Statement of Terry Headley
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House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises

"Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight"

September 13, 2011

Good morning Chairman Garrett, Ranking Member Waters, and members of the Subcommittee. My name is Terry Headley, and I am the president of the National Association of Insurance and Financial Advisors (NAIFA). For the past 38 years I have been a financial advisor, registered representative and investment adviser representative with the Principal Financial Group. In 1982, I formed Headley Financial Group, a special market development office of Principal located in Omaha, Nebraska, which focuses on the small-to-medium business market, personal markets, and the estate and retirement planning markets. I have spent my career helping "main street" investors achieve their financial goals, and I appreciate the opportunity to appear before you today to share NAIFA's views regarding the regulation and oversight of broker-dealers and investment advisers.

My testimony will focus primarily on two regulatory issues of interest to NAIFA's members: The first concerns a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities and retirement accounts to retail customers. Both the Securities and Exchange Commission (SEC or the Commission) and Department of Labor (DOL) have indicated they will promulgate regulations imposing a single, uniform fiduciary standard of conduct on both broker-dealers and investment advisers. Our primary concern is that such regulations not adversely impact the ability of middle-market investors' to receive personalized investment advice and other important services from their financial advisors. The second issue I will discuss today is NAIFA's belief that the Financial Industry Regulatory Authority (FINRA) should serve as the self-regulatory organization (SRO) to conduct periodic examinations of SEC-registered investment advisers. It is clear to us that this would be the most effective, cost-efficient approach to regulating the examination of investment advisers.

NAIFA Members and their Regulatory Environment

NAIFA comprises more than 600 state and local associations representing the interests of 200,000 members and their associates nationwide. NAIFA members focus their practices on one or more of the following: financial advising and investments, annuities and life insurance, and employee benefits. NAIFA is the nation's largest financial services membership association and seeks to ensure that middle-market investors continue to have access to professional services and advice and have a choice of financial products that meet their financial needs and objectives.

Virtually all NAIFA members sell life insurance. In addition, nearly two-thirds of NAIFA members are licensed as registered representatives of broker-dealers ("Registered Representatives") to sell securities to their clients (primarily mutual funds and/or variable annuities). Of our members who deal in securities, 41% are "dually-registered" as Registered Representatives and investment adviser representatives for their corporate Registered Investment Adviser (RIA). Two-thirds of all NAIFA members, and 93% of our dual-registered members, provide retirement planning services.

Community-based NAIFA members, many of whom are small business owners, provide affordable financial services to middle-market investors. The clear majority of NAIFA members' clients have household incomes of less than $100,000, and a sizable percentage of our members' clients have less than $50,000 invested in the financial markets. NAIFA members who engage in securities activities are subject to significant compliance and regulatory requirements that provide an abundance of ongoing investor protection through vigorous enforcement of various rules imposed by the SEC and FINRA and, in turn, implemented by broker-dealers. Because our members are also licensed insurance professionals, they must also adhere to comprehensive regulations imposed by the various state insurance departments. As a result of these multiple regulatory layers, NAIFA members are among the most comprehensively regulated individuals in the financial services industry. For this reason, we are urging policymakers to consider carefully the impact any new regulations would have on middle-market investors and the NAIFA members who serve them.

I cannot emphasize enough that the investors that NAIFA members serve every day are middle-market investors who rely on the honest, trustworthy guidance of their financial advisors to help manage risk and plan for retirement. Without the personalized advice from financial professionals who have earned their trust over many years of service, these investors would be forced to utilize impersonal, "one-size-fits-all" advice from firms that do not tailor their advice to the specific needs of individual clients. NAIFA members, on the other hand, develop and maintain long-term relationships of trust with their clients. NAIFA members are Middle America and serve Middle America. Because they must take the time to get to know and understand their clients' personal and financial goals, our members are able to offer a broad range of services that middle-market investors truly need and value.

SEC Recommendation to Create a Uniform Fiduciary Standard of Care

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) required the SEC to conduct a study (the "Study") to gather necessary information to evaluate whether a uniform standard of care would be sound policy. Section 913(c) specified 14 issues the Commission had to consider in conducting the Study, including:

- The effectiveness of existing legal or regulatory standards of care for broker-dealers and investment advisers for providing personalized investment advice and recommendations to retail customers;

- Whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for broker-dealers and investment advisers;

- Whether the existence of different standards of care applicable to broker-dealers and investment advisers is a source of confusion for retail customers regarding the quality of personalized investment advice that retail customers receive;

- The substantive differences in the regulation of broker-dealers and investment advisers, when providing personalized investment advice and recommendations about securities to retail customers;

- The potential impact on retail customers, including the potential impact on access of retail customers to the range of products and services offered by broker-dealers, of imposing upon broker-dealers the investment advisers' standard of care for providing personalized investment advice about securities to retail customers of investment advisers, as interpreted by the SEC and the courts;

- The varying level of services provided by broker-dealers and investment advisers to retail customers and the varying scope and terms of retail customer relationships of broker-dealers and investment advisers with such retail customers;

- The potential impact upon retail customers that could result from potential changes in the regulatory requirements or legal standards of care affecting broker-dealers and investment advisers, including any potential impact on access to personalized investment advice and recommendations about securities; and

- The potential additional costs and expenses to (a) retail customers regarding, and the potential impact on the profitability of, their investment decisions, and (b) broker-dealers and investment advisers resulting from potential changes in the regulatory requirements or legal standards affecting broker-dealers and investment advisers relating to their obligations, including duty of care, to retail customers.

This past January, the SEC staff released that Study, which recommended creating a common fiduciary standard of care for broker-dealers and investment advisers. Significantly, the Study found that investors "generally were satisfied with their financial professionals."[1] The staff recommendation for a uniform fiduciary standard of care is not premised upon investors being *disserved* by the current standards, but rather investors being *confused* by the current standards.[2] NAIFA supports clarification to ensure client understanding of the different rules and business models of investment advisers and broker-dealers; however, any clarification or modification to the standard of care applicable to broker-dealers should not come at the cost of

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[1] SEC Staff Study, Study on Investment Advisers and Broker Dealers (Jan. 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf. at pg. V.
[2] *Id.* ("Many retail investors and investor advocates [stated] that retail investors do not understand the differences between investment advisers and broker-dealers or the standards of care applicable to broker-dealers and investment advisers.")

decreasing investors' satisfaction with or access to their financial professionals. Thus, if the SEC is intent on developing a uniform standard of care for both broker-dealers and investment advisers, it is imperative that the SEC must first examine *whether* a uniform standard can be imposed in a manner that does not decrease investors' satisfaction with or access to financial professionals.

In considering the Study's recommendation of a fiduciary standard for broker-dealers, it is important to note that the plain language of section 913 makes clear that any uniform fiduciary duty that is ultimately promulgated by the SEC be "no less stringent than" the general fiduciary duty currently applied to investment advisers, and need not be the *same* standard as is currently applied to investment advisers. In addition, Dodd-Frank appropriately includes exceptions providing that broker-dealer commission compensation and the sales of proprietary products would not automatically violate a possible uniform standard.

Dodd-Frank recognized that broker-dealers provide different professional services and operate under different business models than investment advisers. While broker-dealers primarily sell products to investors and offer routine financial advice incidental to the sale of such products, investment advisers primarily manage portfolios and engage in providing more comprehensive financial advice. Indeed, if Congress intended the SEC to duplicate the Advisers Act standard and apply it to broker-dealers, it could have simply repealed the current broker-dealer exemption found in the Advisers Act– an approach Congress rejected. <u>Any new standard contemplated by Congress or regulators should recognize and adapt to the differences between broker-dealers and registered investment advisers or else risk adverse, unintended consequences – namely, limiting the products and services available to middle-market investors.</u>

Simply applying the existing investment adviser fiduciary standard to broker-dealers would not be appropriate. For one thing, the Advisers Act was not designed to regulate broker-dealer activity. More specifically, it was not designed to apply to the incidental advice broker-dealers and their representatives routinely offer to their clients. Further, the case law regarding investment advisers' fiduciary duty was developed in the context of a business model that is inapplicable to broker-dealers. If the fiduciary duty applicable to investment advisers is imposed on broker-dealers without accounting for the different business models and clientele of each respective profession, the case law—to say nothing of SEC guidance documents—could be misinterpreted and misapplied in a number of ways that would disadvantage the broker-dealer business model with no corresponding benefit to middle-market investors.

There are further adverse, unintended consequences that would result from the application of the current investment adviser fiduciary standard to broker-dealers. Because broker-dealers would be forced to adjust their operations and compliance programs to an additional regulatory framework, fewer clients would ultimately receive professional service and advice. As compliance costs and the potential for liability increases, it would become economically unfeasible for financial professionals to work with less affluent clients.

NAIFA members on average report that approximately 58% of their clients earn less than $100,000 in household income per year, while just 11 percent earn an average of $250,000 per

year.[3] NAIFA members serve these middle-market clients despite substantial regulatory burdens. Broker-dealers and their Registered Representatives today devote considerable time and resources to complying with numerous federal and state regulations. They have an obligation to recommend only those investments and overall financial strategies that are suitable for their clients.[4] The suitability requirements compel a Registered Representative to have an "adequate and reasonable basis" for any recommendation that he or she makes. Whether a recommendation is "reasonable" relates to the specific securities or strategies recommended, and Registered Representatives are further obligated to determine "customer-specific" suitability, taking into account every client's particular financial situation, needs, and other security holdings. NAIFA members have an obligation to investigate and obtain comprehensive information about their clients' unique circumstances in determining the courses of action they recommend.

Thus, a wholesale application of the current Advisers Act duty to broker-dealers would negatively impact product access, product choice, and affordability of customer services for those consumers who are most in need of these services. This concern is borne out by data NAIFA has collected over the past year.[5] An analysis of two surveys—one involving consumers and the other NAIFA members—shows that consumers with household incomes in the middle-market range represent a core client base for NAIFA members. If a universal fiduciary standard of care is imposed, many members would be forced to discontinue providing many of these important services to middle-market clients. As mentioned above, 58% of NAIFA members' clients average less than $100,000 in household income per year. According to the survey, which polled more than 3,300 NAIFA members, most members involved in securities activities are concerned that the additional regulatory requirements and potential legal implications of a fiduciary standard could significantly increase their compliance costs. If costs were to go up by 15 percent, 65 percent of our members said they would need to take actions that would limit their client's access to financial advice. For example:

- 31 percent say they would limit their practice to affluent clients only;
- 20 percent would not offer securities to their clients;
- 14 percent would increase fees for their clients;

Any such results would not be in the best interests of investors, and certainly would not further the regulators' goal of enhancing consumer protections. It is crucial that middle-market investors be able to obtain personalized financial advice so they can plan adequately for their futures. Without their financial advisors, many investors would have nowhere to turn when they need reassurance in a shaky market, assistance in rebalancing their portfolios, or understanding the investment choices available. NAIFA is concerned that the SEC Study unduly discounts the risk that the additional regulatory burdens imposed on financial professionals by the Study's recommendations could result in investors having fewer broker-dealers and investment advisers

[3] Jim Mitchel & Shannon O'Keefe, 2010 NAIFA Survey Report (Nov. 2010) (on file with NAIFA)
[4] The concept of "suitability" appears in specific SRO rules, such as NASD Rule 2310 (updated in FINRA proposed rules 2090 and 2111) and FINRA Rule 2330, and has been interpreted to be an obligation under the antifraud provisions of the federal securities laws.
[5] Jim Mitchel & Shannon O'Keefe, 2010 NAIFA Survey Report (Nov. 2010) (on file with NAIFA)

to choose from, having less access to products and services, and having to pay more for the services they do receive.

In recommending the adoption of a new uniform fiduciary standard, the Study not only discounts the very real possibility of these negative consequences, but does not adequately articulate or substantiate the problems that a uniform fiduciary standard would solve. The Study does not claim that retail investors are systematically being harmed or disadvantaged under the fiduciary or suitability standard, and therefore it lacks a basis to conclude that a uniform standard or harmonization would enhance investor protection. NAIFA supports efforts to determine if problems exist and wants to be part of the dialogue on how best to fix any identified problems. We are however concerned that proceeding down a regulatory path without a stronger empirical and analytical foundation could lead to the unintended consequences described above.

For these reasons, NAIFA urges the members of the Committee to encourage the SEC to more thoroughly consider the impact that an SEC-imposed uniform fiduciary standard would have on middle class Americans' access to sound financial advice. We agree with former Commissioner Casey and Commissioner Paredes that further analysis of investor returns (controlling for risk and investor characteristics) generated under the two existing regulatory regimes would be fruitful, as would a survey of investors to obtain a general overview of the characteristics of investors who invest through a broker-dealer as compared to those who invest on the basis of advice from an investment adviser. Finally, should the Commission impose a uniform fiduciary duty, it must account for the unique attributes of the broker-dealer business model, provide new guidance documents for industry, and be sufficiently clear and comprehensible so broker-dealers can adjust their business practices with minimal disruption. This should include, for example, a clear definition of "personalized investment advice" so broker-dealers (and their customers) adequately understand their legal responsibilities and obligations, as well as clear guidance regarding disclosure that would satisfy the uniform fiduciary standard of guidance. Further, any new disclosure should be informed by investor testing, which is required by Section 912 of Dodd-Frank when the SEC is developing new rules.

Department of Labor Proposed Rule to Redefine "Fiduciary" in Retirement Savings Marketplace

On a separate but related issue, the Department of Labor (DOL) has issued proposed regulations that would expand the definition of "fiduciary" for purposes of ERISA and parallel provisions in the tax code. Under current law, individualized investment advice only makes a person an ERISA fiduciary if there is a mutual understanding between the parties that the advice will also be provided on a regular basis for a fee. The new proposal eliminates the contractual concept of mutual agreement and presumptively makes anyone who gives personalized investment advice, if any affiliate gets paid in connection with the advice, an ERISA fiduciary.

Being an ERISA fiduciary is not the same as the Investment Advisers Act concept of fiduciary. "Best interest of the client" is not enough—advice must be solely in the client's interest. More concretely, a fiduciary and affiliates cannot receive commissions, bonuses, or other forms of variable compensation without special permission from the DOL in the form of a prohibited transaction exemption. These PTE's, as they are called, come with a host of

conditions and regulatory requirements. Thus, ERISA fiduciary status is more restrictive than any uniform fiduciary standard that we expect the SEC might devise. Moreover, the restriction on the receipt of commissions is inconsistent with the provisions of Section 913 of Dodd-Frank, which specifically provides that receipt of a commission by a broker-dealer cannot, in and of itself, violate a fiduciary standard.

Though it is highly restrictive and though Congress has passed no law encouraging the DOL to reexamine a definition that has been in place throughout ERISA's 36-year history, the DOL is proposing to vastly expand the universe of employee benefit plan service providers who will be fiduciaries. Even more radically, they are proposing the definition apply to advice given in the IRA market, even though IRA owners are retail investors not locked into their service providers as employee benefit plan participants are, and IRAs are subject only to tax code requirements; the DOL does not have direct enforcement authority over these accounts. NAIFA is gravely concerned that, without changes, the DOL proposal will not only raise costs and restrict access to retirement savings advice and education, but also wipe out the broker-dealer model of investing in IRAs.

Several weeks ago, in a hearing in the Health, Employment, Labor and Pensions subcommittee of Education and Workforce, Assistant Secretary of Labor Phyllis Borzi stated that the DOL's proposed definition of "fiduciary" would force the retirement savings marketplace to create a new business model, and yet she could not elaborate on what this new model would look like, or what the costs would be to investors and small businesses. She could not quantify the problem that this change is supposed to address. She has repeatedly indicated that revisions to the proposal need to be made, and new PTEs will be required to make it work, yet the DOL has not put these revisions and new PTEs out for public comment. Though there are legitimate reasons for reexamining a 36-year-old regulation to see if it still works in today's marketplace, there is no reason to rush through a radical change without even giving the public an opportunity to comment on the full picture.

The new DOL restrictions on retirement investment advice are also likely to cause serious confusion for investors and advisers potentially faced at the same time with new and inconsistent SEC fiduciary standards. A middle-market investor who calls her Registered Representative for investment suggestions likely will not understand why the adviser can only give specific recommendations for non-retirement accounts; she will likely be confused, frustrated, or even angry if she asks "maybe I should put some of my IRA funds in that investment too?" and the adviser says "I can't answer that." Since the SEC process at least has Congressional authorization, the DOL should wait until the SEC completes its consideration of the fiduciary issue and then reassess whether there are substantial regulatory gaps that would support a change to the ERISA regulations. And at a minimum, the DOL should re-propose a revised rule along with all associated PTEs so the public has the opportunity to assess and comment on the full picture.

FINRA Examination of SEC-Registered Investment Advisers

In response to a directive in section 914 of the Dodd-Frank Act, the SEC earlier this year issued a staff study (the "Adviser Study") about enhancing the investment adviser examination

process. The Adviser Study recognizes that in the past 6 years the number of SEC-registered investment advisers has increased, but the resources dedicated to adviser examinations have decreased. Recognizing this fact, the staff Adviser Study offered three possible solutions for Congress to consider: authorize one or more SROs to examine advisers; impose user-fees on advisers to fund SEC exams; or authorize FINRA to examine dual-registered advisers.

NAIFA supports reasonable examinations to ensure that financial professionals are complying with the law. Statistics have made it very clear that investment adviser examinations are not occurring with sufficient frequency—on average, SEC-registered investment advisers are examined approximately once per decade. NAIFA believes the most efficient, cost-effective answer is to authorize FINRA to conduct all examinations of SEC-registered investment advisers. Because virtually all NAIFA members who are registered investment advisers are already subject to comprehensive broker-dealer regulations as well, authorizing FINRA to examine SEC-registered investment advisers will be the most efficient option for dual-registered NAIFA members.

FINRA is already subject to SEC oversight, and it would clearly be more efficient and effective for FINRA to expand its current, substantial examination capabilities to cover RIAs than it would be to establish new SROs or significantly increase SEC exam programs. According to the Adviser Study, FINRA examined 57 percent of its broker-dealer members in 2008, and it examined 54 percent of its members in 2009.[6] The SEC's Office of Compliance Inspections and Examinations, by contrast, examined 9 percent of investment advisers in 2010, a 29.8% rate of decrease since 2004.[7] With its current budget stretched thin and future appropriations uncertain, adding additional responsibilities to the Commission makes no sense when a perfectly capable entity like FINRA already exists. Moreover, adding to SEC duties would be antithetical to Congressional and Administration efforts to avoid imposing unnecessary regulations on the business community. Authorizing FINRA to conduct all RIA examinations is a common-sense solution to a solvable problem.

Pursuant to a request in Chairman Garrett's invitation letter for this hearing, we have reviewed draft legislation enclosed with the letter which would amend the Investment Advisers Act to establish an application and registration process for "National Investment Advisers Associations" (NIAA). NIAAs would examine investment advisers and, when circumstances warrant, discipline them for violations of SEC and relevant NIAA standards. The draft legislation also provides a framework for the registration and SEC oversight of NIAAs generally similar to that applicable to broker-dealer self-regulatory organizations under section 19 of the Securities and Exchange Act. While NAIFA has not had time to formulate a position on the various parts of the draft, we believe it moves in the right direction and provides a useful basis for further discussion and consideration. We look forward to working with the Subcommittee on this important matter.

Conclusion

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[6] SEC Staff Study, *Study on Investment Advisers and Broker Dealers* (Jan. 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf, at pg. 30.
[7] SEC Staff Study, *Study on Investment Advisers and Broker Dealers* (Jan. 2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf, at pg. 14.

At NAIFA we realize that there are many complexities associated with regulating and overseeing broker-dealers and investment advisers. We appreciate the opportunity to share our views with you today on issues that we view as critical to ensuring all investors are both protected and have access to competent financial advice and services. At a time of increased economic uncertainty, investors need access to trustworthy financial professionals they can rely on. We welcome the opportunity to assist you in any way that we can.

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United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Terry Headley	National Association of Insurance and Financial Advisors (NAIFA)
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: Terry K. Headley	

Please attach a copy of this form to your written testimony.