February 6, 2019

Public comment regarding SEC File Number 57-07-18

Sent via email to: rule-comments@sec.gov

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

Re: Release No. 34-83062; File No. s7-07-18

Dear Mr. Fields:

We write as a group of former SEC Senior economists, who have recently met to discuss the Commission's current position on the terms of advice provided by registered investment advisers and broker-dealers to retail customers.

Government regulators have struggled with defining the responsibilities of registered investment advisers (IAs) and broker-dealers (BDs) when providing ongoing financial advice to retail customers. For example, the Department of Labor first proposed a "fiduciary responsibility" rule in 2010 to govern advice about retirement accounts. They approved a final rule in June 2016 that was struck down by the courts in April 2018. The SEC proposed rules for non-retirement investment accounts in 2007, which were never finalized, and again in 2018.

This past April, the SEC proposed a set of three related rules (the "Proposal"). One clarifies the fiduciary responsibility of SEC-registered IAs, as defined in Section 206 of the Investment Advisers Act of 1940. The second proposal imposed new restrictions on BDs offering ongoing financial advice to retail customers. The third proposal requires both IAs and BDs to

provide a short, newly-designed amendment to advisers' Form ADV. This "Customer Relationship Summary" (CRS) is designed to explain in plain English the nature of the services that will be offered within the advisory relationship. The three proposals together occupy nearly one thousand double-spaced pages (408 pages in the *Federal Register* format). They have attracted more than 6,000 comment letters during the comment period.

It has been frequently reported that the proposals do not specifically define the term "best interest" as it applies to providing financial advice. This concept is difficult to define, in large part because the market often provides financial products offering similar risk-return characteristics, which differ substantially in the amount of compensation paid to the adviser. Thus, the Commission confronts important questions about advisers balancing their own compensation against the effect of that compensation on the customer's expected returns. We wonder if the extreme asymmetry of information and financial sophistication between advisers and many of their clients constitutes a market failure that the April proposals are intended to ameliorate.

We find it worrisome that the proposals' economic analysis does not fully consider some potentially-important dimensions of the retail client-adviser relationship. Each proposed SEC rule must include an economic analysis (EA) of the proposal's likely effects. The logic is that a new rule cannot be adequately evaluated without first specifying the problem it is intended to address, and without some indication of how the rule's economic costs and benefits would be distributed across the affected individuals and firms. In addition, economic analysis can help establish objective criteria by which the effectiveness of the rule can be evaluated if it is ultimately adopted by the Commission. In this case, we find that the EA is weak and incomplete, in at least

three specific dimensions. Moreover, the analysis appears inconsistent with parts of the Commission's own adopted guidance for fashioning a rule's EA.[1]

First, the EA for these three rules does not completely identify the specific problem(s) needing attention, even though the Commission's own "*Current Guidance on Economic Analysis in SEC Rulemaking*" states that the first "basic element[s] of a good regulatory economic analysis [is] … a statement of the need for the proposed action" (*Guidance*, page 4). The EA here identifies the main economic problem as the possibility that brokers and their customers might misunderstand one another's assessments of the appropriate risk-return tradeoff. In response to this problem, the EA suggests that a mandatory standard of adviser behavior might improve communication between the broker and the customer. Nowhere does the EA emphasize that an adviser's compensation provides numerous opportunities for her to favor one investment over another on the basis of the compensation it pays to her or to her firm.[2]

Overall, we find the EA's discussion of potential problems in the customer-adviser relationship to be incomplete. We can identify several features of the market for ongoing retail investment advice that might be considered problematic. Does disclosure or potential conflicts of interest provide customers with the information required to make informed choices? Does an adviser's superior knowledge of financial issues make it difficult for a retail customer to understand when a broker is working against his interests? Are customers confused about the fiduciary responsibilities of IAs vs. BDs who offer financial advice? If so, is that confusion

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[1] https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

[2] Nevertheless, the EA does recognize the presence of "material "conflicts of interest that might cause an adviser to recommend a security or strategy in part because of the compensation it will provide to the adviser (*Federal Register* 83(90), May 8, 2016, p. 21631).

important? Should advisers be permitted to sell only their own company's products, or must they provide access to a broad range of products that might benefit the customer? Should IAs and BDs be subject to the same standards in protecting a customer's "best interest"? Might imposing new standards of behavior lead to higher prices for financial advice or otherwise limit some customers' access to good financial advice? Is this likely to be true?

Second, the EA appears to provide inadequate discussion of the existing economic literature related to financial advising. As an illustration, a well-regarded paper by del Guercio and Reuter[3] concludes that equity mutual funds sold through advisers are more expensive <u>and</u> less remunerative than similar equity funds sold directly by a fund's investment adviser (e.g., Vanguard or Fidelity). Surely this result, if accurate, should play a role in assessing customers' "best interests." Yet we could find no citation to this paper in the EA.

Third, the proposal continues to rely heavily on advisers <u>disclosing</u> "material" conflicts of interest, defined as those conflicts that might affect the advice provided to a retail customer. Required disclosures have traditionally taken the form of written statements, with information provided at various times during the customer relationship. The proposed CRS seems to provide some useful information to new advice customers. However, the CRS information does not apply to individual customers and we are unaware of any requirement that an adviser provide a single, easy-to-digest periodic report summarizing the retail customer's <u>actual</u> cost of managing her funds. Moreover, we are aware of no evidence that disclosures enable retail customers to

[3] Diane Del Guercio and Jonathan Reuter, *Mutual Fund Performance and the Incentive to Generate Alpha,* 69 J. Fin. 1673 (2014). In his statement at the Open Commission Meeting in April, Commissioner Jackson similarly criticized the EA for its paucity of references to the academic literature and cites the del Guercio and Reuter (2014) paper.

understand the implications for their own welfare.[4] So a critical question remains unaddressed in the EA: will the required new disclosures meaningfully inform customers? We feel (preliminarily) that the new CRS forms would provide some helpful information. But we would far prefer for there to be evidence that the intended targets of these disclosures feel the same. It also seems possible that another form of disclosure might prove more enlightening than written documents, at least for some customers. In her statement at the April 2018 Commission Open Meeting Commissioner Peirce suggests that if firms were more "creative in their use of videos, interactive computer-based disclosure, mobile apps, and so forth, investors [might] be more likely to take in and think about the information we want them to understand."[5]

The Commission's April proposals may be responding to some, but not all, of the potential problems associated with the provision of retail investment advice. Many aspects of this problem pose difficult conceptual and legal issues, which makes it crucial for the EA to identify which problems constitute market failures, and which problems might be ameliorated by new regulations. As the Commission's own *Guidance* emphasizes, sound policy must first identify a new rule's purpose. Furthermore, plausible alternatives to a proposed policy cannot be identified without clearly understanding the problem being addressed. Unfortunately, the Commission's Economic Analysis of its April 2018 proposals fails to consider adequately any of these potential problems as the target of the proposed rules.

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[4] Given the Commission's and FINRA's long reliance on disclosure as a response to potential conflicts of interest, it would seem that the Commission might benefit by commissioning studies related to this question.

[5] Peirce, Hester, "Statement at the Open Meeting on Standards of Conduct for Investment Professionals", available at https://www.sec.gov/news/public-statement/statement-peirce-041818.

We close by noting that some of the economic analyses' shortcomings may reflect policy conflicts within a Commission that may feel pressured to "do something" in the wake of the DOL's highly publicized efforts in a closely related policy space. Given the Commission's past difficulties in developing financial advice proposals, not to mention the DOL's recent experience, one might conjecture that policymakers were unable to attain a coherent consensus. This is consistent with the statements of several Commissioners who voted to propose these rules only with substantial reservations. In our experience, agreeing on the economic need for a new rule often helps produce a more coherent and effective rule. This practice may be particularly relevant here, because the issues surrounding retail financial advice are many and difficult. Some policies might improve one part of the situation, while making others worse. And we all share concerns about unintended consequences – although a good EA should try to anticipate those. Our comments here are directed at the overall proposals, including their economic analysis.

Each of us has overseen the writing of economic analyses for past Commission rules. We understand the challenges of finding data to help identify relevant costs and benefits. But the EA for the three April 2018 proposals seems to fall short of the best attainable analysis, and we are concerned about the Commission's reputation for doing careful economic policy analysis. Good policy-making starts with carefully specifying the problem being addressed. We encourage the Commission to do better on this important rule.

Respectfully, a group of former SEC Senior economists.

Charles Cox, Chief Economist 1982 to 1983

Kenneth Lehn, Chief Economist 1987-1991

Susan Woodward, Chief Economist 1992-1995

Erik Sirri, Chief Economist 1996-1999

Mark Ready, Chief Economist 2000-2001

Larry Harris, Chief Economist 2002-2004

Chester Spatt, Chief Economist 2004-2007

James Overdahl, Chief Economist 2007-2010

Kathleen Hanley—Deputy Chief Economist, 2011-2013

Craig Lewis, Chief Economist 2011-2014

Mark Flannery, Chief Economist 2014-2016

Cc: Chairman Jay Clayton
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