Consumer Federation of America

February 21, 2018

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549-1090

Dear Chairman Clayton:

As you are doubtless aware, the Massachusetts Securities Division brought charges against Scottrade last week for dishonest and unethical practices related to its alleged violation of the Department of Labor's conflict of interest rule.[1] As the Commission reportedly moves closer to proposing its own best interest standard for broker-dealers' investment recommendations, the Massachusetts action provides a timely reminder of the need to include in any such standard tight restrictions on practices that encourage and reward advice that is not in customers' best interests.

The Massachusetts complaint perfectly illustrates the abusive conduct that can occur behind the scenes at companies that claim to support a best interest standard. On a section of its website devoted to the DOL rule, Scottrade proclaimed its commitment to "compliance with all relevant regulations" and welcomed the DOL rule as bringing "transparency to investors everywhere."[2] Scottrade made clear, moreover, that it knew that its rollover recommendations were covered by the DOL rule and that its practice of engaging in sales contests to encourage rollovers was inconsistent with the rule.[3] Accordingly, it updated its compliance manuals to state that, "The firm does not use or rely upon quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation or other actions or incentives that are intended or reasonably expected to cause associates to make recommendations that are not in the best interests of Retirement Account clients or prospective Retirement Account clients." [4] In short, Scottrade gave every public appearance of being a model corporate citizen in its response to the DOL's heightened standards for retirement accounts.

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[1] *In re Scottrade, Inc.*, Administrative Complaint, No. E-2017-0045 (Feb. 15, 2018) http://bit.ly/2By4rMW.
[2] *See* Scottrade, Understanding the Department of Labor's Fiduciary Rule, http://bit.ly/2ojXXZP (last visited February 20, 2018).
[3] Scottrade, Understanding the Department of Labor's Fiduciary Rule. "When the Department of Labor fiduciary rule takes effect, Scottrade brokerage will serve as a fiduciary when making recommendations to clients regarding the rollover or transfer of a retirement account."
[4] *In re Scottrade, Inc.*, Administrative Complaint at 3.

As the well-documented Massachusetts complaint makes clear, the reality behind the scenes was very different. The complaint describes a "firm-wide culture characterized by aggressive sales practices and incentive-based programs," which only intensified in the period after the DOL rule's impartial conduct standards went into effect.[5] Far from abandoning sales contests, as its compliance manual indicated, Scottrade ramped up its use of such contests, according to the complaint, making no effort to exclude retirement accounts.[6] It allegedly set performance metrics and quotas for referrals to its investment advisory program, for example, that agents had to meet to qualify for certain prizes. And its "internal-use materials instructed agents to target a client's 'pain point' and emotional vulnerability, while training sessions lauded the use of emotion over logic in getting a client to bring additional assets to the firm," according to the complaint.[7]

While the issues in the Scottrade case appear to be particularly stark, there's no reason to believe they are unique. On the contrary, recent media reports suggest that some of the best known, most widely respected securities firms continue to offer incentives to encourage recommendations of managed accounts that are profitable for the firm but may be costly for investors.[8] The firms justify the practice by pointing to their "extensive policies and procedures designed to make sure their representatives … act in clients' interests and don't unduly push any product or service."[9]

But there is, or should be, a fundamental difference between conflicts that are inherent to a particular business model and the incentives that firms intentionally create to encourage certain conduct. It is one thing to say that a firm whose representatives are paid through commissions should have policies and procedures to ensure that those reps don't churn accounts or inappropriately recommend the highest paying investments, or that advisers who are paid through assets under management fees should have policies and procedures to ensure that they don't inappropriately recommend rollovers in order to increase their assets under management and, with it, their payday. It is an entirely different matter to suggest that firms should be able to create incentives designed to drive certain conduct, then excuse it on the grounds that they have policies and procedures in place to ensure that investors aren't harmed as a result. That's true whether the incentive takes the form of a sales contest, or sales quota, or increased compensation. And the SEC rules should reflect that distinction.

Indeed, the recent reports regarding managed accounts suggest that, far from having gone too far in restricting conflicts, the DOL may not have gone far enough. Its provision allowing differential compensation based on neutral factors created a loophole that firms appear to be exploiting to justify offering incentives that place the interests of the firm ahead of customers' best interests. As long as firms remain free to create such incentives, financial professionals can be expected to act on those incentives in ways that undermine the best interest standard. The SEC can and should do better in developing a rule proposal that reins in the toxic incentives that

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[5] *Id* at 2-3.
[6] *Id* at 4.
[7] *Id* at 5.
[8] *See* Gretchen Morgenson, "The Finger Pointing at the Finance Firm TIAA," The New York Times (Oct. 21, 2017) http://nyti.ms/2BIFu1z; Jason Zweig and Anne Tergesen, "Advisers at Leading Discount Brokers Win Bonuses to Push Higher-Priced Products," The Wall Street Journal (Jan. 10, 2018) http://on.wsj.com/2HB35lh.
[9] Zweig and Tergesen.

pervade the broker-dealer business model and, in some cases, the investment adviser business model as well, as the SEC's recent actions involving recommendations of high-cost mutual fund share classes illustrate. With its approval of "clean shares," the agency took a monumental step toward creating a dramatically less conflicted broker-dealer business model. Its proposed standard of conduct rule should build on that success. Moreover, as the Massachusetts action makes clear, whatever standard the SEC ends up adopting, that standard must be backed by effective enforcement so that firms take seriously their obligation to comply. Otherwise, investors are likely to see lip service paid to a best interest standard but business as usual when it comes to advisers' actual conduct.

The SEC has an opportunity to transform the securities business into a profession where investors' interests truly do come first. The Massachusetts complaint against Scottrade provides a timely reminder of the scale of the cultural transformation that is needed to achieve that goal. Timid half measures will not suffice. Investors need and deserve the protections afforded by a strong, enforceable fiduciary standard for all investment advice, backed by real restrictions on practices that undermine that standard. We look forward to working with you to achieve that goal.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

Micah Hauptman
Financial Services Counsel

cc: The Honorable Robert J. Jackson Jr.
The Honorable Hester M. Peirce
The Honorable Michael S. Piwowar
The Honorable Kara M. Stein