are all but unreadable, in part, but not entirely because of the space limitations. While still working to keep the disclosures short, we encourage the Commission to consider expanding the permissible length at least modestly, reducing the required content, or some combination of the two. The Commission should also do more to require the information to be presented in a visually appealing way and provide guidance on how that goal is to be achieved.
- Language: In many of the forms we've reviewed, the key information is presented in language that we believe few investors would fully understand. The limited testing that was done by us and others validates that concern. Based on the results of the added comprehensive testing we are recommending the Commission undertake, the Commission staff should work with plain English disclosure experts to arrive at descriptions of key issues – such as the differences between brokerage and advisory services, the differences in the standard of conduct for brokers and advisers, and the potentially harmful impact of conflicts of interest – in language typical investors are likely to understand.
- Disclosure of Services Offered: We are concerned that the disclosures don't clearly differentiate between brokerage services and advisory services. This appears to derive largely from the Commission's apparent reluctance to describe brokerage services as what they are – sales recommendations. If the Commission insists on maintaining distinctly different regulatory regimes and standards for brokers and advisers, on the grounds that they offer distinctly different services, it must at least be willing to give investors the information they need to differentiate between those services. (Of course, unless the Commission also restricts brokerage firms' ability to portray their services as advisory services, even dramatically improved disclosure in the Form CRS is unlikely to be sufficient to prevent investors from being misled. On the other hand, if the Commission were at least to clarify the Form CRS disclosures, they should no longer actively contribute to that confusion.)
- Disclosure of the Standard of Conduct: We are particularly concerned that the prescribed language regarding the standard of conduct for brokers and advisers in Form CRS obscures rather than clarifies important differences between the two standards. These differences include important matters, such as when and to what the standard applies (the

entire relationship versus on a transaction-by-transaction basis), what is required with regard to conflicts of interest (mitigation versus disclosure), and whether it includes a duty to monitor the account.

While we believe modest but important improvements can and should be made to Form CRS, we do not believe even the best designed disclosures can carry the full weight of responsibility currently attached to these disclosures under the securities laws. In particular, we remain unconvinced that disclosures regarding conflicts of interest in Form CRS, the ADV Form, or Reg. BI disclosures will ever be sufficiently clear regarding the magnitude and effect of conflicts of interest to enable investors to protect themselves against their potentially harmful impact. Unless the Commission can provide evidence that such disclosures are an effective means of investor protection, we believe it will need to rethink its heavy reliance on disclosure for this purpose. In place of disclosure, it will need to consider much tighter restrictions on the harmful incentives that undermine compliance with the best interest obligation under both Reg. BI and the Advisers Act fiduciary duty. We recognize, however, that such a significant change in the Commission's regulatory approach can only be adopted on the basis of sound and compelling evidence, which is why undertaking the studies outlined above is such a pressing priority.

Conclusion

For decades, the Commission has failed to live up to its central investor protection mission when it comes to the regulation of broker-dealers and investment advisers. You have an opportunity to correct that failure, and we urge you to do so. It is, in CFA's view, the most important step you can and should take to protect the interests of millions of financially unsophisticated individuals who turn to the markets to save for retirement or other important life goals and desperately need advice they can trust to navigate those decisions. CFA stands ready to do whatever we can to assist you in this effort.

Sincerely,

Barbara Roper
Director of Investor Protection

cc: The Honorable Hester Peirce, Commissioner
The Honorable Allison Herren Lee, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner

Appendix A: Letters to the SEC Regarding the Standard of Conduct for Broker-Dealers and Investment Advisers

CFA has written to the Commission repeatedly over the years urging it to strengthen the standards that apply to broker-dealers and investment advisers when they provide advice and recommendations to individual investors. The following are some of those letters. Between them, they should help to document the importance of the issue for typical, financially unsophisticated investors and the failings in the Commission's long-standing regulatory approach, and provide concrete suggestions for a pro-investor reforms.

Letter from Barbara Roper, CFA Director of Investor Protection, to Securities and Exchange Commission Chairman Arthur Levitt, urging him to strengthen regulation of broker-dealers' investment advice, October 1999, http://bit.ly/2eXC5T4.

Letter from Roper to SEC, commenting on fee-based brokerage account rule proposal, January 2000, http://bit.ly/2eMqEhg.

Letter from Roper to SEC, commenting on a renewed proposal to adopt a fee-based brokerage account rule, September 2004, http://bit.ly/2wZ3xHw.

Letter from Roper to SEC Chairman William Donaldson, rebutting SIA arguments regarding the fee-based brokerage account rule and offering a pro-investor alternative, October 2004, http://bit.ly/2vVbiKP.

CFA comment letter challenging the SEC's interpretation of solely incidental to exemption for broker-dealers, including its mischaracterization of the legislative history on which that interpretation is based, February 2005, http://bit.ly/1T6xNS2.

Letter from Fund Democracy, CFA, Consumers Union and Consumer Action to SEC, commenting on the revised fee-based brokerage account rule proposal, February 2005, http://bit.ly/2xc8M7i.

Letter from CFA and Fund Democracy to SEC Chairman Christopher Cox, challenging the staff interpretation of the applicability of the Investment Advisers Act to financial planning services offered by broker-dealers, February 2006, http://bit.ly/2xQ5l36.

Letter from Roper to SEC, commenting for the staff study regarding the standard of conduct for broker-dealers and investment advisers, August 2010, http://bit.ly/2f7gcBf.

Letter from Roper to SEC, commenting on the RFI on the standard of conduct for broker-dealers and investment advisers, July 2013, http://bit.ly/2veGjfw.

Letter from AARP, CFA, Fund Democracy, CFP Board of Standards, Financial Planning Association, and NAPFA in response to the Request for Information regarding the standard of conduct for broker-dealers and investment advisers (with a particular focus on evidence of investor harm), April 2014, http://bit.ly/2gPXyhx.

Letter from Roper and CFA Financial Services Counsel Micah Hauptman to SEC Chairman Jay Clayton in response to his request for comment on the Standard of Conduct for Investment Advisers and Broker-Dealers, September 14, 2017, https://bit.ly/3fPX6fS.

Letter from Roper and Hauptman to SEC Chairman Clayton urging him to investigate potential rule violations related to broker firms' implementation of the DOL fiduciary rule with regard to recommendations of fee accounts, October 3, 2017, https://bit.ly/3t3rneP.

Letter from Roper and Hauptman to SEC Chairman Clayton responding to misleading arguments in industry comment letters, March 15, 2018, https://bit.ly/3fT6HlX.

Letter from two dozen organizations to SEC Chairman Clayton urging him to delay the comment deadline for the proposed Regulation Best Interest and Customer Relationship Summary until 90 days after testing results are made public, May 21, 2018, https://bit.ly/3fUMCM3.

CFA comment letter (from Roper and Hauptman) on proposed Regulation Best Interest, Form CRS Customer Relationship Summary, and Commission Interpretation Regarding Standard of Conduct for Investment Advisers, August 7, 2018, https://bit.ly/3mwR6dh.

Letter from AARP, CFA, and the Financial Planning Coalition to Chairman Clayton on results of independent usability testing of proposed Form CRS, September 12, 2018, https://bit.ly/323ZG9L.

CFA comment letter (from Roper and Hauptman) to SEC Secretary Brent J. Fields, urging the agency to delay Reg. BI finalization in wake of RAND Study, December 7, 2018, https://bit.ly/3uyec5Z.

Letter from AFL-CIO, Americans for Financial Reform, Better Markets, Consumer Action, Consumer Federation of America, and PIABA to SEC Chairman Clayton detailing necessary changes to the Commission's proposed regulatory approach under Reg. BI, Form CRS, and the Advisers Act guidance, April 26, 2019, https://bit.ly/2Rj7Nxj.

Statement of CFA Director of Investor Protection Barbara Roper Regarding SEC Adoption of Anti-Investor Advice Standards for Brokers and Advisers, June 5, 2019, https://bit.ly/2QapPB3.