Consumer Federation of America

Fund Democracy
The Mutual Fund Shareholder's Advocate

September 30, 2005

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Dear Chairman Cox:

Congratulations on your appointment as Chairman of the Securities and Exchange Commission. We were pleased to read, in your opening speech to the agency staff, your unequivocal commitment to ensuring that the Commission acts as the advocate for average investors and your clear recognition that investor confidence in the integrity of our nation's securities markets is essential to those markets' success. These are views that CFA and Fund Democracy share, and we would like to offer our support in achieving those goals.

With that in mind, we are writing to suggest an area where Commission policy is in need of a major overhaul in order to achieve your goal of putting investors' interests first. That issue is the regulation of financial professionals. A series of misguided policy decisions by the Commission over the past two decades has created a marketplace in which financial professionals who are indistinguishable to the average investor – based on the titles they adopt, the services they offer, and the ways in which they market those services – are subject to two very different standards of conduct.

As the recent mutual fund sales abuse scandals made clear, this blurring of the lines between advisers and salespeople exposes investors to very real risks. First, they risk placing their trust in a financial professional who markets themselves as an adviser but accepts no responsibility to act in their best interest. Second, they risk relying on recommendations from that individual with no understanding of the conflicts of interest that may bias those recommendations. When, as a result, investors end up purchasing mediocre, high-cost investment products, it can cost them thousands or even tens of thousands of dollars over the lifetime of a long-term investment. Given our nation's poor record of long-term saving, these are losses most individuals can ill afford and no one should have to accept.

The recently adopted rules on fee-based brokerage accounts offer the Commission a convenient starting point from which to rectify this situation and develop in its place a rational, investor-oriented policy for the regulation of financial professionals. The goal of that policy should be to ensure that all those who will be perceived by investors as offering the same

services will be subject to the same standards of conduct and that all those offering personalized investment advice will be subject to appropriate investor protections. This will only occur, however, if two conditions are met: 1) the new rule defining financial planning is implemented with an eye toward protecting investors, rather than protecting brokers from regulation as investment advisers, and 2) the study the Commission has pledged to conduct is used to lay the foundation for a more thoughtful regulatory approach.

1) Place investor interests over broker-dealer interests in implementing the new financial planning rule.

The recently adopted, but not yet fully implemented, rule on fee-based brokerage accounts would appear to offer significant progress toward rationalizing the regulation of financial professionals, by recognizing that financial planning is an advisory service that ought to be regulated under the Investment Advisers Act. If the Commission implements the rule with an eye toward how best to protect investors – by ensuring that it covers all broker-offered services that will be perceived as financial planning by investors – it could offer significant progress indeed. On the other hand, if the Commission adopts a narrow, legalistic approach to the rule's implementation – one that provides loopholes brokerage firms can use to keep services that clearly constitute investment advice outside the Advisers Act's reach – then this rule will do virtually nothing either to enhance investor protections or to rationalize regulation of financial professionals.

Recent reports that the Commission is prepared to allow Wachovia to offer its Envision planning program outside the protections of the Advisers Act would suggest, if correct, that the latter is likely to be the case. As explained by a Wachovia spokesperson, the plans have been determined not to warrant Advisers Act regulation because they consist only of investment planning and do not include the estate planning and insurance planning that are part of a comprehensive financial plan. This suggests that the SEC considers financial planning an investment advisory service, to be regulated under the Investment Advisers Act, not because it includes personalized investment advice, but because it also includes things that clearly aren't investment advice. Such an interpretation is absurd on the face of it and entirely misses what would seem to be a fairly obvious point – it is not the comprehensive nature of financial planning that makes it an investment advisory service, it's the extensive investment advice that's included.

We can only hope that these reports are inaccurate. They would be easier to dismiss, however, if they were not entirely consistent with the Commission's misguided approach to this issue over the past two decades. Time after time, the SEC has been willing to accommodate the brokers as they sought to transform themselves into advisers without being regulated as advisers. The most recent example of this came in the rule release on the fee-based account rule, in which the Commission finally defined the broker-dealer "solely incidental to" exemption from the Investment Advisers Act only to define it out of existence. The Commission defined "solely incidental to" to include any advisory services provided "in connection with and reasonably related to" brokerage services, a stunning rejection of the plain statutory language and the likely impetus behind Wachovia's interpretation that its investment planning service can be offered outside the Investment Advisers Act. This highlights what should be obvious to anyone with your stated respect for the English language – we need a new definition of the "solely incidental

to" exemption that is consistent with the clear meaning of the statutory language, not one that was developed to provide cover for the Commission's past poor policy decisions in this area. Without a new, accurate definition of the broker exemption, both implementation of the new financial planning rule and development of a more rational policy going forward will be hopelessly undermined.

2) Use the study of additional regulatory and legislative initiatives to lay the foundation for a rational, pro-investor policy for the regulation of financial professionals.

When the Commission adopted the fee-based brokerage account rule, it committed to conducting a study of further regulatory and legislative initiatives to eliminate investor confusion and address the blurring of lines between brokers and investment advisers. Such a study has the potential to lay the foundation for a sound, pro-investor policy. We are convinced, however, that it will only accomplish this goal if it is conducted by an expert from outside the agency. Such an expert can look objectively – in a way we believe the Commission staff cannot – at past policy decisions that have contributed to the current confusion. It is unfortunate that the Commission decided to conduct the study after adopting the rule, rather than before it made up its mind on the issues the rule substantially resolves, but pretending that the Commission staff will now be able to conduct an independent evaluation of its decision will only multiply the error.

Moreover, past internal discussions of these issues have too often devolved into turf battles between the divisions of Market Regulation and Investment Management. This seriously detracts from the Commission's ability to provide the needed analysis based on investors' interests rather than on whose regulatory territory is being encroached upon. We therefore strongly urge you to look outside the agency for an objective expert when determining who will conduct this study.

A. Improve pre-engagement disclosure by financial professionals.

One area that we believe deserves careful attention as part of that study is the need for improved disclosure on which investors can base their selection of a financial professional. Evidence, including the SEC's own focus group testing, suggests that, once investors select a financial professional, they rely heavily on that adviser's recommendations. That makes the selection of the right financial professional of the utmost importance to their investing success.

Unfortunately, investors do not consistently receive the information they need to make an informed choice. If the financial professional in question is an investment adviser, the client is entitled to pre-engagement disclosure of fairly extensive information about their method of practice, compensation, and conflicts of interest. However, this information is often provided in a form that only a securities attorney could easily understand. If the financial professional is a broker, the investor is not required to receive any such pre-engagement disclosure. NASD Regulation and the state securities regulators make extensive disciplinary information available, but most investors are not aware of this resource and do not take advantage of it. While the SEC's pending point-of-sale disclosure proposal is a good first step toward making important information about costs and conflicts of interest available, it occurs well after the critical

decision has been made – the point at which the customer decides to retain the broker. By the time the customer has received the point-of-sale document, he or she has in most cases already decided to follow the broker's advice.

In order to improve investors' ability to make an informed selection among financial professionals, we believe all financial professionals (brokers, financial planners, and investment advisers alike) should be required to provide pre-engagement disclosure that covers at least the following key issues: what services the financial professional offers, how they charge for those services, what their legal obligation to clients is, how they arrive at their recommendations, what conflicts of interest may bias their recommendations, and whether they have any disciplinary events on their record. This information should have to be provided in plain English and in a uniform manner so that it can be easily understood and compared.

A good starting point for developing such a document is the ADV form, as proposed to be revised by the SEC staff several years ago. We strongly urge you to resurrect the rule revising the ADV form, which has been left to languish for too long, and to look into extending these requirements to all financial professionals under Commission jurisdiction who provide recommendations to retail investors.

B. Strengthen the interpretation and enforcement of advisers' fiduciary duty.

While one of our organizations' policy goals is to get all those who offer personalized investment advice regulated as advisers, this is just a first step toward providing adequate investor protections. Although investment advisers are acknowledged to be fiduciaries, with an unequivocal obligation to act in their clients' best interests, this obligation has not always been as stringently enforced as it could or should have been. Of particular concern is the fact that advisers have not consistently been held accountable for considering products' costs when determining whether they are in their clients' best interests. While we certainly do not consider cost to be the only important consideration, it does have a significant long-term impact on investors' returns. For that reason, CFA and Fund Democracy have urged the Commission to make clear that advisers have an explicit fiduciary duty to consider costs when determining what products to recommend. We hope you will ensure that this issue is addressed in the study of financial professional regulation.

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No issue is more important for average retail investors than the regulation of financial professionals. That is because most investors do not challenge, or even carefully review, the recommendations they receive from their broker, financial planner, or investment adviser. One can argue that investors' willingness to place blind trust in financial professionals is both foolish and risky – and CFA has made exactly that argument for the better part of two decades – but it is important to recognize that this behavior is both encouraged by industry marketing practices and unlikely to change. It is therefore essential that regulatory policy governing financial professionals take this inevitable investor behavior into account. Unfortunately, this has not been the case in the recent past. Instead, the Commission policy has preserved distinctions between brokers and advisers long after these distinctions have ceased to make sense either in

terms of how these two classes of financial professionals conduct their businesses or in terms of how they are perceived by the investing public.

CFA and Fund Democracy support the above steps to bring regulatory policy into line with marketplace realities and investor expectations. We urge you to make this a priority during your tenure as SEC Chairman. Thank you for your attention to our concerns. Please feel free to contact us if you or members of your staff would like to discuss these issues further.

Respectfully submitted,

Barbara Roper
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Consumer Federation of America

Mercer Bullard
Founder and President
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cc: Commissioner Paul Atkins
Commissioner Roel Campos
Commissioner Cynthia Glassman
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