Consumer Federation of America

July 30, 2007

The Honorable Christopher Dodd
Chairman
Committee on Banking, Housing
and Urban Affairs
U.S. Senate
Washington, D.C. 20510

The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing
and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Chairman Dodd and Ranking Member Shelby:

We were pleased to learn that you are planning to hold a hearing this week with Securities and Exchange Commission Chairman Christopher Cox on the current state of the securities markets. This timely hearing offers an excellent opportunity to review a variety of issues of importance to investors. Our purpose in writing to you is to identify investor protection issues currently before the Commission that we view as being of key importance to retail investors and that we would encourage you to raise during the hearing.

I. Develop a Rational, Pro-Investor Approach to the Regulation of Investment Professionals

Arguably the single most important issue directly affecting average retail investors is the regulation of investment professionals. That is because most individual investors investing outside a retirement plan choose to invest with the assistance of a broker, financial planner, or investment adviser and because most of those who do so rely very heavily, if not exclusively, on the recommendations they receive from those professionals.

The regulation of investment professionals is greatly in need of reform. Today, individuals who use titles and offer services that are indistinguishable to the average investor, and who market those services as if they were identical, are permitted to operate under two very different standards of conduct. In particular, brokers have been permitted to call their salespeople financial advisers, offer extensive retirement and investment planning services, and market their services based on the advice offered, all while escaping regulation under the Investment Advisers Act. As a result, they do not have the same duty to act in clients' best interest that financial planners and investment advisers typically assume. Nor do they have to provide pre-engagement disclosure of material information, including method of compensation and conflicts of interest, required of advisers.

The recent U.S. Appeals Court decision overturning the fee-based brokerage account rule, and the SEC decision not to appeal that decision, opens the way for pro-investor reform. It

ensures that brokers who charge fees for advice are regulated as advisers. However, it does not in and of itself resolve all problems in this area. In fact, when combined with the SEC's failure to adequately restrict the advice brokers can offer without being regulated as advisers, the court decision has the perverse effect of making method of compensation rather than services offered the primary determinant of regulatory status.

In order to create a regulatory policy that makes sense and protects the interests of investors, the following steps are needed:

- require all those investment professionals who give extensive personalized investment advice to be regulated as advisers, just as Congress intended when it adopted the Investment Advisers Act;
- prevent those who do not provide personalized investment advice from holding themselves out to the public as advisers; and
- require all investment professionals – brokers, investment advisers, and financial planners alike – to provide uniform pre-engagement disclosure of key information investors need to make an informed choice among investment professionals.

The SEC has commissioned a study by the Rand Corporation to help determine what additional legislative and regulatory steps may be needed to improve regulation in this area. We hope the RAND Corporation study will serve as the basis for development of a pro-investor policy along the lines described above. We urge you to lend your support to such an approach.

II. Ensure that New Audit Standards Lead to Quality Audits

Reforming regulation of financial professionals relates directly to the retail investing experience. But retail investors also have a vital stake in the overall integrity of the market. Nothing has been more important in this regard than the reforms adopted in the wake of accounting scandals at Enron and a host of other major public companies. These reforms have been under threat from those who claim – in direct contradiction to masses of evidence – that they threaten to undermine the competitiveness of U.S. securities markets. Despite overwhelming evidence that the Sarbanes-Oxley Act reforms have benefitted, rather than undermined, our markets' competitiveness and that their benefits have greatly outweighed their costs, these concerns have been allowed to shape regulatory policy, including through a weakening of the standards for internal controls audits.

Just last week the SEC gave final approval to a new standard for an integrated audit of financial statements and internal controls. We have serious reservations about certain aspects of the new standard, and the accompanying SEC guidance for public companies, which we believe threaten to undermine the effectiveness of these audits. We nonetheless applaud the SEC for turning aside requests both for additional weakening amendments and for further delay in its implementation for the smallest public companies. We appreciate the role this committee has played in defeating a proposed amendment to exempt the majority of public companies from the internal control requirements, and we urge you to show the same leadership in opposing any

further delays in implementation for small companies.

We believe the committee also has an important role to play in ensuring that the new standards lead to quality audits – an outcome that is far from guaranteed in our view. We are concerned, in particular, that the new standards rely for their effectiveness on a risk-based approach to the internal controls audit. While this approach is ideal in theory, it has been nothing short of a disaster when applied to the financial statement audit. The failed audits that led to the passage of SOX, after all, were risk-based audits. Two reasons for the failure of this approach seem obvious:

- It relies heavily on auditors to exercise professional judgment, but many of those doing the audit work lack the experience or expertise on which to base such judgments.

- It leaves auditors vulnerable to pressure from management to reduce the amount of testing they do to support their audit opinion.

The former shortcoming could be addressed through a clear statement of principle – that the assessment of risk and decisions about the design of the audit must be performed by members of the audit team with adequate experience and expertise to make those judgements. However, no such principle was included in this supposedly principles-based approach. The latter shortcoming is particularly troubling in light of pervasive message in both the PCAOB's new audit standard and the SEC's new management guidance that they are designed to result in less testing and less expensive audits. With auditors being second-guessed by regulators over the thoroughness of their audits, company managers are likely to find it all too easy to intimidate them into lightening up on the audit, even at the expense of audit effectiveness.

We urge this committee to use its oversight function to ensure that this does not occur. In particular, we urge the committee to work with the SEC and perhaps the GAO to determine why the risk-based approach has so often failed in the past and what can be done to ensure that it works in the future.

III. Ensure that the Move to Recognize International Standards Does Not Undermine the Quality of Financial Reporting or Investor Protections

The SEC appears to be rushing headlong to permit the use of international accounting standards with little consideration of likely negative consequences. While we support efforts to bring U.S. and international accounting standards into alignment, we believe the current efforts have gotten ahead of themselves. The recognition of international standards as an alternative to U.S. GAAP should come after that alignment has been achieved and not before.

International accounting standards are widely regarded as providing greater "flexibility" than U.S. GAAP. Flexibility in accounting is not necessarily a good thing, however, since it allows for widely divergent treatment of similar circumstances. (One can only imagine how enthusiastically Enron would have embraced the opportunity to use international accounting standards.) The lack of consistency in accounting treatment under international standards is

evident even when companies are required to reconcile their financial statements to U.S. GAAP. We believe this required reconciliation serves as an important check on the most "creative" use of international standards. If that reconciliation requirement is lifted, its disciplining effect will also be lost – to the detriment of reporting clarity, transparency, and investor protection.

In recent months, the agency has also begun to float the notion of "mutual recognition" or "substituted compliance" for foreign regulators whose regulations offer protections "comparable" to those in the United States. The idea behind such an approach is that we would allow exchanges and brokers from foreign countries with comparable regulatory protections to do business here without having to register fully with the SEC or be regulated by the SEC, and our brokers and exchanges would in turn gain access to their markets.

This raises serious questions about what "like-minded" foreign jurisdictions would qualify for such treatment. For example, the United Kingdom is often praised here as a model to guide U.S. regulatory reform. But its investor protections are far from comparable. Not only does it allow companies to list there that couldn't begin to meet basic U.S. listing standards, but its enforcement program is all but non-existent. As the *Wall Street Journal* recently reported, the U.K.'s FSA is currently facing "tough questions at home about whether it does enough to protect individual investors" and "is often looked on as a toothless tiger." It is hard to imagine that a mutual recognition policy wouldn't recognize the United Kingdom, but is just as clear that to do so would expose U.S. investors to serious risks. Furthermore, it is easy to imagine that political pressure would be brought to bear on the SEC to recognize regulatory jurisdictions that offer even weaker protections, subjecting U.S. investors to even greater risks.

We believe both these developments – the rush to recognize international accounting standards and the move toward mutual recognition of foreign regulators – pose enormous perils to U.S. investors. We therefore urge this committee to use its oversight authority to slow this process and to ensure that any moves in the direction of greater reliance on international standards and regulations are carefully weighed and undertaken cautiously and gradually, if at all.

IV. Guarantee Meaningful Investor Input into Any Proposed Changes to Financial Reporting Policies

Last month, the SEC issued a release announcing the creation of a new Advisory Committee on Improvements to Financial Reporting. Although the first meeting is scheduled for later this week, according to the release, we have yet to see a listing of its members. Previous such committees, including for example the Advisory Committee on Smaller Public Companies, have failed to provide adequate representation for investor advocates, and their recommendations have as a result ignored investor concerns. We fear that this is likely to be the case for this new committee as well. This is of great concern, since these committees often have a significant impact on commission policy.

The Advisory Committee on Improvements to Financial Reporting is, as its name implies, expected to review a number of issues of vital concern to investors. These include the merits of principles-based vs. rules-based standards and the growing use of international accounting standards. Two items on the committee's agenda in particular would seem to be

issues that should not only take full consideration of investors' views, but should in fact be driven by investors' preferences – the current systems for delivering financial information to investors and accessing that information and whether there are current accounting and reporting standards that do not result in useful information to investors.

It is absolutely essential that investors have more than token representation in these policy discussions. Perhaps our fears will prove unfounded, and that full representation is already being provided. If not, we urge the committee to use its oversight authority to ensure that this committee – and future advisory committees convened by the SEC – provide the full and fair representation that investors deserve.

V. Ensure that the Transition to Greater Use of the Internet for Disclosure Improves the Delivery of Information to Investors

Chairman Cox has made the expanded use and enhanced quality of Internet disclosure a signature issue. We share his belief that use of the Internet has the potential to improve the quality and timeliness of disclosures. We also applaud the Chairman for preserving the option of paper disclosure, without undue barriers, for those investors who for whatever reason prefer to receive information in this format. This is essential since many investors, particularly but not exclusively older investors, remain reluctant to use the Internet for this purpose. We believe the Commission could benefit from doing more research to understand investor attitudes toward use of the Internet, how best to overcome any reluctance regarding Internet use, and how to make best use of the Intent to enhance investor understanding of disclosures.

A related issue that is important to ensuring that investors benefit from enhanced use of the Internet for disclosure purposes revolves around the question of what constitutes delivery and dissemination of information in the Internet age. Some have suggested that availability or accessibility equals distribution – in other words that simply posting information on the Internet should satisfy delivery and dissemination requirements. We strongly disagree. Certainly for retail investors, and we believe for many institutional investors as well, some more active form of delivery is necessary to satisfy notification requirements. This is true both in the Regulation FD context and in the context of disclosures from investment professionals to their customers. We urge the committee to oversee policy in this area to ensure that it develops in a pro-investor manner that enhances, rather than detracts from, information transparency.

VI. Improve Transparency of and Competition in Broker-Dealer Compensation Practices

Under Chairman Cox's leadership, the Commission has begun to investigate possible reforms of mutual fund 12b-1 fees. We support this effort, and believe significant steps could be taken to improve investor understanding and awareness of these fees. Moreover, we believe such improvements could be adopted without eliminating the option of paying for broker-dealer services through some kind of incremental sales load.

However, 12b-1 fees are far from the only form of broker-dealer compensation that lacks transparency or is protected from competitive forces. For example, there is every reason to

believe that, if the SEC were to make 12b-1 fees more transparent, more broker compensation for the sale of funds would simply be transferred to less transparent mechanisms, such as revenue sharing payments. Moreover, if brokers are forced to provide better disclosure of the compensation they receive when selling mutual funds, they are likely to sell other investment vehicles that require less disclosure. There is no guarantee that these investments would be a better investment option for investors than mutual funds, or even as good an option.

We therefore believe the Commission should look more comprehensively at the issue of broker-dealer compensation practices, with an eye toward identifying all areas where compensation lacks transparency and is protected from competitive forces and developing uniform policies for reform that cut across all product lines. Only then will investors be assured that well-intended reforms in this area actually deliver significant investor benefits. We urge the committee to lend its support to such an effort.

VII. Eliminate the Soft Dollar Safe Harbor

As you know, Chairman Cox has recently urged Congress to "repeal or substantially revise" Section 28(e) of the Securities Exchange Act, which provides a safe harbor for use of soft dollars to purchase eligible brokerage and research services. We strongly concur. The soft dollar safe harbor was adopted over 30 years ago to ease the transition to a non-fixed-commission environment. Its repeal is long overdue.

Allowing advisers to use shareholder assets – their brokerage commissions – to pay for a broad range of services creates enormous potential for abusive practices. These include: the risk that money managers will use client commissions to benefit themselves, by paying for services through soft dollars that they could and should pay for directly themselves; the risk that money managers will use one client's trades to benefit another client, by using soft dollars paid by mutual fund shareholders, for example, to pay for services that benefit a hedge fund run by the same manager; and the risk that they will use soft dollars to hide expenses from their clients, which is possible because portfolio transaction costs are not included in the expense ratio and are not clearly disclosed to shareholders. Money managers who can simultaneously shift costs onto shareholders and hide those costs from view have little incentive to negotiate the lowest price. As a result, the ability of the market to discipline costs is seriously impeded.

Because their use drives up portfolio transaction costs, makes a mockery of the expense ratio as an accurate reflection of mutual fund costs, creates significant conflicts of interest between funds and their shareholders, and interferes with the functioning of the free market, CFA has long supported a ban on the use of soft dollars to pay for any goods or services, including research, that could readily be purchased with hard dollars. We urge this committee to close the soft dollar safe harbor, as Chairman Cox has advised.

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U.S. securities markets are flourishing. Some would cite this as an argument that further reforms are not needed. Such thinking, however, leads to a misguided approach in which major reforms are only adopted in the wake of, and in response to, a major market crisis. We believe instead that this moment of relative calm offers an opportunity to adopt carefully crafted, well

thought out reforms that promote market integrity and the interests of investors. This letter is intended to provide, not a comprehensive list, but rather a rough overview of issues that could benefit from such an approach. We urge this committee to consider these views as it undertakes both its oversight role and its own investigations of market issues with an eye toward protecting investors and promoting the integrity of our markets.

We appreciate your attention to our concerns.

Respectfully submitted,

Barbara Roper
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