



## Consumer Federation of America

May 9, 2011

The Honorable Spencer Bachus  
Chairman  
Financial Services Committee  
U.S. House of Representatives  
Washington, D.C. 20515

The Honorable Barney Frank  
Ranking Member  
Financial Services Committee  
U.S. House of Representatives  
Washington, D.C. 20515

The Honorable Scott Garrett  
Chairman  
Capital Markets and Government  
Sponsored Entities Subcommittee  
Financial Services Committee  
U.S. House of Representatives

The Honorable Maxine Waters  
Ranking Member  
Capital Markets and Government  
Sponsored Entities Subcommittee  
Financial Services Committee  
U.S. House of Representatives

Dear Chairman Bachus, Ranking Member Frank, Chairman Garrett and Ranking Member Waters:

I am writing on behalf of the Consumer Federation of America (CFA) in response to concerns expressed by some members of this Committee regarding the Securities and Exchange Commission's proposal to impose a fiduciary duty on brokers when they offer personalized investment advice to retail investors. While CFA has long advocated a universal fiduciary duty for personalized investment advice, we understand that Members of Congress are likely to be concerned when they hear claims that imposing a fiduciary duty on brokers could increase costs to middle income and rural investors or cause them to lose access to valued products and services. The SEC proposal, as outlined in the Section 913 study, should lay those fears to rest.

With the release of its Section 913 study, the SEC made clear that it is very sensitive to the need to preserve the broker-dealer business model and, with it, investor access to affordable, transaction-based advice paid for through commissions on product sales. With those concerns in mind, the SEC proposed to impose the fiduciary duty through parallel rules under the '34 Act and the '40 Act, rather than regulating brokers directly under the Advisers Act, and to do so in a way that preserves brokers' ability to charge commissions, sell proprietary products, sell from a limited menu of products, and offer transaction-based advice. While issues remain to be worked out regarding exactly how the fiduciary duty would be applied in various situations, they are precisely the type of issues that are appropriately resolved during the rule-making progress. Moreover, our own discussions with members of the broker-dealer community suggest that these issues are imminently resolvable.

For these reasons, the SEC proposal has engendered a significant, if not unprecedented breadth of support. Most remarkably, the proposal has won praise not just from the traditional advocates of a fiduciary duty – investor advocates, state securities regulators, and investment adviser and financial planning groups – but also from the major broker-dealer groups. In its official statement on the report,

for example, SIFMA praised the agency for recognizing “that any fiduciary standard should not pick business model winners and losers.” The Financial Services Institute was, if anything, even more positive, noting that the study had addressed its concerns regarding the fiduciary duty proposal by acknowledging “the importance of investor choice and access to services” and proposing “a means to reduce the costs associated with the proposed regulatory changes.”

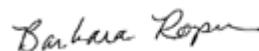
Unfortunately, a relatively small but highly vocal portion of the broker-dealer community continues to attack the SEC proposal on the grounds that it would harm middle income and rural investors. In doing so, as the attached document is intended to show in greater detail, proponents of this view ignore serious short-comings in existing investor protections as well as the significant steps the SEC proposes to take to ensure that the fiduciary duty would be applied in a way that is consistent with the broker-dealer business model. We are concerned that arguments with so little basis in fact appear to be persuading some Members to advocate a go-slow approach on this top investor protection priority for retail investors.

We recognize that some Members share the concern, expressed by SEC Commissioners Casey and Paredes in their dissent, that the SEC has failed to provide sufficient economic justification for moving forward with a rule. We view this argument with mixed sentiments. On the one hand, we believe the SEC report clearly documents a serious market failure in need of a regulatory solution: that brokers and investment advisers offer personalized investment advice under two very different regulatory standards; that investors are unable to make an informed choice between the two types of service providers because they cannot tell them apart and do not realize they are subject to different standards; and that disclosure alone cannot resolve this investor confusion.

On the other hand, we believe there is a powerful economic argument to be made in favor of holding brokers to a fiduciary duty when they give investment advice. Specifically, an effectively enforced fiduciary duty could save investors tens of billions of dollars a year in excess costs and reduced payouts by forcing brokers to make recommendations based on the best interests of the investor rather than their own bottom line. While it may be impossible to precisely quantify this economic benefit, we believe the best way for the SEC to satisfy the demands to provide a stronger economic basis for rulemaking is to document the significant costs that investors bear and the benefits they lose as a result of conduct that is permissible under a suitability standard but unacceptable under a fiduciary duty.

In its study, the SEC has proposed a way to move forward on fiduciary duty that maximizes investor protections while minimizing industry disruption. In doing so, it was won broad support from industry and investor advocates alike. It would be tragic if opposition from a few industry members intent on maintaining the status quo were able to derail that progress. Despite the self-interested claims of certain industry members, it is the middle income investors who must make every dollar count who are most in need of these enhanced protections.

Respectfully submitted,



Barbara Roper  
Director of Investor Protection

cc: Members of the Committee

## **Response to Arguments about Fiduciary Duty “Unintended Consequences”**

During congressional consideration of legislative proposals to impose a fiduciary duty on brokers when they give investment advice, a concern was raised that doing so may have the effect of denying middle-income and rural investors access to valued products and services. The Section 913 report mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and released earlier this year by the Securities and Exchange Commission (SEC) should lay those fears to rest. With its proposal to impose the duty through parallel rules under the Investment Advisers Act and the Securities Exchange Act, the agency has made clear its intention: to apply the fiduciary duty only to brokers’ personalized investment advice to retail customers and not to a broader range of brokerage services; to continue to permit brokers to charge commissions for their services; to continue to permit brokers to sell proprietary products and to sell from a limited menu of products; and to develop a workable approach to principal trading consistent with a fiduciary duty.

The approach advocated by the SEC has won strong support from those groups that have long advocated a fiduciary duty: investor advocates, state securities regulators, and investment adviser and financial planning groups. But it has also won praise from leading members of the broker-dealer community. In particular, both of the two major broker-dealer trade associations – SIFMA and the Financial Services Institute – have endorsed the regulatory approach proposed by the SEC. SIFMA, for example, specifically praised the agency for recognizing “that any fiduciary standard should not pick business model winners and losers.” FSI issued the following favorable comment: “The Study acknowledges the importance of investor choice and access to services. It proposes a means to reduce the costs associated with the proposed regulatory changes and avoids picking winners and losers thereby leaving the choice of provider to investors. These were major concerns for FSI and we are satisfied to see that the Study addresses them.”

Despite this important progress, a relatively small segment of the broker-dealer community, particularly the brokers whose business model depends on the sale of often high-cost variable annuities, continue to argue that imposing a fiduciary duty on brokers would harm Main Street investors by increasing their costs or denying them access to valued products and services.<sup>1</sup> We recognize that Members of Congress are understandably concerned by claims that middle income or rural investors could be harmed by the fiduciary duty proposal, and as such have attempted to analyze the basis for this claim. In doing so, we have found that those expressing this concern fail to recognize or acknowledge serious short-comings in regulatory protections under the existing standard, ignore those aspects of the SEC proposal designed to protect the broker-dealer business model, and fail to provide any facts to support their claims regarding the effect of a fiduciary duty on compliance costs. Given the lack of substantiation offered, and the support for the SEC approach expressed by other members of the broker-dealer community, we can only conclude that these concerns are unfounded.

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<sup>1</sup> See, for example, the National Association of Insurance and Financial Advisors (NAIFA) issue brief on this topic and earlier fact sheet on a LIMRA International survey of NAIFA members.

## **I. Critics ignore serious short-comings in existing regulatory protections.**

A basic premise of the argument against extending a fiduciary duty to brokers offering personalized investment advice is that the current system is working well, providing investors with both adequate protection and the ability to choose whether to work with a broker or an adviser. To arrive at that conclusion, however, one would need to ignore, deny, or gloss over serious short-comings in the current system.

A. For example, it has been suggested that the suitability standard governing broker-dealers is a more robust standard than the fiduciary duty. This is factually untrue.

- A fiduciary duty requires extensive up-front disclosures of information important to investor decision-making, particularly with regard to conflicts of interest. Brokers operating under a suitability standard are not subject to comparable disclosure requirements, though their conflicts of interest are typically greater.
- Certain recommendations that satisfy the suitability standard would not be permissible under a fiduciary duty. The following is a simplified example of how this can harm investors.

A broker operating under a suitability standard and choosing between two variable annuities to recommend would be free to recommend the one that pays him the highest compensation as long as both were considered appropriate investments for the customer. He would not have to disclose that conflict to the customer.

A broker operating under a fiduciary duty would have to analyze the two options to determine which of the two annuities would be best for the customer, for example by determining which has the features most suited to the client's situation and would offer the highest payout. The broker would then have to recommend that option. In addition, he would have to disclose all material information about the recommendation, including conflicts that could affect his judgment.

The difference in costs or payouts to the investor can amount to many thousands of dollars, potential returns middle-income investors can ill afford to forego.

- Those who are best able to judge the extent of the investor protections afforded by the two standards – the federal, state, and industry self-regulators who enforce those standards – all have stated repeatedly that the fiduciary duty affords important protections not offered by the suitability standard. All have advocated extending the fiduciary duty to brokers' advisory activities.

B. In addition, it has been suggested that any differences in the two standards don't matter since investors are able to choose whether to work with a broker or investment adviser. However:

- Numerous surveys have shown that investors cannot distinguish between brokers and advisers. The RAND Study found, for example, that focus group participants could not tell whether their own financial professional was a broker or adviser, even after the differences between the two had been explained to them.

- Surveys have also shown both that investors are unaware that brokers and advisers are subject to different standards of conduct when providing investment advice and that they expect advisers to act in their best interests.
- Absent an understanding of these most basic differences, investors cannot make an informed choice of whether to work with a broker or adviser.
- Lacking financial sophistication, investors may be slow to recognize when they are being taken advantage of, if that recognition comes at all.

## **II. Critics ignore specifics of the SEC proposal when suggesting that the broker-dealer business model would be harmed.**

The argument that middle-income investors would be harmed by adoption of a universal fiduciary duty for investment advice is based on the idea that doing so would require a dramatic change in the way brokers operate and charge for their services. This was never a persuasive claim, as investment advisers have adopted a wide variety of practice models consistent with a fiduciary duty, including sale of securities for commissions. Now that the SEC has issued its report clarifying its intent to preserve the ability of brokers to charge commissions, sell proprietary products, sell from a limited menu of products, and offer transaction-based advice, this argument has gone from being unpersuasive to being outright deceptive. The following discussion briefly examines and refutes each component of this argument.

- A. Some fiduciary opponents imply that, because most investment advisers typically charge fees, imposition of a fiduciary duty would either prevent brokers from charging commissions or force them to charge fees. Neither is true.
  - The SEC has proposed to rely on Section 913(g) of the Dodd-Frank Act to impose the fiduciary duty on brokers' investment advice. To the degree that there was any doubt about the ability to charge commissions under a fiduciary duty (a questionable claim to begin with since many fiduciary financial planners charge commissions), that subsection makes clear that fees and commissions are equally acceptable forms of compensation.
  - Since the SEC proposal would not require brokers to charge fees, statements that most investors would choose to go without advisory services if their advisor charged up-front fees of \$2,500 are completely irrelevant to the question of whether investors would be harmed by imposition of a fiduciary duty.
  - Similarly, statements that consumers want to be able to choose whether to pay for advisory services through fees or commissions are also irrelevant, since there is nothing in the SEC proposal that would deny them that choice.
- B. Similarly, some fiduciary opponents falsely imply that, because many investment advisers serve wealthy clients, imposition of a fiduciary duty would force brokers to limit the availability of their services to wealthy clients.

- Investment advisers typically offer on-going account management services, comprehensive financial planning, or a combination of the two, services that are more likely to be attractive to wealthier clients and for which they typically set account minimums and charge up-front planning and/or on-going account management fees.
  - The SEC proposal and the legislative provision on which it is based recognize the benefit to investors of maintaining the availability of transaction-based advice. Toward this end, it makes clear that there would be no on-going fiduciary duty where there is no on-going advice.
  - By preserving the ability of brokers to offer transaction-based advice, the proposal preserves their ability to offer advisory services on terms that are more affordable for middle-income investors.
  - At the same time, the proposal would raise the standard that applies to those transaction-based recommendations, ensuring that they serve the best interest of the investor rather than primarily serving the bottom line of the broker.
- C. By focusing solely on fees and ignoring commissions, some fiduciary opponents falsely imply that services offered by brokers are more “affordable” than those offered by typical investment advisers.
- Fees are not the only costs paid by investors, although they are the most visible. Commissions also impose significant costs on investors by subtracting from the amount that goes toward the investment.
  - Consider, for example, variable annuities. These are considered to be among the more expensive investment products marketed to average investors. As a recent *Smart Money* article noted: “Variable annuities are notorious for the fees they charge. Indeed, the average annual expense on variable annuity subaccounts (including fund expenses plus insurance fees) is typically more than a full percentage point more than on the average open-ended mutual fund. Unfortunately, variable annuity fees don't stop there. Many variable annuities act like B shares of mutual funds, paying commission from the ongoing fees; the average contract fee is \$30 to \$35.”<sup>2</sup>
  - These costs are exacerbated when brokers are free to recommend the variable annuity (or other investment product) that pays them most, rather than the one that is in the best interest of the investor.
  - A fiduciary duty would bring those costs, and the conflicts of interest associated with them, out into the open and require brokers to consider costs to the investor, among other factors, when making their recommendations.

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<sup>2</sup> “What’s Wrong With Variable Annuities,” *Smart Money*, August 1, 2010.

### **III. Fiduciary opponents have offered no data to substantiate claims about increased costs under a fiduciary duty.**

Some fiduciary opponents have suggested that adopting a universal fiduciary duty for investment advice would significantly raise compliance and liability costs for brokers and that this could cause them to stop serving middle-income investors, reduce services to those investors, or raise their costs. We are not aware, however, that those making this claim have offered any hard data to support the contention that compliance and liability costs would increase significantly under a universal fiduciary duty for investment advice. There are a number of reasons to doubt this claim.

A. Some fiduciary opponents have suggested, for example, that compliance costs would increase by as much as 15 percent if a universal fiduciary duty for investment advice were adopted, but they have offered no factual basis to justify this figure.

- However, these fiduciary opponents simultaneously maintain that they already follow “know-your-customer” procedures adequate to satisfy a fiduciary duty, including: spending a great deal of time getting to know their clients; requiring customers to fill out detailed suitability questionnaires and to provide extensive documentation to support their responses; reviewing this information and considering additional factors to narrow the selection of financial products from the thousands available to a narrower group of financial products that they believe are most appropriate for the client’s objectives.
- If this is an accurate description, there should be little additional compliance cost associated with determining which of those products is best for the customer.
- Moreover, a LIMRA survey of NAIFA members calls into question these concerns about compliance costs. According to that survey, NAIFA members are more likely to have dropped their broker-dealer registration primarily because of existing compliance burdens (18 percent) than to have dropped their investment adviser registration for the same reason (9 percent). This suggests that the compliance burdens associated with being an investment adviser have proven no more onerous to NAIFA members than regulation as a broker-dealer and indeed that the opposite may be true.

B. Claims about increased liability costs associated with a fiduciary duty are equally unsupported and ignore the legal environment in which brokers currently operate.

- Some fiduciary opponents have suggested that brokers would be exposed to greater liability under a fiduciary duty because fiduciary duty is an inherently “amorphous” or ill-defined standard. But fiduciary duty is no more amorphous a concept than suitability. Both are principles-based, facts-and-circumstances specific standards.
- The SEC proposal makes clear that it intends to provide extensive guidance to assist brokers in implementing the fiduciary duty.
- Brokers already face liability under a fiduciary standard, since violation of fiduciary duty is the leading claim filed by investors in FINRA arbitration, and arbitrators are not

required to follow the law in reaching their decisions and thus are free to make awards based on a perceived violation of fiduciary duty.

- Some state courts have also held brokers to a fiduciary standard in circumstances where they determined that there was a relationship of trust and reliance.

**IV. Middle-income investors are among those most in need of the protections afforded by a fiduciary duty.**

Fiduciary opponents often cite concern over its potential impact on middle income investors who may have only a few thousand dollars a year to invest. While it is true that such investors cannot typically afford the account minimums or management fees charged by many investment advisers, it is equally true that they cannot afford to pay the high commissions charged by many brokers when lower cost options are readily available. The SEC proposal protects the interest of these investors by preserving their access to commission- and transaction-based services while simultaneously ensuring that those services are delivered with the investor's best interests in mind.