Statement of Micah Hauptman
On behalf of the Consumer Federation of America
To the New Jersey Division of Consumer Affairs, Bureau of Securities
November 2, 2018

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

In an ideal world, we would not be having this conversation. The DOL rule would still be in effect, providing strong protections to retirement savers, and the SEC and state insurance regulators would be putting the finishing touches on rules to match those protections for non-retirement accounts.

But that is not where we find ourselves today.

- The DOL rule was struck down by the 5th Circuit and the Trump Administration refused to continue to defend the rule.
- Instead of stepping in to fill the void after the DOL rule was struck down, the SEC has proposed a rule that presents a host of problems.[1] It fails to create a uniform fiduciary standard for investment advice offered by brokers and investment advisers. Instead, it relies on disclosures to enable investors to distinguish between the two standards, which past experience tells us they will not be able to do and which recent testing confirms is ineffective.[2] In addition, the "best interest" standard is vague and undefined and, depending on how it is interpreted, could do little more than rebrand the existing FINRA suitability standard as a best interest standard. At worst, it could actually weaken the protections investors currently receive.
- The NAIC model suitability for annuity transactions proposal is weaker still.

We, therefore, greatly appreciate states, such as New Jersey, that have been willing to look at ways they can step in to fill the void by providing investors with the protections they need and deserve.

The two main points I'd like to focus on today are why it is entirely appropriate to apply a fiduciary duty to brokers' and advisers' investment advice and what that fiduciary duty should entail.

[1] *See* Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, Regulation Best Interest, August 7, 2018, https://bit.ly/2CS6DQ1.
[2] Press Release, CFA, "Independent Testing Shows SEC's Proposed Customer Relationship Summary Form May Add to Investor Confusion," (September 12, 2018), https://bit.ly/2Mv4efu.

1. **First, as background, you should be aware that the broker-dealer industry[3] has become accustomed to presenting inconsistent arguments on this issue, depending on what will be most expedient for them before their particular audience.**

   - According to their ***legal* position** — which the 5th Circuit panel endorsed in the DOL fiduciary litigation — SIFMA, FSI, and their allies claimed that brokers are mere salespeople, with no relationship of trust and confidence with their customers, no different from other commercial sales relationships, in which both parties understand that they are acting at arms-length. They even likened themselves to car dealers.[4]
   - According to their ***public relations* position,** however —shared by virtually every broker-dealer in their marketing materials — they are "trusted advisors" who provide investors with a "pay as you go" advice model. In other words, they say they are just different types of advice providers who get paid in a different way from investment advisers.[5]

These positions are plainly inconsistent. By presenting different arguments to different audiences, broker-dealer and insurance firms have been able to achieve their regulatory and business objectives, reaping all the benefits of being advice providers who are in positions of trust and confidence with their clients, without any of the responsibilities that are appropriate to their advisory role.

2. **Despite their legal arguments to the contrary, broker-dealer and insurance firms hold themselves out as trusted investment advice providers and seek to foster relationships of trust and confidence, which is the hallmark of a fiduciary relationship at common law. Applying a fiduciary duty to these relationships is entirely appropriate given their advisory role.**

There are myriad ways in which brokers and insurers seek to persuade the investing public that they are providing trusted investment advice. For example, they routinely market themselves as "financial advisors," "financial consultants," or "wealth managers," giving the impression of specialized advisory expertise. They commonly describe their services as "investment advice" or "retirement planning" and market those services as designed to serve customers' best interests. In holding out as impartial experts, they seek to occupy positions of trust and confidence with their customers.

Here are just a few examples of firms' marketing materials supporting the conclusion they function as "trusted advisors."[6]

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[3] The insurance industry makes the same arguments.

[4] *See* Brief for Chamber of Commerce, SIFMA, FSI, *et al*., *Chamber v. DOL*, In the United States Court of Appeals for the Fifth Circuit, On Appeal from the United States District Court for the Northern District of Texas, Case Number 17- 10238, at 1, http://bit.ly/2f4wVBW ("The DOL seeks to…erase universally recognized distinctions between salespeople and fiduciary advisers…"); *Id*. at 41 ("A broker, insurance agent, or other financial-sales professional may make 'individualized solicitations much the same way a car dealer solicits particularized interest in its inventory.'") (internal cites omitted).

[5] *See* Micah Hauptman and Barbara Roper, *Financial Advisor or Investment Salesperson? Brokers and Insurers Want to Have it Both Ways*, CONSUMER FEDERATION OF AMERICA, January 18, 2017, http://bit.ly/2jKUbFD.

[6] Many insurers engage in the same type of marketing.

- D.A. Davidson states: "**Trust** is the cornerstone of the relationship between you, as an investor, and the D.A. Davidson & Co. financial professionals working for you. Your needs should **always come first**."[7]
- Mass Mutual states: "Join millions of people who place their **confidence and trust** in us."[8]
- Raymond James states: "[I]t's developing a long-term relationship built on understanding and **trust**. Your **advisor** is there for you throughout the **planning** and investing process, giving you **objective and unbiased advice** along the way."[9]
- Schwab states: "A relationship you can **trust**, close to home."[10]
- UBS states: "The UBS Wealth Management Americas approach is based on the **trusted relationship** of our Financial **Advisors** and their clients. Our experienced **Advisors** are committed to understanding clients' needs and delivering insightful, informed **advice** to help them realize their dreams."[11]

These and other firms' marketing materials are devoid of any prominent reference that indicates they are mere salespeople engaged in arms' length commercial transactions.

And let's look at how SIFMA characterizes brokers in the press. SIFMA's CEO Kenneth Bentsen recently stated that, "there is no evidence that the advice an investor would receive [from a broker versus adviser] would differ either in kind or quality."[12] Bentsen's rhetoric claiming that brokers are advisers too and brokers' advice is no different from fiduciary advisers' advice is plainly inconsistent with SIFMA's legal argument, that brokers are mere salespeople pushing products.

Or FSI, which states that they advocate "on behalf of independent financial advisors…so they can provide affordable, objective financial advice to hard-working Main Street Americans."[13] That doesn't sound like they're salespeople just like car dealers.

The industry's marketing campaign to blur the line between product sales and investment advice has unquestionably "succeeded." After decades of being told they should trust their "financial advisor" to put their interests first, the majority of investors are unable to determine whether their own financial professional is a salesperson or a true advisor or whether the service being offered constitutes mere investment sales or fiduciary investment advice. Survey after survey has shown that investors do not distinguish between the sales recommendations they receive from broker-dealers and insurance agents and the advice they receive from fiduciary advisers.[14]

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[7] D.A. DAVIDSON, Your Rights, https://bit.ly/2ADEM4B (last visited August 21, 2016) (emphasis added).
[8] MASS MUTUAL, https://bit.ly/1LKF5YF (last visited August 21, 2016) (emphasis added).
[9] Raymond James, Why a Raymond James Advisor, https://bit.ly/2qheDme (last visited April 4, 2018) (emphasis added).
[10] SCHWAB, Find a Branch, https://bit.ly/2yIk81Y (last visited August 21, 2016) (emphasis added).
[11] UBS, About Us, https://bit.ly/2caSp1Q (last visited August 21, 2016) (emphasis added).
[12] Kenneth Bentsen, SIFMA CEO, *Is it Time to Adopt a Uniform Fee-Only Standard for Financial Advice?*, WALL STREET JOURNAL, March 18, 2018, https://on.wsj.com/2CSQObK.
[13] Letter from David T. Bellaire, FSI, to the DOL, Regulatory Definition of the Term "Fiduciary" as it Relates to Investment Advice, July 21, 2015, https://bit.ly/2qmmf74.
[14] *See, e.g.*, Angela A. Hung, et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, Rand Corporation, Sponsored by the United States Securities and Exchange Commission (January 2008) https://bit.ly/2LSDOsr; 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

And recent research shows that, when asked if their financial professional is a broker-dealer or investment adviser, the majority of investors state that they believe their financial professional is an investment adviser, with only a small minority stating that they are a broker-dealer.[15] The odds that this is actually the case are extremely remote. These findings are consistent with the views that investors have shared with us. They seek out financial professionals because they know their own limitations, they depend on their financial professional's expertise and rely on it, and they trust that the advice they receive will be in their best interest, untainted by conflicts of interest. In short, investors reasonably expect and believe that they are in advisory relationships of trust and confidence, regardless of whether they work with a broker-dealer or an investment adviser.

This isn't the result of merely being confused about a complex marketplace. It's the result of actively being misled by the industry. The industry's desire to market themselves as trusted advisors is understandable. Clearly, if they portrayed themselves as mere salespeople engaged in arms' length sales transactions, they wouldn't be nearly as effective at attracting clients.

The harm to investors is immense when they reasonably, but mistakenly believe they are getting advice that's in their best interest based on a trusted relationship with their advisor. In addition to paying higher costs, investors who rely on biased sales recommendations as if it were unbiased advice can end up facing unnecessary risks or receiving substandard returns as a result of incentives that pervade the compensation system for sales-based financial professionals. Cumulatively, these industry practices drain tens of billions of dollars every year out of investors' pockets and into the pockets of firms and their financial professionals. According to one study, New Jersey IRA investors alone lose approximately $610 million a year as a result of conflicted advice.[16] The results are even larger when considering all accounts and the full range of products sold within accounts.

3. The Securities Bureau should crack down on firms' and financial professionals' dishonest and unethical business practices.

To the extent broker-dealers misrepresent their sales representatives as advisers and their arm's length sales recommendations as advice that should be trusted and relied upon, it is incumbent upon the Securities Bureau to hold firms and individuals accountable for engaging in these dishonest or unethical business practices. Thus, we suggest a framework that requires firms or financial professionals who consider themselves to be in an arm's length sales relationship to hold out in a way that makes it abundantly clear that that's the service they are providing. They should not to be able to hold out in any way that would suggest to a reasonable person that they are an advice provider who would occupy a position of trust and confidence. This includes using titles or describing their services in ways, as described above, which convey to a reasonable person that the firm or financial professional is in a position of trust and confidence. If they do hold out in any

(March 10, 2005) https://bit.ly/1MkdujW; Infogroup/ORC, U.S. Investors & The Fiduciary Standard: A National Opinion Survey (September 15, 2010) https://bit.ly/2PzpF4g.

[15] *See* Brian Scholl, Office of the Investor Advocate and Angela A. Hung, RAND Corporation, The Retail Market for Investment Advice, submitted to the SEC, October 12, 2018, https://bit.ly/2PwCPz8.

[16] Heidi Shierholz and Ben Zipperer, *Here is what's at stake with the conflict of interest ('fiduciary') rule*, ECONOMIC POLICY INSTITUTE, May 30, 2017, https://bit.ly/2EQJ9gE.

way that suggests they are an advice provider who occupies a position of trust and confidence without complying with the fiduciary appropriate to their role, their activity should be deemed a dishonest and unethical business practice.

A fiduciary relationship arises at common law where there is a special relationship of trust and confidence between the parties.[17] As discussed above, brokers hold themselves out and function as "trusted advisors" whose only concern is their clients' best interest. Therefore, to the extent brokers continue to hold out and function as advice providers who occupy positions of trust and confidence with their clients, they should be subject to a fiduciary duty appropriate to their role.

Under this framework, using titles, such as advisor, consultant, wealth manager, and other similar titles would *per se* convey to a reasonable person that the firm or financial professional is in a position of trust and confidence. Similarly, referring prominently to one's services as advice or planning or otherwise suggesting that advice is the primary service being provided would *per se* convey to a reasonable person that a firm or financial professional is in a position of trust and confidence. The same would hold true for firms that describe the relationship as one of trust or use other terms to convey the same concept.

4. The specific formulation of the fiduciary standard of conduct is critical.

At common law, a fiduciary duty includes both a duty of care to act with prudence and a duty of loyalty to refrain from engaging in self-dealing.

In our view, the duty of care should be defined as "advice that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the client." This formulation is the same standard that the DOL used in its Best Interest definition, and it's consistent with the common law application of the duty of care.

The duty of loyalty should be defined as "advice that is made without regard to the financial or other interests of the broker-dealer, agent, investment adviser, or their affiliated entities." This is also the same formulation that the DOL used in its Best Interest definition, which in turn came directly from the standard Congress identified in section 913(g) of the Dodd-Frank Act as the appropriate standard for a uniform fiduciary rulemaking. Thus, this approach to raising the standard would be more faithful to the framework that Congress intended than the one the SEC has proposed. In enforcing this standard, it's critical that the fiduciary duty be interpreted as requiring the person making the recommendation to recommend, from among those they have reasonably available, the product or products that are best for the investor.

In addition to getting the standard of conduct right and giving it real meaning, it is critical to reinforce that standard with strong anti-conflict requirements. In other words, firms must be

[17] The SEC recognizes in its Regulation Best Interest proposal that states have authority to apply a common law fiduciary duty to brokers, stating, "a broker-dealer may have a fiduciary duty under certain circumstances. This duty may arise under state common law, which varies by state." Proposed Regulation Best Interest, SEC, 83 Fed. Reg. 21640, 21641 (May 9, 2018), https://bit.ly/2qkPFSQ.

required to rein in the use of harmful incentives that encourage and reward bad advice. This includes cracking down on the use of sales contests, trips, bonuses, and quotas for meeting certain production requirements, for example, or to favor the sale of products and services that are most profitable for the firm, rather than those that are best for the customer. To be meaningful, the standard must not allow firms and financial professionals merely to disclose conflicts of interest in order to satisfy the duty of loyalty. There is simply no evidence that disclosure is effective in protecting investors from the harmful impact of conflicts.

5. The Securities Bureau should work with the Banking and Insurance Department to strengthen protections for investors when they receive recommendations to purchase annuities and other insurance products with an investment component.

One area where even the best of SEC rules would have a very limited impact is on the insurance market. This is because the SEC has no authority to regulate non-securities and exempt-securities, despite the fact that insurance products are often sold as investments. Moreover, these products can have very harmful features and be sold subject to particularly acute conflicts of interest.[18] Unfortunately, but predictably, following the *vacatur* of the DOL fiduciary rule, there's been a recent surge in annuity sales,[19] sales that likely would not pass muster under a rigorous best interest standard. We would therefore urge the Securities Bureau to work with the Banking the Insurance Department to apply the same strong fiduciary standard to recommendations of annuities and other insurance products that include an investment component. It would be particularly important in the insurance context to require firms to eliminate harmful practices — such as product specific sales contests — that encourage recommendations that are not in the consumer's best interest. While these practices are already largely restricted under FINRA rules,[20] they are all-too-common in the insurance markets.

Conclusion

Thank you again for allowing me to speak to you today. We would welcome the opportunity to work with you in any or all of these areas, and we greatly appreciate your willingness to consider an expanded role for New Jersey on an issue that is, in our view, the single most important gap in investor protection facing retail investors today.

[18] *See* Letter from Barbara Roper and Micah Hauptman, CFA, to the DOL, Fiduciary Rule Examination, April 17, 2017, https://bit.ly/2mZITzQ (Section IV summarizing existing and new research regarding harmful practices in the annuity market).
[19] Ben Eisen and Lisa Beilfuss, *Steak Dinner and Annuities: Retirement Product Surges After Fiduciary Rule's Demise*, WALL STREET JOURNAL, October 27, 2018, https://on.wsj.com/2OYAOMy.
[20] *See, e.g.*, FINRA Rule 2320(g)(4) (Variable Contracts of an Insurance Company); FINRA Rule 2341 (Investment Company Securities); FINRA Rule 2310(c) (Direct Participation Programs).