August 7, 2018

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Proposed Rule, Regulation Best Interest, File Number S7-07-18, 83 Fed. Reg. 21574 (May 9, 2018)

Dear Mr. Fields:

We appreciate the opportunity to comment on the proposal captioned above ("Proposal," "Release," or "proposed rue").[1] The Commission deserves credit for finally attempting to establish better protections against the powerful conflicts of interest that influence so many advisers and take a huge financial toll on investors, amounting to tens of billions of dollars in lost savings every year. This as a long overdue effort that has the potential to produce one of the most significant investor protection enhancements in decades, re-establishing the Commission as a true champion of the millions of everyday Americans who depend on a strong regulator to safeguard them from fraud, abuse, and conflicts of interest among those who provide investment advice.

Unfortunately, the Proposal is so flawed that it threatens to do more harm than good. It is portrayed as a rule that would require all broker-dealers[2] ("brokers") recommending securities investments to act in the best interest of their clients. In reality, it would establish a much weaker standard, one that is almost indistinguishable from the familiar and ineffective suitability requirement that has governed brokers for years. As a result, investors will continue to suffer huge losses from adviser conflicts of interest. Worse, brokers will be positioned to reassure their clients that they are **required** to serve their best interest, thus misleading them into a false sense of trust and security and compounding rather than solving the threat posed by adviser conflicts of interest.

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] In this letter, the term "broker" refers to brokers, dealers, and natural persons who are registered representatives of broker-dealers, unless the context indicates otherwise.

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This outcome is especially difficult to justify in light of the history and context. The Commission has known for many years that brokers take advantage of their clients when giving them investment advice under the suitability standard. Numerous persuasive studies—one conducted by the Commission's own staff—have confirmed the abuses taking place and have urged the Commission to address the problem by imposing a strong and uniform fiduciary standard on all advisers. Nearly a decade ago in the Dodd-Frank Act,[3] Congress actually gave the Commission explicit authority to implement that standard. And the Department of Labor ("DOL") even forged a navigable path, not only demonstrating the quantifiable and enormous financial toll that conflicts take on investors but also developing a strong best interest standard that protects investors while preserving the broker-dealer business model.

The Commission has now acted, yet virtually every aspect of the Proposal is flawed in some significant respect. We urge you to thoroughly revise and strengthen the Proposal so that it can offer real relief to the millions of Americans constantly subjected to adviser conflicts of interest that eat away at their savings, degrade their quality of life, and dim their prospects for a better standard of living. Unless the Commission can radically improve upon the Proposal in the ways identified below, it will be vulnerable to a legal challenge, as it currently fails to meet basic requirements under the Administrative Procedure Act.

OVERVIEW OF THE PROPOSAL

The Proposal sets forth a general standard of conduct for brokers, and then lays out three requirements that will satisfy that general standard.

The Proposal generally provides that a broker making a securities recommendation "shall act in the best interest of the retail customer at the time the recommendation is made, without placing the . . . interest of the broker . . . ahead of the retail customer."[4] Then it states that this "best interest obligation" will be fully satisfied if the broker complies with three duties relating to disclosure, care, and conflicts of interest. Those three provisions would require the broker, in summary, to:

(1) reasonably disclose information about the scope and terms of the relationship and the material conflicts of interest associated with the recommendation (the "Disclosure Obligation");

(2) exercise reasonable diligence, care, skill, and prudence to (a) understand the risks and rewards associated with the recommendation and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (b) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that customer's investment profile and the potential risks and rewards associated with the recommendation; and (c) have a reasonable basis to believe that a series of recommended transactions, even if in the customer's best interest when viewed in isolation, is not excessive and is in the best

[3] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 913, Pub. L. 111-203, 124 Stat. 1376 (codified in scattered sections of 15 U.S.C.).

[4] Release at 21681.

interest of the customer when taken together in light of the retail customer's investment profile (the "Care Obligation"); and

(3) establish, maintain, and enforce written policies and procedures reasonably designed to (a) identify, and at a minimum disclose or eliminate, all material conflicts of interest associated with the recommendation; and (b) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with the recommendation (the "Conflict of Interest Obligation").[5]

The Release explains that the Proposal would improve investor protection and the regulation of broker recommendations in "four key ways," since it would, in summary:

(1) foster retail customer awareness and understanding;

(2) enhance securities law provisions by establishing an express care obligation that goes beyond existing suitability obligations and cannot be satisfied by disclosure alone;

(3) enhance the disclosure of conflicts of interest, thereby helping clients evaluate recommendations from brokers;

(4) require mitigation, not just disclosure, of some conflicts of interest (those arising from financial incentives associated with a recommendation).[6]

In fact, the Proposal falls short of these goals and what it should actually be: a uniform fiduciary duty that requires brokers and all advisers always to act in the best interest of their customers without regard to the financial or other interest of the broker, dealer, or investment adviser.

SUMMARY OF COMMENTS

I. THE PROPOSAL IS MARKED BY A NUMBER OF PERVASIVE WEAKNESSES IN THE OVERALL APPROACH THAT THE COMMISSION ADOPTED.

A. The Commission acknowledges the widespread existence of adviser conflicts in theoretical terms, but it fails to reflect a genuine appreciation of the scope and scale of the resulting harm to millions of investors, amounting to tens of billions of dollars a year in lost savings.

B. The Proposal recounts an extensive regulatory and legislative history clearly pointing the way to a stronger and more unified approach, but it expressly rejects this background in crafting the proposed rule, opting instead to rely on the narrowest possible authority in the Dodd-Frank Act.

5 Release at 21682.
6 Release at 21585.

C. The Commission's approach seeks above all else to protect and preserve the broker-dealer business model, not protect investors. The Commission conformed the Proposal to the broker business model, rather than requiring brokers to conform their practices to standards of conduct that would best serve investors. This betrays the Commission's core duty which is to protect investors, not protect or promote any particular industry model. Nor is the Commission's compromised view of its regulatory role even necessary. There is no reason why the broker commission-based model cannot thrive under a true best interest or fiduciary standard.

D. The Proposal relies far too much on disclosure, which offers at best limited protections for investors and consumers. Here the challenge is especially great, since the underlying reality—different standards of care and loyalty imposed on the same advisory conduct—is so inherently confusing. Yet the disclosure requirements in the Proposal are weak by design. And even if they were vastly better, they could never substitute for a strong, affirmative best interest or fiduciary standard—which is absent from the Proposal.

E. The Proposal affords too much discretion to the industry in the manner of compliance with already vague requirements. For decades, many brokers dispensing investment advice have intentionally taken advantage of their clients by recommending high-cost, high-risk, and low-performing investments that enrich the adviser at the client's expense. The practice is deeply engrained and deeply profitable. It is therefore fundamentally unrealistic to expect that the brokers subject to the Proposal will use their broad discretion in a way that effectively neutralizes those conflicts of interest and maximizes investor protection.

II. THE PROPOSAL HAS SPECIFIC DEFECTS THAT WILL RENDER IT OF LITTLE VALUE IN PROTECTING INVESTORS.

A. The Commission has expressly elected not to adopt a uniform fiduciary duty applicable to all advisers—brokers and investment advisers alike—who recommend securities investments to their clients. The Proposal does not even constitute a genuine best interest standard. The Release makes clear that the reference to "best interest" has no meaning apart from the three limited constituent duties set forth in the Proposal. They amount only to the familiar suitability standard tweaked with some disclosure requirements and a duty to mitigate—never eliminate—some but not all material conflicts of interest.

B. The specific "disclosure obligations" set forth in the Proposal will be especially ineffective due to their timing; the requirement of only reasonable, not full and fair, disclosure; the broad discretion brokers will have when deciding how to comply; and the powerful and continuing incentives brokers will have to minimize their effectiveness.

C. The "Care Obligation" in the Proposal adds virtually nothing to the traditional suitability standard. Although it contains a reference to the new "best interest" test, that standard as framed in the Proposal is too weak to add significant value.

D. The "Conflict of Interest" obligation only requires brokers to establish policies and procedures focused primarily on disclosure. This aspect of the Proposal is flawed because (1) it relies too much on process, omitting any affirmative requirements to address conflicts of interest directly and instead requiring only the establishment of policies and procedures; (2) the required policies and procedures focus too much on disclosure and in some cases mitigation, without ever requiring the elimination of any conflicts of interest, no matter how intense; and (3) in keeping with the overall approach in the Proposal, it affords far too much discretion to brokers to determine how to comply with the "Conflict of Interest" obligation.

E. The Proposal includes other gaps that can and should be closed.

1. The Proposal should protect institutional as well as retail investors.
2. The Proposal must narrowly circumscribe the exceptions for a "continuing duty of care."
3. The Proposal should cover recommendations as to the type of account.

III. THE ECONOMIC ANALYSIS IN THE PROPOSAL IS DEEPLY FLAWED.

A. The ECCF analysis is incomplete and in some respects misguided. It fails to acknowledge the pre-eminent duty of the SEC to protect investors; it fails to acknowledge the deleterious economic impact of adopting such a weak standard for brokers that is not commensurate with an investment adviser's duty; and it construes some potential economic effects of the Proposal as negatives, when in reality they are positives. It is clear that a stronger rule would further advance efficiency, competition, and capital formation.

B. The cost-benefit analysis is flawed in that it fails to recognize the scale of the problem it must address; it fails to apply equal rigor to the assessment of costs and benefit; and it mischaracterizes some of the costs and benefits of the Proposal.

IV. THE PROPOSAL MUST CLARIFY AND EXPAND INVESTORS' PRIVATE REMEDIES FOR VIOLATIONS OF ANY FINAL RULE.

A. The Commission should expressly affirm FINRA's current approach, which bans the use of waiver clauses abolishing an investor's right to participate in a class action. The Commission should go further in any final rule and exercise its authority under the Dodd-Frank Act to ban the use of mandatory arbitration clauses, whether they govern individual or class actions.

B. Investors deserve the right to seek relief in court when they have been injured by virtue of an adviser's recommendations that violate applicable rules and regulations. Mandatory arbitration as currently operated is unfair and ineffective for investors. Recognizing these infirmities, Congress expressly granted the Commission the authority to ban or limit the use of mandatory arbitration, and the Commission should make full use of that power in any final rule.

COMMENTS

In the balance of this comment letter, we first review the principal concerns raised by the overall approach that the Commission has adopted. We then describe in greater detail some of the weaknesses found in the core sections of the Proposal, and we follow that with our views on the economic analysis developed by the Commission. We also urge the Commission to ensure that investors have the right to enforce any final rule in court, whether through individual actions or participation in class actions. Finally, we conclude with a brief summary of the major revisions we urge the Commission to implement.

Our analysis shows that the Proposal is severely compromised and unless substantially improved, will do little to help investors avoid the sometimes devastating but always corrosive financial losses arising from adviser conflicts of interest.

V. THE PROPOSAL IS MARKED BY A NUMBER OF PERVASIVE WEAKNESSES.

The basic approach to regulation reflected in the Release suffers from multiple flaws: (1) it minimizes ongoing investor harms; (2) disregards Congress's explicit language and intent; (3) caters far too much to the broker business model; (4) relies excessively on disclosure rather than substantive standards of conduct; and (5) affords the industry almost unfettered discretion in how to comply with the proposed rule. None of these choices are necessary or appropriate under the circumstances, and collectively they render the Proposal woefully ineffective.

A. The Commission acknowledges the widespread existence of adviser conflicts in theoretical terms, but it fails to reflect a genuine appreciation of the scope and scale of the resulting harm to millions of investors.

The Release offers a detached, hypothetical, and even antiseptic portrayal of the underlying problem that the Proposal is intended to address. For example, it describes conflicts of interest in consistently bland terms, observing that "Like many principal-agent relationships, the relationship between a broker-dealer and an investor has inherent conflicts of interest, which **may** provide an incentive to a broker-dealer to seek to maximize its compensation at the expense of the investor it is advising."[7] It goes on to note that "concerns regarding the potential harm to retail customers" arising from such conflicts "have existed for some time."[8]

Nowhere in the Release does the Commission ever acknowledge or grapple with the true scale of the financial harm that conflicts of interest cause or the very real human anguish that comes with those losses. The Commission's blind eye to this reality is in stark contrast with the DOL's assessment of the huge losses attributable to conflicts of interest among advisers in the retirement space. The DOL produced an exhaustive economic analysis to support its rulemaking, showing that conflicts of interest are costing investors tens of billions of dollars every year in lost

[7] Release at 21757 (emphasis added).
[8] Release at 21575.

retirement savings.[9] That estimate was extremely conservative, since it only examined the impact of conflicts of interest on one type of account (IRAs) and one type of investment (front-load mutual funds). Were the analysis expanded to encompass all types of investment accounts (retirement and non-retirement alike) and all types of securities products (from other types of mutual funds, to individual securities, to variable annuities, to non-traded REITS), the magnitude of harm would be revealed as even more staggering.

In short, the Release asks whether the Commission has "correctly identified the problem, its magnitude, and the set of reasonably available solutions and alternative approaches,"[10] and the answer to that question is a resounding "No."

B. <u>The Proposal acknowledges an extensive regulatory and legislative history clearly pointing the way to a stronger and more unified approach, but it expressly rejects this background in crafting the proposed rule, opting instead to rely on the narrowest possible authority in Dodd-Frank.</u>

In the Release, the Commission reviews the long history of mounting concerns over conflicts of interest among advisers and the repeated calls for the establishment of a strong and uniform fiduciary duty that would apply equally to brokers and investment advisers. For example, the Release reviews Section 913 of the Dodd-Frank Act, dating back to 2010, which granted the Commission explicit authority to impose such a duty. Section 913 allowed the Commission to require all advisers "to act in the best interest of the customer, without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[11] It further stipulated that the standard should be "no less stringent than the standard applicable to investment advisers under [the IAA] when providing personalized investment advice about securities."[12]

The Release also discusses—

- the subsequent study[13] conducted by the Commission's own staff in 2011 that recommended the establishment of a uniform fiduciary standard based on Section 913(g);

- the recommendation to the same effect issued by the Commission's Investor Advisory Committee in 2013;

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9 *See* Dept. of Labor, Regulating Advice Markets, Definition of the Term "Fiduciary," Conflicts of Interest - Retirement Investment Advice, Regulatory Impact Analysis for Final Rule and Exemptions (Apr. 2016), *available at* https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2/conflict-of-interest-ria.pdf. We hereby incorporate by reference, as if fully set forth herein, the entire rulemaking record developed in connection with the DOL's fiduciary rule, including, without limitation, the Regulatory Impact Analysis cited above, the original rule release and accompanying analysis, and the final rule release and accompanying analysis.

10 Release at 21664.

11 Dodd–Frank Act, § 913(g)(1).

12 *Id.* Elsewhere, Section 913 similarly makes clear that the standard applicable to a broker or dealer "shall be the same as the standard of conduct applicable to an investment adviser . . . ." *Id.*

13 *See* Sec. & Exch. Comm'n, Study on Investment Advisers and Broker-Dealers (2011), *available at* https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

- the example set by the DOL's 2016 rule[14] strengthening the scope and content of the standards governing fiduciary advisers under ERISA; and

- Chairman Clayton's June 2017 request for public input on the standards of conduct.[15]

Rather than following these findings and recommendations, the Commission has expressly rejected them, opting instead for a solution predicated on the much more narrow authority in Section 913(f) of the Dodd-Frank Act. The Proposal focuses solely on broker obligations and makes only modest enhancements, explaining that "Based on our evaluation, we have determined at this time to propose a more tailored approach focusing on enhancements to broker-dealer regulations to address our current concerns."[16] What resulted is an amalgam of increased disclosure obligations, coupled with an ill-defined duty to "mitigate"—but never eliminate—some conflicts of interest. It is not a true best interest standard.

It is not only investors who will suffer as a result of the weaknesses in the Proposal. Many broker-dealer representatives and other advisers would prefer to act in their clients' best interest but are subjected to intense pressures and incentives created by firms to increase revenues by compromising the best interests of their clients. A strong rule that eliminates these influences would not only protect investors, but also improve the environment for the benefit of well-meaning advisers who seek to provide the best possible advice to their clients

C. <u>The Commission's approach seeks above all to protect and preserve the broker-dealer business model, not protect investors.</u>

The Release makes clear that the Commission was guided primarily by a desire to avoid disruptions in the broker-dealer world. The Commission conformed the Proposal to the broker business model, rather than forcing brokers to conform their practices to standards of conduct that would best serve investors. For example, the Release explains that "The proposed best interest obligation for broker-dealers set forth in Regulation Best Interest builds upon, **and is tailored to**, existing broker-dealer relationships and regulatory obligations under the federal securities laws and SRO rules."[17] And throughout the Release, the Commission echoes its view that a minimalist regulatory approach is necessary "to preserve—to the extent possible—investor choice and access to existing [brokerage] products, services, and payment options."[18]

This outlook is conceptually flawed, legally indefensible, and unnecessary. The Release attempts to rationalize its approach by observing that "Over time, different bodies of laws and standards have emerged that are generally tailored to the different business models of broker-

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14 Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 8 2016).

15 Release at 21576-82. The Release also acknowledges the state of confusion in which investors find themselves, observing that investors are unaware of the different standards governing brokers and other advisers and actually expect advice in their best interest. Release at 21578 & n. 28.

16 Release at 21590.

17 Release at 21584 (emphasis added).

18 Release at 21575, 21576, 21579, 21583.

dealers and investment advisers and that provide retail customers protection specific to the relationship types and business models to which they apply."[19] This premise is flawed because it ignores the fact that the "emergence" of different standards was the direct result of a prolonged regulatory failure by the Commission to subject brokers rendering investment advice to the same fiduciary standard that Congress intended to apply to all advice, as reflected in the Investment Advisers Act. Put another way, the broker and investment adviser business models are not different in the relevant sense: With respect to the act of rendering investment advice, they are identical "models" and should be subject to the same standard. The Commission's own failure to prevent advisory activities from becoming hopelessly embedded in the broker-dealer model under a lax set of rules is no justification for refusing to correct the problem now.

The Commission's solicitude for the broker business model is also legally untenable. The Commission's primary duty under the securities laws is to protect investors, not protect or promote any particular business model. The Commission's overly accommodating approach betrays its core mission.

Nor is the Commission's compromised view of its regulatory role even necessary. There is no reason why the broker commission-based model cannot thrive under a true best interest or fiduciary standard. The industry's response to the DOL rule provides recent empirical evidence proving the point: The evidence, some of which is acknowledged in the Release,[20] shows that brokers were adapting to a strong fiduciary rule, new products were emerging, prices were falling, and advice was widely accessible under both commission-based and fee-based compensation models.

D. <u>The Proposal relies far too much on disclosure.</u>

The Proposal is more than anything else a disclosure regime. Disclosure figures prominently not only in the explicit "Disclosure Obligation" set forth in the Proposal, but also in the "Conflicts of Interest Obligation." In addition, the Proposal is accompanied by another extensive release that would establish an elaborate new disclosure regime known as the "Client Relationship Summary," which includes hundreds of pages of explanatory material.

Unfortunately, while disclosure is an important investor protection tool, it is a limited measure that cannot substitute for strong affirmative standards of conduct. It is difficult to apply effectively and subject to evasion on many levels. To be of value, disclosures must be timely, clear and comprehensible, actually read and digested, and capable of leading to meaningful investor choices from among disclosed options. And even where those conditions apply, disclosures can be neutralized by "off the record" oral representations and other strategies that minimize their significance. In fact, studies show that regulation by disclosure alone can actually undermine investor protection by emboldening advisers to ignore the client's best interest once

[19] Release at 21662.
[20] Release at 21583, 21663.

they have "checked the disclosure box," and by rendering investors even more vulnerable to conflicted advice once they receive disclosures.[21]

Moreover, even an ideal disclosure regime is, by itself, little more than a modified version of "buyer beware." In the end, as acknowledged in the Release, excessive reliance on disclosure places too much of the burden on retail customers to understand disclosures, appreciate their significance, and determine what alternatives they should pursue.[22] In short, even clear and abundant disclosures leave investors vulnerable to harm. The Proposal, dominated by disclosure obligations and little else, cannot adequately protect investors.

These concerns have special force with respect to the Proposal. In this context, it is difficult to imagine any disclosure regime capable of elucidating the inherently confusing reality that the Commission has created by allowing advisers performing identical tasks (recommending securities investments to clients) to be governed by very different regulatory regimes (the suitability standard for brokers and the fiduciary duty for investment advisers). Compelling evidence of this challenge can be found in the Commission's strenuous effort to layer multiple and complex new disclosure requirements into its regulatory scheme. But because the underlying state of regulation of brokers and investment advisers has become so deeply confusing and inconsistent, that mountain of disclosure cannot possibly enlighten or protect investors adequately.

E. The Proposal affords too much discretion to the industry in the manner of compliance with already vague requirements.

The Proposal is a skeletal set of provisions, comprising less than a single page in the Federal Register. None of the core terms are defined and no prescriptions are set forth to ensure that compliance with the rule will be meaningful. As explained again and again in the Release, the Commission has chosen to allow brokers wide latitude in deciding how to comply with every aspect of the new requirements. This decision reflects the Commission's resolve to accommodate brokers and allow them to tailor compliance to their own unique facts and circumstances.

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[21] There is a growing consensus among experts that mere disclosure is not an effective cure for the ills posed by conflicts of interest and that a fiduciary duty is a more effective solution. *See* Angela Hung et al., Effective Disclosures in Financial Decisionmaking (2015), *available at* https://www.rand.org/pubs/research_reports/RR1270.html; George Loewenstein et al., *The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest*, 101 American Economic Review: Papers and Proceedings 423 (2011); Robert Prentice, *Moral Equalibrium: Stock Brokers and the Limits of Disclosure*, 2011 Wis. L. Rev. 1059 (2011) (concluding that disclosures do not give sufficient information to investors and may even cause brokers to give more biased advice); Omri Ben-Shahar & Carl Schneider, *The Failure of Mandated Disclosure*, 159 U. Pa. L. Rev. 647 (2011) (finding that disclosure as a regulatory tool has a history of being ineffective); Daylian Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. of Legal Studies 1 (2005). Similar findings were presented at a recent meeting of the SEC's Investor Advisory Committee's on December 7, 2017, where four panelists discussed the limitations and sometimes the counterproductive effects of disclosures as a remedy to conflicts of interests. *See* Meeting of the Securities and Exchange Commission Investor Advisory Committee (Dec. 7, 2017), https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac120717-agenda.htm; Sunita Sah et al., *The Burden of Disclosure: Increased Compliance with Distrusted Advice*, 104 J. of Personality and Social Psychology 289 (2013) (describing 6 experiments revealing that disclosure can increase pressure to comply with advice if the advisees feel obliged to satisfy their advisors' personal interests).

[22] Release at 21661.

Unfortunately, many members of the industry cannot be trusted to exercise their discretion in a way that serves the best interests of investors. For decades, many brokers dispensing investment advice have intentionally taken advantage of their clients by recommending high-cost, high-risk, and low-performing investments that have enriched the adviser at the client's expense. The practice is deeply engrained and deeply profitable. It is therefore fundamentally unrealistic to expect that the brokers subject to the Proposal will use their broad discretion in a way that effectively neutralizes those conflicts of interest and maximizes investor protection.

II. THE PROPOSAL HAS NUMEROUS SPECIFIC DEFECTS THAT WILL RENDER IT OF LITTLE VALUE IN PROTECTING INVESTORS.

Turning to more targeted comments, the Proposal has major weaknesses in every one of its major components: the general, ostensible duty to act in the "best interest" of the client; the Disclosure Obligation, the Care Obligation, and the Conflict of Interest Obligation. We detail those specific problems in this section of our letter.

A. The proposed "best interest" standard does not actually require brokers to act in the best interest of their customers.

Contrary to the overwhelming weight of expert recommendations and analysis, the Commission has expressly elected not to adopt a uniform fiduciary duty applicable to all advisers—brokers and investment advisers alike—who recommend securities investments to their clients. As the Release explains, "We wish to underscore that proposed Regulation Best Interest focuses on specific enhancements to the broker-dealer regulatory regime, . . . and therefore would be separate and distinct from the fiduciary duty that has developed under the Advisers Act."[23]

Unfortunately, the Proposal does not even constitute a genuine best interest standard. The Release makes clear that the reference to "best interest" has no meaning apart from the three constituent duties set forth in the Proposal. The Release explains that the Commission is not proposing to define what "best interest" means. It goes on to say that "the best interest obligation does not impose **any** obligations other than those specified by the rule."[24] It drives home the point by observing that the Proposal requires the broker to act in the best interest of the retail customer "**by complying** with each of the components set forth in paragraph (a)(2) of the rule."[25] Thus, the "best interest standard" in the Proposal has no independent meaning or significance, apart from the other requirements in the Proposal. It amounts primarily to a revised suitability standard, accompanied by some additional disclosure obligations. And it never requires brokers to eliminate conflicts of interest, opting instead merely to require disclosure of conflicts, or in some cases, the mitigation of conflicts.

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[23] Release at 21585.
[24] Release at 21598.
[25] *Id.*

Not a true best interest standard.

The formulation of the "best interest" element in the Proposal suffers from another important flaw. It adds a limiting phrase that eliminates any possibility that the Proposal could embody a true best interest standard. The Proposal states that the broker must make a recommendation "without placing the financial or other interest of the broker . . . ahead of the interest of the retail customer."[26] In other words, a tie goes to the broker. Contrast this provision with a true best interest or fiduciary standard, which requires advisers to **subordinate** their own interests to what is best for their customers. The Release acknowledges this departure from fiduciary norms when it specifically asks for comment whether the Proposal should ensure that brokers place "the interest of the retail customer **ahead** of the broker-dealer."[27]

In effect, this language in the Proposal means that rather than subordinating their interests to their customers' interests, brokers will be permitted to put their interests on a par with their client's interest, a concept that is fundamentally at odds with a true best interest standard. The term "best" is normally a superlative term, one that means—or should mean—the maximum degree or apex above all else. However, when coupled with the phrase allowing for parity of broker and customer interests, as in the Proposal, the term "best interest" becomes inaccurate and misleading.

In essence, suitability.

The Proposal adopts a standard that is in essence no different than the suitability standard that currently applies to broker recommendations. As the Release explains, FINRA and a number of reported cases have interpreted the suitability standard to require only that brokers make recommendations that are "consistent with" or not "clearly contrary to" the best interest of the customer."[28] Even more revealing, FINRA's interpretive guidance explicitly states that the suitability standard essentially prohibits a broker "from placing his or her interests ahead of the customer's interest." This language closely tracks the Proposal.[29]

Such a weak formulation of the best interest standard will not only harm investors but also create huge practical challenges in the context of attempts to enforce the rule, via either government proceedings or private actions. An investment recommendation substantially tainted or influenced by conflicts of interest will be far easier to defend if the broker need only show that he treated the client roughly as well as he treated himself.

Allowing substantial broker interests to bear on a recommendation.

Other portions of the Release unfortunately confirm the diluted nature of the proposed standard. At a minimum, the Release sows confusion about the actual scope and nature of the "best interest" standard. For example, the Release explains that a recommendation would violate

[26] Release at 21681.
[27] Release at 21591 (emphasis added).
[28] Release at 21577 n. 15 (quoted authorities omitted).
[29] *Id.*

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the Proposal if it were "**predominantly**" motivated by the broker's self-interest and not the customer's best interest.[30] It follows from this stunning interpretation that a recommendation **substantially** motivated by the broker's self-interest **would** pass muster. Yet this is a far cry from a genuine best interest standard. Perhaps even worse, the Proposal elsewhere explains that between two alternative investments that are "otherwise both in the best interest of the client," and where no material differences exist between them from the perspective of the customer, the broker **may** recommend the more expensive or "remunerative" investment.[31] Thus, under the Proposal, all other things being equal, the broker actually may advance his own interests at the expense of the customer.[32] This is the antithesis of a genuine best interest standard.

A clear signal: Preserving the status quo.

The Proposal also contains language that clearly opens the way to the continued recommendation of complex, risky, and expensive investments that are less likely to serve the best interests of most customers. The Release takes pains to emphasize that it does seek to prohibit or even discourage brokers from offering relatively risky and high-cost investments such as actively managed mutual funds, variable annuities, and structured products, all of which are notoriously associated with conflicts of interest and suboptimal outcomes for investors.[33] In addition, the Release offers a long list of practices and products involving clear conflicts of interest that the Proposal would not "per se" **prohibit**, including charging commissions, receiving differential compensation, receiving third-party compensation, recommending proprietary products, recommending securities underwritten by the broker, recommending complex products, allocating trades and research among different types of customers, and considering the cost to the broker-dealer of effecting a transaction, such as the cost of buying or selling illiquid securities.[34]

Although the Release also asserts that these practices and products are not per se **consistent** with the Proposal, the message appears clear: Brokers can freely promote them provided they follow the three protocols set forth in the Proposal. Rather than fashioning a rule that eliminates the harmful effects of conflicts of interest, the Commission appears to have created a blueprint for continuing to engage in conflicted practices, but in a way that is deemed permissible by virtue of a handful of weak new safeguards.[35]

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30 Release at 21588.

31 *Id.*

32 The Release seems to mitigate the outrageous implications of this hypothetical—although only slightly—by observing that the best interest standard could not be met where the broker recommends the more costly of two investments that are "otherwise **identical**." Release at 21588 (emphasis added).

33 Release at 21587.

34 *Id.*

35 The accompanying release setting forth proposed guidance on the standard of conduct for investment advisers raises concerns that are similar to those described above regarding the Proposal. *See* Proposed Commission Interpretation Regarding Standard of Conduct for investment Advisers; Request for comment on Enhancing Investment Adviser Regulation, 83 Fed. Reg. 21416 (May 9, 2018) ("IA Guidance"). First, it reflects the same contradictory formulation found in the Proposal. It states that investment advisers ("Ias") must act in the best interest of their clients, yet it formulates this duty as only requiring that IAs "not subordinate" their clients' interest to their own or "favor" their own interest **over** the client's interest—echoing the point in the Proposal that the broker's interest can be a substantial consideration on a par with that of the client. Second, it merely requires a reasonable belief that the advice is in the client's best interest, rather than imposing a clear duty to deliver only advice that is in the client's best interest. Third, it only prohibits the

<u>*The Commission must impose a genuine fiduciary standard on brokers.*</u>

To adequately protect investors, to fulfill the underlying purposes of the securities laws, and to discharge its primary duty, the Commission must take full advantage of what Congress said and intended in Section 913: It must apply to brokers a genuine fiduciary standard that is "no less stringent" than the fiduciary duty applicable to investment advisers. That standard must clearly require brokers providing investment advice or recommendations "to act in the best interest of the customer, without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."[36] And the final rule must make clear that at all times, brokers may never allow conflicts of interest to influence or taint their recommendations.

B. <u>The specific "disclosure obligations" set forth in the Proposal will be especially ineffective due to their timing and the broad discretion brokers will have when deciding how to comply.</u>

The "Disclosure Obligation" requires that brokers reasonably disclose in writing, prior to or at the time of a recommendation, the material facts relating to the scope and terms of the relationship between the broker and the customer and all material conflicts of interest.[37] The Release explains that this would entail disclosure of the capacity in which the broker was acting (either as broker or investment adviser, for dual registrants), the fees and charges that apply, the type and scope of service provided, and the conflicts of interest associated with the recommendation.[38]

This requirement will not effectively inform and enlighten investors. It is flawed by design, since it will not allow sufficient time for an investor to digest, understand, and act on the disclosure. Moreover, the Proposal gives brokers enormous discretion in determining the manner and content of the required disclosures.

To be effective, disclosures must be carefully designed with several critical attributes in mind. They must be clear and comprehensible; complete without being overly burdensome or lengthy; provided in a timely fashion so investors have a meaningful opportunity to read, digest, understand, and discuss them; and capable of presenting investors with meaningful choices in light of the disclosures. The disclosure obligations in the Proposal fail to meet a number of these requirements.

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recommendation of higher cost products if there are "identical," less expensive alternatives, implicitly approving of situations where the broker charges more for an investment even though it is substantially similar to other, less expensive options. And fourth, even where the most complex and extensive conflicts are present, the guidance stops short of requiring the IA to eliminate the conflicts, opting instead to also allow "adequate mitigation." *See generally* IA Guidance at 21205-209.

36 Dodd–Frank Act, § 913(g)(1).

37 Release at 21681.

38 Release at 21600.

An unacceptable timing requirement.

A major deficiency lies in the timing of the disclosures. Requiring they be made only "prior to or at the time of a recommendation" virtually guarantees that they will be useless to investors. The Release itself highlights the importance of disclosure timing:

> The timing of the disclosure is critically important to whether it may achieve the effect contemplated by the proposed rule. Investors should receive the information early enough in the process to give them adequate time to consider the information and promote investor's understanding in order to make informed investment decisions.[39]

Requiring disclosure to be made prior to "or at the time of" a recommendation cannot possibly achieve this objective. Investors will be routinely confronted with baffling documentary disclosures at the very moment they are being urged to accept an investment recommendation and hand over their money. Under the Proposal, they will have in effect no time to read, understand, consider, and act on the disclosures in advance of their investment decision.

Excessive broker discretion.

The Release reveals a number of other weaknesses in the approach to disclosure. First, the Proposal gives brokers too much discretion. The Release explains that "In lieu of setting explicit requirements by rule for what constitutes effective disclosure, the Commission proposes to provide broker-dealers with flexibility in determining the most appropriate way to meet this obligation."[40] Elsewhere it states that the Commission "is not proposing to mandate the form, specific timing, or method for delivering disclosure pursuant to the Disclosure Obligations."[41] This is a huge mistake without a convincing rationale. Judging from the brokerage industry's overall approach to disclosure so far, characterized by small print, poor timing, opaque and technical language, and lengthy documents, allowing for discretion in this area will virtually assure a failure to communicate helpfully with investors.

Confusion surrounding dual registrants.

The approach to disclosure raises other concerns. The explanation in the Release regarding disclosure by dual registrants about the capacity in which they are acting is confusing and inadequate. The Release indicates that dual registrants would be allowed to provide a one-time written disclosure about their advisory capacity, followed by subsequent oral disclosures if and when they change roles when making recommendations.[42] Customers will be oblivious to or at a minimum confused by what are likely to be rushed and cursory verbal disclosures delivered as an aside.

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[39] Release at 21605.
[40] Release at 21603.
[41] Release at 21601.
[42] *Id.*

Only reasonable, not full and fair disclosure.

Finally, the Proposal adopts an overly narrow and forgiving standard for the disclosure obligation, by requiring only that brokers "reasonably disclose" certain information to customers.[43] It stands in contrast to a more effective, unqualified requirement to make full and fair disclosure of all material conflicts of interest. As noted in the Release, this weaker requirement enables brokers to avoid the strict liability that would come from a straightforward duty simply to "disclose" certain material facts, yet that is the appropriate standard to ensure that customers receive adequate disclosure.[44]

C. The "care obligation" in the Proposal adds virtually nothing to the traditional suitability standard.

The second core component of the Proposal is the "Care Obligation," which provides as follows:

> (ii) *Care Obligation.* The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation exercises reasonable diligence, care, skill, and prudence to:
>
> (A) Understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (B) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (C) Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.[45]

The Release repeatedly explains that the Care Obligation "is intended to incorporate and enhance existing suitability requirements applicable to broker-dealers."[46] Confirming the point, the three elements of the Care Obligation closely parallel the elements of FINRA's suitability rule.[47]

The essential enhancement that the Proposal supposedly offers, as repeatedly highlighted in the Release, is adding a best interest test in place of the existing suitability test. Thus, for example, under the Proposal, a broker would have to have a reasonable basis for believing that the recommendation was in the **best interest** of at least some customers, not only **suitable** for some

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43 Release at 21604.

44 *Id.*

45 Release at 21682.

46 Release at 21608-09

47 *See* FINRA Rule 2111, and Supplementary Material .05 (reasonable-basis suitability, customer-specific suitability, and quantitative suitability).

customers.[48] According to the Release, the Commission believed it was appropriate to draw and build on these existing suitability requirements because the "contours of the obligation are well-defined," the approach would promote "consistency and clarity," and it would "facilitate the development of compliance policies and procedures for broker-dealers."[49]

The fundamental problem with this approach is two-fold. First, as explained elsewhere in this letter, it is not the Commission's responsibility to make life easier for brokers; its principal mission is to protect investors. Second, this change to the suitability standard will do very little to strengthen protections against adviser conflicts of interest, largely because the meaning of "best interest" under the Proposal is so weak. The Release makes clear that the "enhancement" is merely the compromised version of the "best interest" standard set forth in the opening section of the rule. The Release notes, for example, that the "best interest" requirement appearing in the Care Obligation is one which the Commission "**would interpret** to require the broker-dealer not put its own interest ahead of the retail customer's interest, when making a recommendation."[50] Thus, the "best interest" standard that the Proposal splices into the traditional suitability requirements is one in name only. In fact, it allows brokers to weigh their own interests quite heavily in the process of making recommendations, and merely prohibits them from placing their own interests **ahead** of their customers. There can be little doubt that this aspect of the Proposal will have a negligible impact on the existing suitability standard or more generally on investor protection.

D. The "conflict of interest" obligation only requires brokers to establish policies and procedures focused primarily on disclosure, without a broad duty to eliminate or at least mitigate conflicts of interest.

The third and final major element of the Proposal is the "Conflict of Interest" provision. It sets forth two related requirements:

> (iii) *Conflict of Interest Obligations.*
>
> (A) The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations.
>
> (B) The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

This aspect of the Proposal is objectionable for at least three reasons: (1) It relies too much on process, omitting any affirmative requirements to address conflicts of interest directly and instead requiring only the establishment of policies and procedures; (2) the required policies and

48 Release at 21609.
49 Release at 21611; *see also* Release 21612 (explaining that the Proposal adopts information-gathering requirements consistent with the suitability rule to "provide clarity" to brokers and to "maintain efficiencies" for brokers that have already established infrastructures to comply with their suitability obligations).
50 Release at 21609.

procedures focus too much on disclosure and in some cases mitigation, without ever requiring the elimination of any conflicts of interest, no matter how intense; and (3) in keeping with the overall approach in the Proposal, it affords far too much discretion to brokers to determine how to comply with the "Conflict of Interest" obligation.

A policies and procedures requirement only.

The first problem with the "Conflict of Interest" obligation is that it simply requires brokers to establish, maintain, and enforce policies and procedures—nothing more. Those policies and procedures must meet certain criteria and must be "reasonably designed" to achieve certain goals, including disclosure, along with either mitigation or—if the broker chooses—elimination of certain types of conflicts. The Release portrays this requirement as involving a long and seemingly impressive list of substantive elements, including defining conflicts, establishing structures for identifying conflicts, periodically reviewing those structures, and establishing training procedures.[51] But as conceded in the Release, nowhere in the Conflict of Interest provision does the Proposal require brokers to actually undertake these steps or to pursue any other disclosure, mitigation, or elimination measures; it is solely a matter of including them in the policies and procedures.[52]

This indirect and passive approach to addressing the serious matter of conflicts of interest is indefensible. In keeping with the tenor of the entire Proposal, the Release attempts to justify this approach on the basis of a perceived need to ease the burdens on brokers. For example, the Release cites to minimizing compliance costs for brokers, affording them flexibility, and allowing them to easily adjust their existing supervisory systems to streamline compliance with the Proposal.[53] But there is no basis in the law for this inverted set of priorities. The Commission's mission first and foremost is to protect investors, not cater to the needs of brokers or any other segment of the financial industry. Moreover, and as discussed further below, none of the economic analysis requirements applicable to the Commission support this approach. In any case, it is inconceivable that the benefits to brokers of this approach would outweigh the costs to investors that will inevitably follow from such a weak solution to the problem of conflicts of interest.

This approach certainly fails one of the tests posited in the Release. The Release asks whether the "Conflict of Interest" obligation would cause a broker-dealer to act in a manner that is consistent with what a retail investor would expect.[54] The answer quite clearly and emphatically is "No." Any investor told that a broker had a duty to limit the harmful effects of conflicts of interest would be surprised and disappointed to learn that the broker was in effect only required to write a policies and procedures manual.

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[51] Release at 21619.
[52] Release at 21623.
[53] Release at 21617, 2118, 21623.
[54] Release at 21623.

No duty to eliminate any conflicts, mitigation at best.

Another cardinal weakness in the Proposal is that it never requires the "absolute **elimination** of any particular conflicts," no matter how powerful they may be.[55] Eradicating a conflict is solely an optional course of action that advisers may choose to take. The strongest obligation found in the Proposal is a mitigation requirement, and even that only applies to the subset of conflicts that arise from the financial incentives associated with a recommendation.[56] The Release makes emphatically clear that the Commission does "not intend to require broker-dealers to mitigate every material conflict of interest in order to satisfy their Conflict of Interest Obligations.[57]

The Release justifies this approach with the extraordinary assertion that forcing an adviser to **eliminate** conflicts of interest could mean that the adviser might not receive compensation for its services, "which is not the Commission's intent."[58] This epitomizes the overly accommodating approach to regulating conflicts of interest found throughout the Release: Above all, the Commission strives to minimize the inconvenience, costs, or lost revenues that advisers might suffer from the Proposal, at the expense of strong protections that investors require against conflicts of interest.

This lax approach does not square with reality or even with some of the acknowledgements in the Release. For example, the Release notes that "certain material conflicts of interest arising from financial incentives may be more difficult to mitigate and may be more appropriately avoided in their entirety for retail customers."[59] The Release cites familiar examples, such as non-cash compensation in the form of sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management."[60] And yet, rather than prohibiting these practices, as it should, the Commission simply admonishes that brokers "should carefully assess the broker-dealer's ability to mitigate these financial incentives and whether they can satisfy their best interest obligation."[61]

Nor is this hands-off approach consistent with what Congress intended in the Dodd-Frank Act. Congress adopted an especially guarded approach to commissions and other forms of adviser compensation. For example, Section 913 provides that the receipt of commissions or other forms of compensation for the sale of securities shall not, "in and of itself," be considered a violation of the standard. The "in and of itself" wording reflects Congress's intent that the SEC should take great care to ensure that carve-outs permitting such forms of compensation must remain narrow. Even more compelling evidence is found elsewhere in Section 913, where Congress specifically required the SEC 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

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[55] Release at 21619.
[56] Release at 21682.
[57] Release at 21618.
[58] Release at 21619.
[59] Release at 21621.
[60] Release at 21622.
[61] *Id*.

of investors."[62] Clearly, sales contests and other practices present such intense conflicts of interest that they should be prohibited under the Proposal. And with respect to mitigation, the Proposal should require brokers to mitigate **all** material conflicts of interest that are not required to be eliminated entirely.

Excessive compliance discretion.

Another defect in the Proposal is the enormous amount of discretion that it affords to advisers in determining how to comply with the Conflict of Interest requirements. For example, advisers will be permitted to exercise their judgment as to whether and how a conflict can be effectively disclosed, what mitigation methods may be appropriate, and whether and how—if ever—to eliminate a conflict.[63] Excerpts from the Release illustrate the point. As to the disclosure obligation, the Release tepidly asserts that "If a broker-dealer determines to satisfy its obligation to address conflicts of interest through disclosure, the broker-dealer **should consider** the preliminary guidance on aspects of effective disclosure. . . ."[64]

Elsewhere, the Release explains its hands-off approach to mitigation measures as follows:

> [I]n lieu of mandating specific mitigation measures or a "one-size fits all" approach, the Commission's proposal would leave brokers with flexibility to develop and tailor reasonably designed policies and procedures that include conflict mitigation measures, based on each firm's circumstances."[65]

Yet again, with respect to the duty to establish policies and procedures that address conflicts of interest, advisers themselves are left to determine their content as they see fit:

> We believe there is no one-size-fits-all framework, and broker-dealers should have flexibility to tailor the policies and procedures to account for, among other things, business practices, size and complexity of the broker-dealer, range of services and products offered, and associated conflicts presented.[66]

This essentially self-regulatory model is not effective, and it will not work, least of all in a framework intended to curb deeply engrained and highly profitable practices and incentives that advisers have relied upon for decades.

E. The Proposal includes other gaps that can and should be closed.

The Proposal should protect institutional as well as retail investors.

The Proposal laudably expands the scope of the rule to include not only natural persons but also "any" person, provided the recommendation is primarily for personal, family, or household

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62 Dodd-Frank Act § 913(g)(1) (emphasis added).
63 Release at 21617.
64 Release at 21619 (emphasis added).
65 Release at 21620.
66 Release at 21618.

purposes.[67] "[The rule] would cover **non-natural persons** that the Commission believes would benefit from the protections of Regulation Best Interest (such as trusts that represent the assets of a natural person)."[68] It should go further.

While retail investors, whether acting individually or via a trust, are desperately in need of the protections that could be afforded by a strong new fiduciary duty rule, they are not the only ones who are vulnerable to conflicts of interest. Section 913 recognizes this fact by expressly allowing the Commission to extend the protections of the fiduciary duty beyond retail customers and to "such other customers as the Commission may by rule provide."[69]

The Commission should invoke this authority to ensure that institutional investors also benefit from a strong best interest or fiduciary duty, especially where they lack the sophistication in financial matters that is often assumed but too often absent in reality. Consistent with the Advisers Act, institutional clients should not be treated differently than retail investors when it comes to such a fundamental protection, regardless of the purposes to be served by an adviser's recommendation. At a minimum, institutional investors that are especially vulnerable, that lack sufficient financial sophistication, or that represent the interests of retail investors collectively (including, for example, pension funds) would clearly benefit from, and should be protected under, the new fiduciary duty rule.[70]

The rule must narrowly circumscribe the exceptions for a "continuing duty of care."

The Release makes clear that the Proposal would not impose a continuous duty of care on brokers or a duty to monitor the performance of an account, although such an obligation might be created by contract.[71]

This approach represents a potentially huge loophole in the fiduciary standard. Claims for breach of fiduciary duty often arise when clients find themselves neglected by an adviser who has engendered a reasonable expectation that the client's interests were under a continuing duty of care. The SEC must therefore write its rule to ensure, for example, that brokers cannot resort to clauses in fine-print contracts that operate as a convenient "on-off switch" for the fiduciary duty. Furthermore, the rule must provide that the duties in the Proposal, once triggered, only end where the adviser's role in "providing personalized investment advice about securities" has truly concluded; where the client has received timely and clear disclosure in writing that the adviser is no longer subject to those duties; and where the client has acknowledged the cessation of those duties in writing. If compensation to the adviser continues, then the relationship should be deemed

[67] Release at 21596.
[68] Release at 21596 (emphasis added).
[69] Dodd-Frank Act § 913(g)(1).
[70] The Dodd-Frank Act reflects this approach in other contexts by requiring swap dealers and security-based swap dealers to adhere to a "best interest" standard when acting as an adviser to "special entities," including institutional investors such as municipalities and pension funds. Dodd-Frank Act § 764(a). Even if the Commission decides not to broadly protect all investors from conflicts of interest, retail and institutional alike, then it should at least impose the fiduciary duty whenever an adviser provides advice to such special entities.
[71] Release at 21594.

ongoing. And in all cases, the nature of the relationship and the specific facts and circumstances should determine whether the broker has an ongoing duty to monitor or periodically review the portfolio.[72]

The Proposal should cover recommendations as to the type of account.

The Proposal fortunately covers recommendations to roll over or transfer assets from one type of account to another.[73] This is necessary and appropriate, since those events can be among the most important and consequential financial decisions that an investor ever makes.[74]

However, the Release notes that the Proposal would not apply to recommendations regarding account types generally, such as the choice between a brokerage account or advisory account.[75] This is a significant gap that should be closed, since this decision is also an important one with potentially lasting financial consequences. The Release explains its decision by observing that the choice "is an issue that implicates both broker-dealers and investment advisers that are making recommendations" as to the type of account a client should open.[76] But this only confirms the need to apply a high standard of care to the recommendation.

III. THE ECONOMIC ANALYSIS IS FLAWED ON MULTIPLE LEVELS.

The Commission's economic analysis has two basic components, a consideration of the Proposal's effect on efficiency, competition, and capital formation (the "ECCF analysis"), and in addition, a "cost-benefit" analysis.[77] Each of them reveals gaps and misconceptions. What is evident from the current record is that the Proposal is not strong enough to confer significant benefits, whereas a most robust Proposal could easily be justified on economic grounds.

A. The ECCF analysis is incomplete and in some respects misguided, but it clearly points to the need for a stronger rule.

The ECCF analysis has numerous flaws. It fails to acknowledge either the Commission's preeminent duty to protect investors or the enormous threat investors face from conflicts of interest; it fails to analyze or acknowledge the deleterious economic impact of adopting such a **weak** rule, which is not the same as the standard applicable to investment advisers; and it construes some potential economic effects of the Proposal as negatives, when in fact, they are positive. What is clear is that a stronger Proposal would be much more effective at advancing efficiency, competition, and capital formation.

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72 And Section 913 of the Dodd-Frank Act provides that nothing in the section shall require a broker to have a "continuing duty of care or loyalty" to the customer after providing advice. But rather than a prohibition against an ongoing duty of care or loyalty, this language is simply a clarification that the statute does not impose, per se, an ongoing duty; it remains up to the Commission to draw the appropriate lines.

73 Release at 21595.

74 *Id.*

75 *Id.*

76 *Id.*

77 Release at 21642.

The statutory standard focuses first and foremost on investor protection.

Under the securities laws, the Commission's obligation to conduct economic analysis in the rulemaking process is to consider first and foremost the protection of investors, and then to consider "whether the action will promote efficiency, competition, and capital formation." For example, the Exchange Act provides as follows:

> Whenever pursuant to this chapter the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, **in addition to the protection of investors**, whether the action will promote efficiency, competition, and capital formation.[78]

Under this statutory provision, the Commission's first order of business is to ensure that any rule is adequate to the task of protecting investors. Yet nowhere in its ECCF analysis does the Commission address this primary duty to protect investors. Moreover, nowhere in the economic analysis is there a robust assessment of the nature and magnitude of the harm to investors that conflicts of interest are causing, the need for a strong best interest or fiduciary standard capable of neutralizing those harms, and the savings that investors would receive from the imposition of effective limits on those conflicts.

Turning to the economic factors themselves, the ECCF analysis set forth in the Release is positive insofar as it generally confirms some of the **potential** economic benefits that could result from raising the quality of advice that brokers deliver to customers. Unfortunately, it is unlikely that those benefits will be realized in this case, as the Proposal will not significantly improve the quality of broker advice. The ECCF analysis fails to account for the fact that such a weak rule will actually perpetuate a number of existing obstacles to efficiency, competition, and capital formation that result from the application of very different standards to brokers and investment advisers. And the ECCF analysis mischaracterizes some of the potential economic impacts of the Proposal.

Competition.

The Release notes that the Proposal could increase competition in a number of ways. For example, if broker advice is more trusted and in greater demand, then more brokers may enter the sector, competition may increase, and pricing and service may improve for customers.[79] The Release also notes that the Proposal may enable brokers to compete more effectively for customers who prefer the fiduciary standard.[80]

These would be positive outcomes in theory, but the Release fails to round out the analysis. First, because the Proposal is so weak, it will not confer these economic benefits. On the contrary, it will allow existing economic harms to persist, beyond those imposed on investors. If, for example, the Proposal remains essentially intact in its final form, then it will undermine fair competition. It will confer an advantage on brokers relative to advisers, since brokers will be able

[78] *See* 78 U.S.C. § 78c(f) (emphasis added) (referred to in text as the "ECCF analysis").
[79] Release at 21659-660.
[80] Release at 21660.

to cast themselves as "best interest" advisers and gain or retain clients, even though such brokers are not in fact subject to the same regulatory requirements. Alternatively, if the Proposal were to create a stronger, genuine best interest standard, then the enhancements to competition would be commensurately greater.

The Release also mischaracterizes some of the potential effects on competition. For example, it speculates that increased competition for broker advice resulting from a higher standard could have negative competitive effects through higher prices and less advice.[81] However, the evidence points the other way: In response to the DOL rule, the marketplace for advice has become more accessible, competitive, and affordable. Along the same lines, the Proposal suggests that if brokers decline to recommend certain investment products as a result of the Proposal, then competition for those products will be reduced.[82] But that is the desirable consequence of any rule that raises advisory standards: Products that harm investors, or serve them less effectively than other products, deserve to lose market share. Reduced competition for poor quality goods or services is a beneficial impact.

Capital formation and efficiency.

Similar considerations are relevant to the Commission's analysis of the projected impact of the Proposal on capital formation and efficiency. For example, the Release notes that if customers have more confidence in broker advice, then as a general matter, they may invest more and make more capital available to issuers at lower cost.[83] Some specific, higher quality investment products could be expected to benefit from increased capital formation, while other products may experience reduced demand, or less capital allocation.[84] And higher quality advice may improve efficiency in portfolios as advice improves and gains are better.

Here again, the analysis is incomplete. As noted above, the ability of this Proposal to increase the quality of advice is in grave doubt, and the benefits elucidated in the Release will not in fact be realized to a significant degree without substantial changes. And as before, the failure to improve the Proposal will perpetuate obstructions to capital formation and allocative inefficiencies that exist today: Investors generally remain leery of the capital markets; they are often persuaded to direct capital to unstable, unworthy, or overpriced investments; and they continue to pay inordinately high fees and commissions, thus diverting capital from investment opportunities to the pockets of brokers.

On the other hand, a stronger rule could be expected to markedly improve capital formation and efficiency. Indeed, adoption of a uniform fiduciary standard for brokers and investment advisers could also promote regulatory efficiency, bringing both sets of advisers under one regime and streamlining compliance, oversight, and enforcement.

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[81] Release at 21659.
[82] Release at 21660
[83] *Id.*
[84] Release at 21661.

C. <u>The cost-benefit analysis is flawed, but as even written, it does not support the Proposal.</u>

The law does not require the Commission to conduct a cost-benefit analysis of its rule proposals. As the D.C. Circuit has held, an agency "need not conduct a rigorous, quantitative economic analysis unless the statute explicitly directs it to do so."[85] As discussed above, the securities laws impose no such duty, instead requiring the Commission to conduct a much more limited assessment of the impact of a proposed rule on efficiency, competition, and capital formation.

Nevertheless, it is also settled law that when an agency undertakes a cost-benefit analysis "without any assertion that it is not required to do," the agency must defend that analysis and a court will judge it accordingly.[86]

In this case, the cost-benefit analysis of the Proposal is flawed in a number of respects, as detailed below. However, it bears emphasis as a threshold point that the cost-benefit analysis, as it stands, does little to support the Proposal. The legitimately cognizable costs of compliance with the Proposal are actually quite modest, but the benefits promised by such a weak Proposal are also modest. In short, the cost-benefit analysis fails to identify sufficient benefits that clearly outweigh the costs of the Proposal.

Below, we offer comment on various aspects of the cost-benefit analysis so that if the Commission revises the Proposal, it will be better equipped to conduct an assessment of the true costs and benefits associated with the revised version.

<u>*Equal rigor must be applied to benefits and costs.*</u>

According to the Release, the Commission undertook an analysis "in detail" of the potential economic effects of the Proposal, including the benefits and costs to customers and broker-dealers.[87] Furthermore, the Commission undertook, where possible, to "quantify" the likely economic effects of the Proposal. Having assumed these obligations, the Commission was duty bound to provide equal rigor to the evaluation of both costs and benefits.

The cost-benefit analysis is striking in part because it devoted much more attention to the cost side of the equation than the benefit side, exemplified in part by the fact that it quantified some of the costs expected from the Proposal without doing so for **any** of the benefits. This imbalanced approach is unacceptable. It is certainly true that in many cases, the costs of a rule are easier to monetize than its benefits, and in fact, industry advocates routinely rely on that fact to attack beneficial rules by asserting that the monetized costs outweigh the more amorphous benefits.

But that does not excuse an agency from abandoning any effort at quantifying benefits. And that is certainly true where, as here, an abundant amount of data and analysis already exists that expresses in dollar terms the harm that conflicts of interest impose on investors and the savings that investors stand to reap from regulations that effectively limit those conflicts. Agencies need

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85 *See Nat'l Ass'n of Mfrs. v Sec. & Exch. Comm'n.*, 748 F. 3d 359 (D.C. Cir. 2014) ("*NAM").*
86 *See Am. Equity Inv. Life Ins. Co.*, 613 F.3d 166, 177 (D.C. Cir. 2010).
87 Release at 21629.

not necessarily conduct their own empirical studies to support their cost-benefit analysis. However, they must at a minimum consider relevant resources and data analyses that exist, especially where they are brought to the attention of the agency in comment letters. As explained in *State Farm,* an agency "must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[88]

Here, numerous collections of relevant and persuasive data already exist that bear directly on the costs and benefits associated with regulatory limits on adviser conflicts of interest. They include the Regulatory Impact Analysis prepared by the DOL to support its fiduciary duty rule; the report issued by the Council of Economic Advisers in February of 2015;[89] and innumerable other studies examining the destructive effects of adviser conflicts of interest on investors. Throughout the Proposal, the Commission repeatedly referred to and analyzed the approach taken by the DOL in its fiduciary duty rule, **with the exception** of the DOL's economic analysis. But the Commission is duty-bound to examine that analysis, reckon with it, and attempt to articulate a "satisfactory" explanation of how those facts relate to the choices that the Commission has made in the Proposal.

Of course, because the Proposal adds very little in the way of new protections against conflicts of interest, it cannot claim to produce the same level of investor savings that would come from a more robust provision. However, the existing data cited above nevertheless provides a critically important benchmark about the magnitude of investor losses being sustained every day, the urgent need to fashion a remedy that fully addresses those losses, and the potential benefits of a well-designed rule.

*Some of the costs to **advisers** identified in the cost-benefit analysis are invalid considerations.*

The cost-benefit analysis identifies certain potential costs to advisers associated with the Proposal that cannot be considered legitimate in this context. Two of them stand out. First, the Release repeatedly notes that if the Proposal goes into effect, firms may refrain from recommending certain investment products and thereby lose potential revenue.[90] Presumably the shunned investments would be those that are associated with conflicts of interest, that could not be justified under the Proposal, and that would serve clients poorly. But advisers cannot bemoan revenues lost due to prohibitions against recommending bad investments, any more than pharmaceutical companies, food suppliers, or even criminal enterprises can complain about revenues lost due to limits on the sale of harmful drugs, contaminated foods, or any other injurious products or services.

The cost-benefit analysis also considers the potential costs arising from increased customer arbitrations under the Proposal.[91] This too is an inappropriate consideration. While the costs of

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88 *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.,* 463 U.S. 29, 43 (1983) (quoted authority omitted).

89 Council of Economic Advisers, "The Effects of Conflicted Investment Advice on Retirement Savings" (Feb. 2015) (estimating that conflicts cost at least $17 billion annually in lost retirement savings), *available at* https://obamawhitehouse.archives.gov/administration/eop/cea/factsheets-reports (hereby incorporated by reference as if fully set forth herein).

90 Release at 21643, 21647.

91 Release at 21648, 21649, 21651.

complying with a rule may be legitimate factors in a cost-benefit analysis, the litigation or arbitration costs arising from a firm's **failure** to comply are not, as they arise not from the regulation itself but from the firm's own misconduct. It is up to advisers to control or eliminate such costs by actually complying with the rule.

*Some of the costs to **investors** identified in the cost-benefit analysis are invalid considerations.*

The cost-benefit analysis identifies certain costs to investors that are wholly unpersuasive. For example, the Release repeatedly surmises that investors could suffer from a loss of "choice" if the Proposal induces advisers to restrict the collection of investment products they are willing to recommend and sell, either because of liability fears or because of the additional effort required to fully vet the investment and ensure that it meets the new standard.[92] This is a correlate of the potential costs to advisers arising from lost revenues, and it is equally invalid.

If advisers are reluctant to recommend an investment because it is not in the "best interest" of the client, that represents higher quality recommendations, not actually a reduction in "choice." But even construed as such, that scenario represents a reduction in "choice" that clearly benefits rather than burdens customers. It is no answer to suggest, as in the Release, that a given investment jettisoned by an adviser **might** conceivably benefit some investor.[93] The more likely and reasonable assumption is that the abandoned investment is generally inferior to other available options and therefore should no longer be recommended. Put another way, the more accurate analysis is to say that on average, the gains to the vast majority of investors from culling inferior investment products from the marketplace far outweigh the costs to the relatively few investors who might profit from recommendations to purchase those investments. And of course, such investments will always remain available as choices, since any investor can procure them if they independently choose to do so.

The Proposal offers an even less convincing scenario, in which investors might suffer from the Proposal because their advisers may have a weaker incentive to expend the effort necessary to provide "quality advice."[94] This suggestion has no perceptible basis and none is offered in the Release. The likely impact of the Proposal would be to incentivize better advice, not worse—albeit it to an extremely modest degree given the weaknesses in its design.

IV. THE SEC MUST ENSURE THAT INVESTORS HAVE MEANINGFUL PRIVATE REMEDIES WITH WHICH TO ENFORCE ANY STANDARDS OF BROKER CONDUCT THAT RESULT FROM THE PROPOSAL, INCLUDING THE RIGHT TO PARTICIPATE IN CLASS ACTIONS AND BRING INDIVIDUAL LAWSUITS.

Private remedies will be an essential feature of any final rule. The protections of any new standard for brokers who dispense investment recommendations will be severely compromised if they are not enforceable (and actually enforced) both by the Commission **and** by investors who suffer losses from violations. The Proposal offers very little indication of how the Commission

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92 Release at 21647, 21654, 21657
93 Release at 21647.
94 Release at 21643, 21647.

views private enforcement of the final rule. Apparently, the status quo will persist and customers will be relegated to the arbitration system established and run by FINRA.

To ensure that investors have adequate remedies for breach of the new "best interest" standard, the SEC should take two steps. First, it should at a minimum expressly protect the right of investors to participate in class actions. That is FINRA's current approach, but the SEC should affirm that position as matter of federal regulation, not simply rely on self-regulatory organization interpretation and practice. Second, the Commission should go further and ban all pre-dispute mandatory arbitration clauses, whether individual or class. There are no meritorious arguments in defense of mandatory arbitration. Those proceedings are biased against investors, ineffective in affording meaningful relief, and subject to virtually no right of appeal.[95] The Dodd-Frank Act eliminated any question about the SEC's legal authority to take such a step, as it expressly granted the agency broad authority to limit or prohibit the use of mandatory arbitration.[96]

A. **Mandatory arbitration does not afford meaningful relief to wronged investors.**

The FINRA arbitration forum has never fulfilled its promised role as a fair, expedient, and inexpensive method of redress. On the contrary, it is unfairly skewed toward firms, as panels tend to favor industry. And even a "win" for the investor typically means a monetary award that falls well short of investor harms and attorneys' fees. The process also suffers from a lack of transparency. Typically, there is no publicly issued award explaining the outcome, to serve as a guide for other investors and a deterrent against abuses by firms.

The arbitration process also deprives investors of a meaningful right of appeal. In court, if the judge errs, an appeal is available to challenge the lower court's ruling, including its findings of fact and conclusions law. However, under the Federal Arbitration Act, arbitrations may only be overturned in the rare case where an investor can show, for example, that corruption, misconduct, or a material "miscalculation of figures" occurred. By contrast, mistakes of law—even egregious ones—are not among the enumerated grounds for appealing an arbitration awards.[97]

Moreover, arbitration does not actually provide investors with the often-touted benefit of an "inexpensive" forum for dispute resolution. Firms are invariably represented by seasoned attorneys, forcing investors to retain their own experienced counsel and incur substantial expense.

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95 Consumer Fin. Prot. Bureau, Arbitration Study (Mar. 2015) *available at* https://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf; Stephen Hall, *The Shameless Wall Street Double Standard*, Law360 (June 12, 2017) https://www.law360.com/articles/930747/the-shameless-wall-street-double-standard.

96 *See* Dodd-Frank Act § 921(a) (granting the SEC authority to prohibit or place limits on mandatory arbitration agreements signed before any dispute arises).

97 9 U.S.C. §§ 10, 11; *see also* William Alan Nelson II, *Take It or Leave It: Unconscionability of Mandatory Pre-Dispute Arbitration Agreements in the Securities Industry*, 17 U. PA. J. BUS. L. 573, 604 (2015), *noting Nat'l Cas. Co. v. First State Ins. Group*, 430 F.3d 492, 497 (1st Cir. 2005) ("the First Circuit held that there was no misconduct when the arbitration panel issued the award without forcing the defendant company to produce relevant documents, because the arbitration panel acted within its authority when it chose to render a decision after drawing inferences against the company as to what documents would show").

B. Congress recognized these problems when it expressly authorized the Commission to ban mandatory arbitration.

In recognition of the many flaws in the mandatory arbitration system, Congress expressly granted the Commission authority to eliminate mandatory arbitration clauses. Section 921 of the Dodd-Frank Act allows the Commission to prohibit or impose conditions or limitations on mandatory pre-dispute arbitration clauses used by brokers. The legislative history explains the serious concerns about arbitration that prompted Congress to act:

> For too long, securities industry practices have deprived investors of a choice when seeking dispute settlement, too. In particular, pre-dispute mandatory arbitration clauses inserted into contracts have limited the ability of defrauded investors to seek redress. Brokerage firms contend that arbitration is fair and efficient as a dispute resolution mechanism.
>
> Critics of mandatory arbitration clauses, however, maintain that the brokerage firms hold powerful advantages over investors. Brokerages often hide mandatory arbitration clauses in dense contract language. Moreover, arbitration settlements generally remain secret, preventing other investors from learning about the performance of a particular brokerage firm.
>
> If arbitration truly offers investors the opportunity to efficiently and fairly settle disputes, then investors will choose that option. But investors should also have the choice to pursue remedies in court, should they view that option as superior to arbitration. For these reasons, H.R. 3817 provides the SEC with the authority to limit, prohibit or place conditions on mandatory arbitration clauses in securities contracts.[98]

Congress's decision to authorize the Commission to ban or limit mandatory arbitration was well-founded, and the Commission should take full advantage of that authority in the Proposal. Unless investors have the right to enforce any new standards of broker conduct that result from the Proposal, the final rule—even if substantially improved—will be of little consequence.

CONCLUSION

In closing, we offer a summary of the key changes that are essential for strengthening the Proposal. In short, the Commission should revise the Proposal in accordance with the analysis set forth above, and at a minimum, it should make the following changes:

1. Enhance the core "best interest" standard by imposing on brokers recommending securities investments or strategies a genuine fiduciary standard that is no less stringent than the fiduciary duty applicable to investment advisers. That standard must expressly require brokers to act in the best interest of the customer, without regard to the financial

[98] House Committee on Financial Services on H.R. 3817, H.R. Rep. No. 111-687, Part 1, at 50; 111th Congress's House Financial Services Committee report on H.R. 3817, The Investor Protection Act of 2009 and the precursor legislation to much of Title IX of the Dodd-Frank Act.

or other interest of the broker, dealer, or investment adviser providing the advice. The final rule must also make clear that the broker must at all times put the client's interest **ahead** of its own, and it must further provide that brokers may never allow conflicts of interest to influence or taint their recommendations.

2. Enhance the Disclosure Obligation by requiring disclosures **before** recommendations are made and with sufficient lead time to enable investors to understand the disclosures, discuss them with their broker or others, evaluate the implications of the disclosures, and determine their best course of action among various options. And we urge the Commission to further enhance the disclosure obligations by requiring brokers to make "full and fair disclosure" of all information required to be disclosed, not merely "reasonably disclose" that information.

3. Enhance the Care Obligation by reformulating the definition of "best interest" in accordance with the first recommendation above.

4. Enhance the Conflict of Interest Obligation by imposing a direct duty on brokers to fulfill those obligations, not merely a duty to prepare written policies and procedures embodying those goals. The Commission must also preserve the obligation to establish, maintain, and enforce written policies and procedures designed to fulfill the applicable disclosure, mitigation, or conflict of interest requirements, but it should require that those policies and procedures be **actually** designed to achieve those ends, not just "**reasonably**" designed to do so.

5. Enhance the Conflict of Interest Obligation by requiring brokers to mitigate all material conflicts of interest.

6. Enhance the Conflict of Interest Obligation by requiring brokers to eliminate certain conflicts that are too powerful to be mitigated effectively, including, without limitation, sales contests, quotas, prizes, and bonuses for meeting specified sales thresholds, along with any incentives that encourage and reward brokers for making recommendations that are not in the client's best interest.

7. Reduce the amount of discretion afforded to brokers throughout the Proposal by adding more prescriptive provisions stipulating what brokers must do, at a minimum, to comply with all of the provisions of the Proposal, including the Disclosure, Care, and Conflict of Interest Obligations, including, without limitation, the required form, manner, and timing of disclosures; the form and content of the required policies and procedures; and the specific ways in which brokers must mitigate material conflicts of interest.

8. Expand the scope of the Proposal to cover recommendations made to institutional investors, not only individual investors for personal, family, or household purposes.

9. Limit the circumstances in which a broker may disavow a continuing duty of care, including a provision establishing that whether or not a broker has a continuing duty of

care will depend on the facts and circumstances surrounding the relationship between the broker and the customer.

10. Expand the scope of the Proposal to cover recommendations as to the type of account the customer should open or maintain.

11. Strengthen the economic analysis in accordance with all of the comments set forth in Section III of this letter, including by acknowledging and measuring the extensive damage that conflicts of interest inflict on investors, by assessing the adverse economic impact of finalizing such a weak rule, and by more accurately assessing the costs and benefits associated with Proposal.

12. Enhance the enforceability of the Proposal by prohibiting the use of mandatory arbitration clauses that force customers to give up their right to seek relief in court through individual or class actions.

If these changes are not implemented, the Proposal will never effectively protect investors from adviser conflicts of interest, and the Commission will have lost a unique opportunity to serve the public and discharge its duty under the securities laws.

We hope these comments are helpful.

Sincerely,

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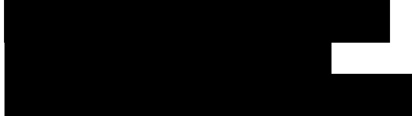

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