

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

March 11, 2019

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority staff
Subject: March 14, 2019 Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets hearing entitled “Putting Investors First? Examining the SEC’s Best Interest Rule”

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Putting Investors First? Examining the SEC’s Best Interest Rule” at 9:30 a.m. on Thursday, March 14, 2019 in Room 2128 of the Rayburn House Office Building. Witnesses for the hearing are:

- **Susan MacMichael John**, CFP® President, Financial Focus, Inc.
- **Dina Isola**, Investment Advisor Representative, Ritholtz Wealth Management
- **Barbara Roper**, Director of Investor Protection, Consumer Federation of America
- **Lee Baker**, President, AARP Georgia State
- **The Honorable Harvey L. Pitt**, Chief Executive Officer, Kalorama Partners

Overview

Retail investors rely on broker-dealers and investment advisers for investment advice and expect that advice to be given in their best interest. However, the regulatory regime that governs the provision of investment advice to retail investors is substantially different depending on whether that advice comes from a broker-dealer or an investment adviser. While investment advisers are held to a “fiduciary standard,” meaning they have to serve the best interests of their clients without regard to their own financial interests, broker-dealers are generally held to a “suitability standard.” This standard requires a broker-dealer to make recommendations that are consistent with the interests of the customer. In practice, this means that brokers are permitted to consider their own compensation interests when providing recommendations.

Brokers’ conflicts of interest may derive from sales quotas for the sale of proprietary products, signing bonuses, and additional fees for the sale of certain products. Such brokers’ conflicts of interest may lead to the sale of underperforming assets to retail investors that may cost at least \$40 billion each year.¹

On April 18, 2018 the SEC proposed to change the current suitability standard of conduct for brokers and provide guidance on the fiduciary standard of conduct for investment advisers. These rules

¹ Letter from Barbara Roper and Micah Hauptman, CFA, to the SEC, Standard of Conduct for Investment Advisers and Broker-Dealers, Sept. 14, 2017, available at: <https://consumerfed.org/wp-content/uploads/2017/09/cfa-letter-to-sec-on-standard-of-conduct-rfi.pdf>.

will impact 2,800 brokerage firms, 7,000 investment advisory firms, 162 million customer accounts managed by brokers and advisers, and \$36.6 trillion in assets.²

The hearing will examine this proposal along with one legislative proposal. The bill would require the SEC to engage in rigorous investor testing of any disclosure intended for retail investors.

Background

Pursuant to Section 913(b) of the Dodd-Frank Act, the SEC, in January 2011, issued a staff report recommending that the SEC consider rulemakings that would uniformly apply a fiduciary standard that is no less stringent than the standard currently applied to investment advisers to both broker-dealer and investment advisers when providing personalized investment advice about securities to retail clients.³ Section 913(g) provides the Commission with the authority to impose a fiduciary standard on broker-dealers. Section 913(f) provides the SEC with less specific authority to conduct rulemaking on the standards of care for advisers considering the results of the mandatory study under Section 913(b).

The SEC did not act pursuant its authority under Section 913 until over seven years later. In the meantime, in April 2016 and after six years of consideration, the Department of Labor (DOL) finalized its own rule requiring all persons providing investment advice about assets in retirement accounts to act as a fiduciary and put the interests of their clients ahead of their own compensation interests.⁴ This rule was designed to protect retirement savers from conflicted advice that costed them \$17 billion annually.⁵

However, on March 15, 2018, the Fifth Circuit Court of Appeals held that the DOL exceeded its statutory authority to promulgate a new fiduciary standard for advisers and vacated the rule in its entirety.⁶ The Court's holding was contrary to that of other courts, including the Tenth Circuit Court of Appeals, which had previously upheld the rule. The Department of Justice, which represents the DOL in litigation, did not seek Supreme Court review.

On April 18, 2018 the SEC proposed a three-part regulatory package, consisting of: (1) a "best interest" standard of conduct for brokers pursuant to Section 913(f) of Dodd-Frank ("Regulation Best Interest" or "Reg BI"); (2) guidance on the fiduciary standard of conduct for investment advisers; and, (3) a relationship disclosure document for brokers and investment advisers ("Form CRS").⁷ The SEC also proposed prohibiting professionals that are not registered investment advisers from calling themselves "adviser" or "advisor." However, the proposal did not address the other titles that professionals may use

² Jason Zweig, *Free Trips Under Fire: SEC Wants your Broker to work for you*, Wall Street Journal, Jul. 20, 2018, available at: <https://blogs.wsj.com/moneybeat/2018/07/20/free-trips-under-fire-sec-wants-your-broker-to-work-for-you/>.

³ Sec. & Exch. Comm'n, Study on Investment Advisers and Broker-Dealers, at ii (2011), available at: <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

⁴ DOL, Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Investment Advice, 81 Fed. Reg. 20945 (Apr. 8, 2016), (to be codified at 29 C.F.R. pt. 2510), available at <https://www.federalregister.gov/documents/2016/04/08/2016-07924/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice>.

⁵ White House Council of Economic Advisers (CEA), The Effects of Conflicted Investment Advice on Retirement Savings, Feb. 2017, available at https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

⁶ *Chamber of Commerce v. U.S. Department of Labor*, No. 17-10238 (5th Cir. 2018), available at: <http://www.investmentnews.com/assets/docs/CI114691315.PDF>.

⁷ SEC, Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, 83 Fed. Reg. 21416 (Apr. 18, 2018) (to be codified at 17 C.F.R. pt. 240), available at: <https://www.federalregister.gov/documents/2018/05/09/2018-08583/form-crs-relationship-summary-amendments-to-form-adv-required-disclosures-in-retail-communications>; SEC, Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, 83 Fed. Reg. 21203 (Apr. 18, 2018) (to be codified at 17 C.F.R. pt. 275), available at: <https://www.federalregister.gov/documents/2018/05/09/2018-08679/proposed-commission-interpretation-regarding-standard-of-conduct-for-investment-advisers-request-for>; SEC, Regulation Best Interest, 83 Fed. Reg. 21574 (Apr. 18, 2018) (to be codified at 17 C.F.R. pt. 240), available at: <https://www.federalregister.gov/documents/2018/05/09/2018-08582/regulation-best-interest>.

like wealth manager, financial consultant, financial manager, money manager, investment manager, financial planner, or investment consultant.

SEC Commissioner Kara Stein opposed the proposal stating that it would be more accurate to label Regulation Best Interest as “Regulation Status Quo.”⁸ She noted that:

...I am concerned that this rule will not only confuse retail investors, but also broker-dealers. In particular, the lack of a definition of best interest, the use of similar terms to mean different things, the use of different terms to mean the same things, and the possibility that the SEC and FINRA interpret the same language in their suitability standards differently. All of these concerns would make it difficult for the industry to discern a clear compliance path. Any resulting confusion may well result in higher compliance costs for broker-dealers, which will likely be passed onto the investor. What’s more, the lack of a clear standard is not likely to give investors more confidence in the broker-dealer business model.⁹

Commissioner Robert Jackson raised similar concerns and although he voted in support of releasing the proposal for notice and comment, he stated that “I could not support these proposals if we were today considering making them final agency rules.”¹⁰

The proposal had a 90-day comment period for the public to weigh in. During that time the SEC has indicated that it will conduct investor testing on proposed Form CRS and hold various roundtables across the country. As discussed further below, the results of the SEC’s investor testing on the proposed Form CRS have been mixed — the Relationship Summary appears to be helpful for investors who already read the documents when choosing an adviser, and who have more investing experience, but less helpful for investors who would not otherwise read the documents.¹¹ In addition, even after reading the Relationship Summary, investors still reported that “there were areas of confusion for participants, including differences between types of accounts or financial professionals.”¹²

The SEC has yet to finalize the proposal, but reportedly is expected to do so in the first half of this year.¹³

In the meantime, states have continued their trend of adopting their own fiduciary standard of conduct for brokers. Maryland, Nevada, New Jersey, and New York are also reportedly in the process of adopting a new fiduciary standard for brokers.¹⁴ Industry groups have cautioned that this approach may result in a patchwork of regulation.¹⁵

⁸ Public Statement of Commissioner Kara M. Stein, Sec. Exch. & Comm’n, Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers, Apr. 18, 2018, available at: <https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818> [hereinafter *Public Statement of Commissioner Stein*].

⁹ Public Statement of Commissioner Stein, *supra* note 8.

¹⁰ Public Statement of Commissioner Robert J. Jackson Jr., Sec. Exch. & Comm’n, Proposed Rulemakings Relating to Investment Adviser/Broker Dealer (IABD) Standards of Conduct, Apr. 18, 2018, available at: <https://www.sec.gov/news/public-statement/proposed-rulemaking-retail-investor-relationships-investment-professionals>.

¹¹ See RAND Corporation, *Investor Testing of Form CRS Relationship Summary*, at 50–51 (2018), available at: <https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf> [hereinafter *RAND Relationship Summary*].

¹² *RAND Relationship Summary*, *supra* note 11, at 50.

¹³ Kenneth Corbin, *As SEC’s Reg BI Looms, States Chart Their Own Fiduciary Path*, *Financial Planning*, Feb. 04, 2019, available at: <https://www.financial-planning.com/news/as-secs-regulation-best-interest-looms-states-chart-their-own-fiduciary-path>.

¹⁴ Corbin, *supra* note 11; Patrick Temple-West, *Top Insurance Industry Groups Criticize State Fiduciary Efforts*, *Politico*, Feb. 19, 2019, available at: <https://portfolio.bisanet.org/Article/top-insurance-industry-groups-criticize-state-fiduciary-efforts>.

¹⁵ Armstrong Robinson, Jack Dolan & Sheila Owens, AALU, *A Best Interest Standard of Care for Annuities and Securities: ENHANCING CONSUMER PROTECTIONS. PROTECTING CONSUMER CHOICE.*, available at: <https://www.aalu.org/a-best-interest-standard-of-care-for-annuities-and-securities-transactions-enhancing-consumer-protections-protecting-consumer-choice/>.

In addition, on February 6, 2019 a group of former SEC senior economists sent a comment letter on the SEC proposed regulations criticizing the SEC's economic analysis of the likely effects.¹⁶ According to the letter, "we find that the [economic analysis] is weak and incomplete, in at least three specific dimensions." Those dimensions are: 1) a failure to completely identify the specific problems the proposal is intended to address; 2) an apparent failure to provide adequate discussion of the existing economic literature related to financial advising; and 3) a heavy reliance on advisers disclosing material conflicts of interest, without evidence that the intended targets of the disclosure find them helpful and informative.

Pursuant to the direction of the SEC to conduct investor testing of the SEC's proposed Form CRS, the SEC's Investor Advocate issued a report on November 7, 2018 on the testing conducted by the RAND Corporation.¹⁷ The investor testing consisted of a nationwide online survey of 1,800 individuals and 31 qualitative in-depth interviews in Denver and Pittsburgh. According to the report, "[n]early 90 percent of survey respondents opined that the Relationship Summary would help them make more informed decisions about investment accounts and services."¹⁸ However, "interview discussions revealed that there were areas of confusion for participants, including differences between types of accounts or financial professionals."¹⁹

Also on November 7, 2018, the SEC's Investor Advisory Committee (IAC) issued recommendations on the SEC proposed Reg BI, advisor guidance, and Form CRS. Among other things, the IAC recommended that the SEC conduct usability testing of the disclosures in Form CRS "and, if necessary, revise them to ensure that they enable investors to make an informed choice among different types of providers and accounts."²⁰ The IAC also noted that the extensive feedback it had received and the comment letters to the SEC suggested that "Form CRS, as currently proposed, is unlikely to achieve its intended purpose of reducing investor confusion and supporting informed decisions."²¹

On September 12, 2018, AARP, the Financial Planning Coalition, and Consumer Federation of America sent a letter to SEC Chairman Clayton detailing the results of their own independent usability testing.²² Their testing consisted of 90-minute, one-on-one interviews with 16 investors from three geographically diverse locations. The key findings of the testing were that: 1) "The overall level of comprehension was poor;" 2) Participants did not understand key differences in the nature of services provided;" 3) "Most participants did not understand disclosures regarding legal obligations;" 4) "Participants were deeply confused by the disclosure of fees and costs;" and, 5) "Participants understood the existence, but not the import, of conflicts of interest."

SEC Disclosure Effectiveness Testing Act (Casten)

The SEC Disclosure Effectiveness Testing Act is a discussion draft that would build on efforts to engage in investor testing by requiring the SEC to conduct usability testing of any new disclosure intended for retail investors. It would also require the SEC to review and test the usability of its existing disclosures for retail investors, such as mutual fund disclosures. Such reviews and tests would be required prior to the SEC adopting a final rulemaking.

¹⁶ Letter from Charles Cox et al., to the SEC, Public Comment Regarding SEC File Number 57-07-18, Feb. 6, 2019, *available at*: <https://www.sec.gov/comments/s7-07-18/s70718-4895197-177769.pdf>.

¹⁷ RAND Relationship Summary, *supra* note 11.

¹⁸ RAND Relationship Summary, *supra* note 11, at 36.

¹⁹ RAND Relationship Summary, *supra* note 11, at 42.

²⁰ Sec. & Exch. Comm'n, Recommendation of the Investor as Purchaser Subcommittee Regarding Proposed Regulation Best Interest, Form CRS, and Investment Advisers Act Fiduciary Guidance, *available at*: <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac110718-investor-as-purchaser-subcommittee-recommendation.pdf> [hereinafter *SEC Recommendation*].

²¹ SEC Recommendation, *supra* note 20.

²² Letter from the AARP et al., to the SEC, Sept. 12, 2018, *available at*: <https://consumerfed.org/wp-content/uploads/2018/09/letter-to-sec-from-aarp-cfa-fpc-regarding-crs-testing.pdf>.