Statement of Ken Ehinger
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On behalf of the Association for Advanced Life Underwriting (AALU)

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
House Financial Services Committee

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Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee, I am Ken Ehinger, President and Chief Executive Officer of M Holdings Securities, Inc.[1] I am testifying today on behalf of the Association for Advanced Life Underwriting. AALU appreciates the opportunity you have given us to testify on draft legislation by Representative Wagner. Her draft legislation would, in essence, require the SEC to identify a real need and determine that there will be real benefits outweighing the costs before upending the current standards that apply to broker-dealers. While we understand that the text of the Wagner proposal is a discussion draft at this point, we support her effort as a sensible proposal that we believe will lead to better rulemaking on the part of the SEC.

I have spent more than three decades in the securities and insurance business. I was honored to share my experience with this Subcommittee when I testified more than a year and a half ago. As I said then, a standard of care for financial professionals that sounds good in theory may fail in practice if it is vague and amorphous and provides no guideposts for compliance. And, a fiduciary duty offers little protection if regulators do not have the tools and resources to effectively oversee the financial professionals who are subject to it. I reiterate those statements today.

During consideration of Dodd-Frank, the then-Chair of the SEC advocated that the bill include a legislative mandate to the SEC to impose a new standard on broker-dealers. Congress rejected that approach and, instead, directed the SEC to study whether there were gaps in existing investor protection before acting on any new rule. [2]

The study produced in 2011 by the SEC staff was criticized on all sides because of the lack of economic analysis and findings of specific harm and market failure supporting its conclusions. The study's lack of empirical support was even acknowledged by a consumer advocate who testified here on the panel with me 18 months ago.

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[1] As President and CEO of M Securities, Mr. Ehinger oversees all aspects of M Financial Group's Broker/Dealer and Registered Investment Adviser. Mr. Ehinger has a diverse background in the securities and insurance industries that spans more than three decades. Additional biographical information about Mr. Ehinger is attached to this statement.

[2] *See* Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011) [hereinafter *SEC Staff Study*], *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

The SEC has stated that it needs to address investor confusion. This issue was highlighted in a 2008 Rand Corporation report, which found that investors were confused about the legal differences between brokers, dealers and investment advisers, although investors were very satisfied with their own financial professionals. [3] But, instead of addressing the confusion issue by working to develop better, clearer and more concise disclosure about the role in which a financial professional serves, the SEC took a different path. Over the past five years, the SEC has used precious time, staff resources, and, yes, private sector resources by continuing to press for a change in the broker-dealer standard of care to conform to the standard that applies to investment advisers. The SEC most recently set out various options for reform in this area in a 72-page release requesting a mountain of data, little of which relates to whether investors are being harmed.[4]

I have great respect for the SEC and for its dedicated staff. I appreciate what Chairman White said last week about her personal commitment to rigorous economic analysis to bolster its rulemakings going forward. But, I would like this Subcommittee to consider for a moment that the Commission has detailed dozens of staff to work on this discretionary rulemaking project over the last few years. I believe the SEC could make much better use of those talented and experienced staff, if it would do two things. First, direct two or three of those staff to develop a targeted disclosure rule that addresses any issue of investor confusion. Second, reassign the others to fill what continues to be, by the SEC's own acknowledgement, a monumental gap in investment adviser inspections and oversight.

Representative Wagner's bill would address these issues very directly. If the criteria in her discussion draft before you today had been in place from the outset, precious time and resources would have been saved by the SEC. The focus on the SEC's regulatory effort would have been to identify real and specific harm and then to craft a rule or other remedy to address that harm cost-effectively.[5] Investors would have been far better off.

It is well recognized that the regulatory and oversight regime for broker-dealers is more rigorous than the regulation of investment advisers. [6] If any changes are to be made to enhance investor protection, priority should be given to bringing adviser regulation up to the level for

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[3] *See* Angela A. Hung *et al.*, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[4] Duties of Brokers, Dealers, and Investment Advisers, 78 Fed. Reg. 45, (March 7, 2013).

[5] Note that the need for rigorous economic analysis is critical, in view of the SEC's experiences in rule challenges, where the D.C. Circuit Court of Appeals has overturned Commission rulemaking for failing to conduct appropriate economic analysis. *See* Business Roundtable and Chamber of Commerce v. SEC, No. 10-1305 slip op. (D.C. Cir. Jul. 22, 2011), *available at* http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/$file/10-1305-1320103.pdf.

[6] *See*, *e.g.*, Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011), *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

broker-dealers. This is critical, since, annually only 8% of the 11,000 registered investment advisors are examined by the SEC, compared to a 50% examination rate for broker-dealers by FINRA and the SEC. And, although all broker-dealers are subject to the dual oversight and regulation of the SEC and FINRA, most investment advisers with less than $100 million in assets under management are not subject to SEC inspection at all. Those advisers are left solely to the states – and the inspection rate varies from state to state. Moreover, broker-dealers also are subject to much more rigorous scrutiny before they are allowed to register; they also are subject to much more rigorous ongoing supervisory requirements.

Potential Impact of a New Standard for Broker-Dealers

As a practical matter, let me discuss how the SEC's effort to change broker-dealer standards would directly affect AALU's membership. AALU is a nation-wide organization of nearly 2,300 life insurance agents and professionals who are primarily engaged in sales of life insurance used as part of estate, charitable, retirement, and deferred compensation and employment benefit services. Many of our members have served the same individual clients and their families for decades. Our customers are of primary importance to us and, for that reason, we work closely with them to understand their needs and objectives in connection with the insurance and investment products we are authorized to sell, within the framework of our contracts with carriers and other obligations under all of the laws and regulations to which we are subject.

All of our members are licensed insurance professionals; many are licensed in multiple states. Many of our members own their own insurance agencies, in some cases with multiple offices, and some of these agencies own or are affiliated with registered broker-dealers or investment advisers. Many AALU members are registered representatives of SEC/FINRA-registered broker-dealers and/or are investment adviser representatives of SEC-registered investment advisers. Our members therefore are subject to multiple layers of federal and state regulation and oversight. We believe we have a unique perspective on the effectiveness of regulation and oversight by various regulators, particularly with regard to sales of insurance-related products.

Many life insurance producers offer variable life insurance and variable annuities, in addition to what may be viewed as more traditional life insurance products. These bundled products offer consumers investment choices for their accumulating cash values – the variable element of the product – with separate guarantees from the issuer such as a guaranteed death benefit and lifetime income guarantees, which are important options for customers seeking to address their life insurance protection and retirement needs and which have been recognized as even more important in recent years of market volatility. It is the sale of these products that triggers broker-dealer registration and SEC, FINRA, and state securities regulation and oversight for those producers. Any major changes in SEC regulation of broker-dealers, such as changing current standards for broker-dealers to an investment adviser-type standard, would have a significant impact on these producers and could potentially affect their relationships with, and their ability to serve, their customers, particularly with regard to the range of products offered as well as the costs of those products. For this reason, AALU on August 30, 2010 filed extensive comments with the SEC in connection with its Section 913 Study, in order to educate the

Commission on the extent of current regulation of insurance producers who sell variable products.[7]

AALU's submission to the SEC explained, for example, that the design of variable life insurance products requires medical and financial underwriting in determining insurable interest that goes beyond the requirements for traditional securities products. The rigor and breadth of applications relating to these products requires an assessment primarily of financial and protection needs. This necessitates an analysis related to death benefit, cash values, tax implications and costs. In each situation, the issuing insurance company is involved in determining the appropriateness of the product for the customer as it relates to risk selection and general suitability. In addition to the SEC's and FINRA's roles in the registration and sales of these products, state insurance commissions also regulate these products. Insurance producers/registered representatives who sell these products are subject to supervision by an SEC/FINRA-regulated broker-dealer and also subject to the terms of their contract with the issuing insurance company, which is subject to regulation by multiple state insurance regulators. Indeed, the scope and level of regulation is significantly higher for variable life insurance products than for other securities products under current law. However, the SEC Staff seemingly gave little weight to the extensive information provided by AALU and other insurance organizations[8] on the comprehensive and overlapping requirements of state insurance regulation and federal, state and FINRA securities regulation relating to variable products, under which insurance producers operate.

We believe consideration of the multiple layers of regulation and oversight of these variable insurance products, together with their product-specific disclosure and due diligence requirements, should have led the SEC Staff to conclude that no change in standards or further regulation is necessary, or at least to specify why, notwithstanding the current multiple and overlapping regulation of these products, a different, more subjective standard – the "best interest" standard – should be applied. We expressed strong concerns that applying such a standard, in addition to all of the existing regulatory requirements, could result in many insurance producers moving away from variable to fixed insurance products, limiting customer choice and increasing costs. The cost of meeting all regulatory and compliance obligations is already significant for all brokers, but especially insurance producers, due to levels of oversight and requirements that already exist. Our submission expressed our serious misgivings that an unwarranted change in the legal standard that requires increased time and compliance costs could render the delivery of this service too costly for insurance producers and the average customer, resulting in limited access to valuable insurance protection. However, the SEC Staff Study report did not acknowledge the comprehensive and overlapping regulation of insurance professionals.

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[7] *See* Comment Letter from David J. Stertzer, Chief Executive Officer, Association for Advanced Life Underwriting, File No. 4-606, Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2631.pdf.

[8] *See* Comment Letter from American Council of Life Insurers, Association for Advanced Life Underwriting, Financial Services Institute, Insured Retirement Institute, National Association of Insurance and Financial Advisors, and Securities Industry and Financial Markets Association, File No. 4-606, Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2532.pdf.

In addition, without any empirical evidence or data, the SEC Staff Study report dismissed concerns that the proposed regulatory changes would limit choice and access to financial products and services.[9]

The regulatory regime applicable to broker-dealers is more rigorous than that applicable to investment advisers, including: the level of regulatory oversight and examinations; the legal requirements for internal supervision programs; the specific liability of supervisors, which is designed to assure that they vigorously supervise the activities of those subject to their supervision; the qualification requirements for salespersons/advisers and supervisors; requirements for training and continuing education; and the nature and totality of the regulatory requirements in furthering effective programs of supervision and oversight to protect retail customers.

If the goal of imposing upon financial intermediaries any legal duty – fiduciary or otherwise – is anything other than to create liability for the intermediary, it should be to protect investors through assuring appropriate broker and adviser conduct. Regulation should provide appropriate and effective guideposts. In other words, regulation should provide clear rules of conduct, from which a financial services organization can develop training for its employees, supervision of their conduct, procedures to achieve compliance, and measures by which they can audit their conduct. Regulators then can examine and measure financial services professionals against these rules and assess for compliance. Thus, the regulations should be (1) clear and understandable to the financial professionals to whom they apply; (2) capable of being measured and monitored by supervisory personnel who are held accountable for compliance (and which are, in fact, monitored by supervisory personnel); and (3) capable of being audited and enforced by regulators. This is the model FINRA follows. It is not the Advisers Act model, where the broad, amorphous fiduciary standard of conduct has evolved essentially from case law and SEC enforcement actions.[10]

Investor Confusion Can, and Should Be, Addressed More Effectively

AALU members believe our customers fully understand the role in which our members operate. Indeed, if there is any concern about the current level of disclosures, we believe many customers feel buried under the weight of required disclosure and account-related documents.

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[9] *See SEC Staff Study*, *supra* n. 2 at 161-162, simply citing SEC staff views rather than specific supporting data: "The Staff believes that its recommended uniform fiduciary standard recognizes the value of preserving investor choice with respect to the variety of products and services involving the provision of investment advice and how investors may pay for them. . . . The Staff believes that the recommended uniform fiduciary standard would not require that broker-dealers limit, nor would it necessarily result in broker-dealers limiting, the range of products and services they currently offered to retail investors. . . . The Staff believes that . . . the recommended uniform fiduciary standard would in and of itself, not adversely impact [the retail investor] populations' access to financial products and services."

[10] *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963); *Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 17 (1979).

Nonetheless, we support efforts, such as FINRA's Notice 10-54, to develop better and clearer disclosure for customers of broker-dealers.[11] Indeed, we believe the FINRA process offers the potential to give thoughtful consideration to the types of disclosures that investors would find most useful in making investment decisions and to simplify the information most relevant to consumers. In AALU's comment letter to FINRA, we advocated for a simple document provided at the beginning of a customer relationship, with information about the roles, conflicts and services provided by a broker-dealer.

On this issue, the 2008 RAND Report also offers some critical insight. Many participants in RAND's survey apparently complained, "[t]he way [disclosures] are written is not easily understandable to the average investor, and the information in disclosures is not sufficient."[12] Of course, we know that both the SEC and FINRA have heard this complaint year after year, over many decades, and yet regulators to date have not written the kind of rules that would facilitate the type of simple, brief, "plain English" disclosures investors want and need. We believe this underscores the need for FINRA, together with the SEC, to develop and implement investor testing and investor education as part of the process of developing any new disclosure rules in this area.

Studies that (1) reflect investor confusion over legal duties that apply to financial professionals but also (2) show investor satisfaction about their own financial services provider point clearly to the need for more effective disclosures and investor education, not the need for wholesale changes in the legal standards.

Need to Address the Investment Adviser Inspection Gap

As we have testified previously, we believe the SEC, in its advocacy of a fiduciary duty almost to the exclusion of other, more pertinent reforms, has misplaced priorities. The first step in protecting investors has to be to assure they are well informed. They need to be informed about the role in which a financial services professional operates. They should be informed about who regulates them and when they were last inspected by a regulator. They need to understand what their rights are if there is a dispute with the financial services professional. They need to understand conflicts of interest. As a first step, the SEC should review current disclosures and consider changes where they believe disclosures are lacking.

Moreover, if investor confusion is to be the basis for new regulation, we submit that few investors understand that if their financial services professional is a registered broker-dealer, it is supervised by the SEC, FINRA, and state securities regulators, and likely is inspected approximately once every two years, but if the investor's financial service professional is a

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[11] *See* FINRA Notice 10-54, *Disclosure of Services, Conflicts and Duties* (Oct. 2010) *available at* http://www.finra.org/Industry/Regulation/Notices/2010/P122361; Comment Letter from David J. Stertzer, Chief Executive Officer, Association for Advanced Life Underwriting, File No. 4-606, Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2631.pdf.

[12] *See* Angela A. Hung *et al.*, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, at 19, *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

registered investment adviser it may be inspected approximately once every 10 years, according to the SEC's own budget projections.[13] Broker-dealers also employ significantly more internal resources, programs and procedures to comply with their responsibilities under Commission and FINRA rules, compared to investment advisers – a difference in regulatory requirements we also believe is unknown to most investors, who arguably would express concern if surveyed on this point. The level of internal broker-dealer resources committed to compliance, together with the industry's financial support of FINRA for its oversight of broker-dealers, is a significant multiple of government and private sector resources devoted to compliance on the investment adviser side.

No standard of care is effective without a mechanism to monitor and enforce its application. The Commission and other regulators and self-regulatory organizations already devote the clear majority of their oversight and inspection resources to broker-dealers. An investment adviser who is compensated based on assets under management or fees for services and time can be just as likely to make an inappropriate recommendation to garner more assets as any commission-based broker. Devoting limited Commission resources to imposing a uniform standard of conduct for brokers, dealers and investment advisers should be considered only if and when the oversight, inspection, and supervision gap between broker-dealers and investment advisers is sufficiently addressed.

Imposing a broad, vague fiduciary duty on broker-dealers would provide no increase in investor protection

While under certain circumstances (such as when a broker has discretionary authority over a customer's account) a broker may be held to the legal standard of a "fiduciary," we believe Advisers Act regulation or a broad fiduciary duty standard has not provided superior investor protection for customers of investment advisers and would not provide a measurable increase in investor protection for retail customers of broker-dealers. In contrast, a regime for advisers that more closely resembles that for brokers and dealers would likely benefit retail customers, in view of the specificity of the rules and the strong examination program resulting from FINRA oversight.

For variable life insurance products sold by licensed insurance agents in particular, which are among the most highly-regulated products sold by the most highly-regulated financial services professionals, nothing under the Advisers Act regulatory scheme compares to the comprehensive and robust customer protections already in place: comprehensive due diligence with respect to the customer's needs and financial capacity; suitability assessment relating to both annuity and investment products; disclosures to customers about the investment product; transaction-by-transaction review and approval by the carrier/issuer; immediate and transaction-by-transaction review of each transaction by a broker-dealers' securities principal; and meaningful and effective oversight by as many as four different levels of regulators (and often involving multiple regulators at the state level). While we do not believe AALU members'

[13] *See* U.S. Securities and Exchange Commission FY 2014 Congressional Budget Justification, *available at* http://www.sec.gov/about/reports/secfy14congbudgjust.pdf.

clients are confused about the insurance producer's role and any potential conflicts, the SEC does not need to look to the Advisers Act or to a newly-created "best interest" standard under Dodd-Frank to address any confusion, should it be identified. The Commission and FINRA have ample other authority (authority existing both prior to and after enactment of Dodd-Frank) to require additional disclosures by brokers to their customers.

Even beyond highly regulated variable products, as discussed above, the Commission/FINRA regulatory and oversight regime for brokers and dealers – which is highly specific, proactive, capable of being monitored by supervisors (and is, in fact, monitored) and capable of being audited by regulators (and is, in fact, regularly audited by regulators) is rigorous. In fact, we believe investors, if fairly surveyed, would choose a regime which provides specific rules of conduct to guide financial professionals, imposes liability upon supervisors for failing to meet robust supervisory requirements, and provides for periodic and robust regulatory oversight, over a regime in which a financial professional may have a legal "fiduciary" obligation but operates under the assumption that a regulator may audit its activities only once every 10 years. The comparative benefits of the broker-dealer regulatory and oversight regime over the current regime for investment advisers have been amply demonstrated.

Imposing an Advisers Act fiduciary duty standard or "best interest" standard could harm investors by reducing customer choice and access to financial services

The concept of "fiduciary duty" addresses the age-old agent monitoring problem (the lack of a principal's control over, and inability to continuously monitor, its agent) by imposing various duties and obligations enforced through the courts. The elements of the duty are principles-based, not rules based, and the duty is, by its very nature, after-the-fact liability creating.[14]

Many of our members operate under the Adviser's Act implied fiduciary duty and under certain specific rules adopted by the Commission under the Advisers Act. But a general fiduciary standard is inappropriate as applied broadly to sales of securities products where the broker does not hold himself/herself out as an investment adviser and does not exercise

[14] At a May 4, 2010 Senate Judiciary Subcommittee hearing, Professor Larry E. Ribstein, Associate Dean of the University of Illinois College of Law and an expert on fiduciary law, testified that "fiduciary duty is one of the most amorphous concepts in the law" – a concept developed through case law, predominantly at the state level. He stated that imposing such a duty "would result in massive uncertainty" and pointed to the lack of clarity after more than 40 years of litigation over the fiduciary standard in section 36 of the Investment Company Act, as well as the "ill-defined duty for investment advisers." At that same hearing, J.W. Verret, Assistant Professor of Law, George Mason University, testified about the difficulty of applying a fiduciary duty standard: "[U]nder a fiduciary standard and after the fact, [] it is too tempting to decide whether a decision was fair at the time it was made in light of how the investment ultimately performs." He noted, "[I]n administering fiduciary duty laws, it is nearly impossible to avoid being influenced by the perfect vision of hindsight." *See* transcript of Senate Hearing 111-835**,** Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?, *available at* http://judiciary.senate.gov/resources/transcripts/111transcripts.cfm.

discretionary authority. It is particularly inappropriate for bundled, self-contained products like variable life and variable annuities, which come pre-assembled with several investment choices and separate contractual guarantees from the issuer such as guaranteed death benefits and lifetime income guarantees. The range and features of these products makes it difficult to determine which product is "best" and, under a "best interest" standard, almost certainly would lead to increased litigation. Our members have a long history of being able to determine suitability – and we operate under FINRA and state insurance regulators' enhanced suitability standards for these products. However, determining what is "best" would be a highly subjective determination, opening a producer to second-guessing and liability, often years after the sale of a product.

- Is the best product in a rising market the one that is most aggressively allocated to equities? Some would argue that is the case.
- But, could the best product for the client that dies three years into the contract be the one with the highest death benefit?
- In a prolonged depressed equity market, is the product with the best income guarantee the most favorable to the client?
- Which is the best product for clients when there are tradeoffs, such as one product with fewer investment choices and lower costs and another with higher charges but a wider range of investment choices?

The 2011 SEC Staff Study and the SEC's most recent release on this subject say nothing about how its proposed best interest test would apply to these products.

Thus, we believe the imposition of a broad new "best interest" or fiduciary duty standard inevitably will lead to uncertainty and litigation. In our view, this will influence many life insurance producers to withdraw from the sale of these products and reduce investor access to them.

Conclusion

AALU believes the current legal and regulatory standards of care for brokers and advisers are fundamentally sound and recognize the importance of delivering a range of choices to customers based on needs and costs. Well-publicized abuses and failures that led to the recent financial reform effort have not been related to the standards of care for brokers, dealers and advisers. Indeed, where there have been abuses and scandals, they in large part have been due to the failure of vigorous regulatory oversight and enforcement of existing standards, and not any identifiable weaknesses in the standards themselves. This problem will remain regardless of any changes to the standard. As a result, the focus should be on the process of ensuring that the standard appropriate to a defined customer relationship is met.

We also believe the issue of investor confusion is somewhat misdirected. There exist many choices and options in accessing financial services that may be "confusing" to customers without their becoming educated beyond their desire. Yet, these differences in product choices, costs and services are fundamental to a delivery system that allows people across all wealth and income levels to access the benefits of financial services in some form. The solution is not to eliminate potential confusion through homogenization, but to ensure understanding of the standard selected to meet their needs and the role in which a financial professional is serving them.

Let me close by saying that life insurance enables individuals and families from all economic brackets to maintain independence in the face of potential financial catastrophe. The life insurance industry, through permanent life insurance and annuities, provides 20% of Americans' long-term savings. Two out of three American families – that's 75 million families – count on the important financial security that life insurance products provide. Therefore, any proposed change in regulation that could limit consumer choices and access to these critical protection and savings vehicles should meet a high burden with respect to the need for the changes.

I have spent most of my professional career working in businesses that are regulated by the SEC. It is in the interest of all of us who are regulated by the Commission to have a strong and respected regulator to police our markets and instill and enhance investor confidence, which is the foundation for capital formation and savings in the U.S.

Thank you for the opportunity to testify in this important hearing. AALU looks forward to continuing to work with you on these critical issues.