Consumer Federation of America

A Framework for Addressing Broker-Dealer and Investment Adviser Conflicts of Interest When Providing Retail Investment Advice

Conflicts of interest are present in both the broker-dealer and investment adviser business models. Some conflicts are inherent to each business model, the natural outgrowth of commission- and fee-based compensation structures. Other conflicts result from the investment products brokers and advisers recommend and the various payments product sponsors make to encourage their sale. Still other conflicts are artificially created by firms to encourage financial professionals to recommend the products and services that are most profitable for the firm. All have the potential to inappropriately influence recommendations, to the detriment of investors, but the nature and severity of those conflicts varies greatly. How the Commission addresses conflicts of interest will largely determine whether investors benefit from the proposed Regulation Best Interest as well as the Commission's accompanying interpretation of the Investment Advisers Act fiduciary duty.

The good news is that there is a workable framework for addressing conflicts of interest that can be adapted to both brokerage and advisory business models. Under this approach, firms would be required to adopt conflict mitigation practices that are tailored to the nature and scope of conflicts of interest present in their particular business. Conflicts that are more likely to result in serious investor harm would be subject to more stringent mitigation requirements. This framework for addressing conflicts would preserve the ability of brokers to receive transaction-based compensation, minimize the risk that misaligned incentives present in both brokerage and advisory business models would result in investor harm, and create an incentive for brokers and investment advisers alike to adopt consumer-friendly practices.

I. Conflicts that are inherent to the business model

A. Explanation of the problem

Conflicts of interest are inherent to both the broker-dealer and investment adviser business models. Brokers and advisers alike have an interest in maximizing their compensation, creating incentives that may not always align with investors' interests.

- **Commission compensation creates an incentive to maximize transactions.** In the brokerage model, the firm and financial professional get paid only if a recommendation results in the completion of a transaction. Therefore, a broker-dealer has an incentive to recommend that an investor complete a transaction, regardless of whether doing so is in the best interest of the customer. This incentive can result in recommendations to roll over a 401(k) to the firm, even when that results in increased costs to the investor, or to churn an account in order to increase the number of transactions, for example.
- **AUM fees create an incentive to gather assets.** Investment advisers who charge a fee based on assets under management get paid only if they are managing a client's money. The more of the client's money they manage, the more they get paid. As with brokers, this incentive can result in

recommendations to roll over a 401(k) to the firm, regardless of the benefits to the client. It can also cause advisers to avoid financial recommendations, such as paying off debts or investing in real estate, that would reduce assets under management. Because an adviser compensated through AUM fees gets paid the same amount regardless of the level of service provided, that adviser also has an incentive to do the least amount of work necessary to maintain the account (a practice known as reverse churning).

- **Other payment methods also create conflicts.** While AUM fees represent the most common compensation method among investment advisers, some advisers charge hourly fees while others charge engagement or monthly fees. Each comes with its own set of conflicts. When the client pays by the hour, for example, the adviser has an incentive to maximize the time it takes to complete the job. The opposite is true when the adviser is paid by the engagement, and the incentives associated with monthly fees resemble the incentives under AUM fees to engage in reverse churning.
- **Dual registrants have an additional layer of conflicts.** Firms that offer both brokerage and advisory accounts, or different accounts with different payment models, have an incentive to recommend the type of account that is most profitable for the firm, rather than the type of account that is best for the investor.

Conflicts of interest that are inherent to the business model are typically fairly simple and straightforward. They boil down to the fact that the firms and financial professionals have an incentive to maximize compensation, whatever their compensation structure, that may not always result in recommendations that are in investors' best interests.

B. Framework to appropriately address this problem

Addressing conflicts that are inherent to the business model starts with disclosure and informed consent. The disclosure must be sufficient to ensure that the investor understands the nature of the conflicts of interest associated with the particular business model and how the recommendations they receive could be affected, since without such understanding consent cannot truly be "informed." It is critically important to recognize, however, that when investors consent to the existence of conflicts, they do not consent to be harmed as a result of those conflicts. Firms and financial professionals must still have an obligation to provide advice that is in the investor's best interest, even after the conflicts have been disclosed and consented to.

To ensure that conflicts of interest that are inherent to the business model do not taint the advice they offer, firms must adopt strong policies and procedures tailored to the conflicts specific to their business model. So, for example, broker-dealers must have policies and procedures in place to ensure that their reps do not engage in excessive and unnecessary transactions. Advisers who charge AUM fees must have policies and procedures in place to ensure they do not neglect the account. To achieve this, firms must have surveillance mechanisms to identify and curtail recommendations that are the natural result of the business model's conflicts and that are not in the investor's best interest. At dual registrant firms, this should include supervisory procedures designed to ensure that their financial professionals recommend the type of account that is best for the investor, rather than the type of account that is most profitable for the firm.

All three types of firms must have policies and procedures in place to ensure that rollover and asset transfer recommendations are in the best interests of the customer, and not just the firm. Under such an approach, firms must require rigorous analysis and documentation showing why their advice or recommendation is in the investor's best interest. For example, to ensure that any recommendation to roll over a workplace retirement account into an IRA is in the investor's best interest, a firm's policies and procedures must require that the professional undertake a rigorous analysis comparing the customer's current account with reasonably available options at the firm. This analysis would include a comparison of the relative costs, available investments, and different level of services, for example, in order to make an ultimate assessment of the value of the recommended transaction. Further, the firm's policies and procedures must require that the financial professional document this analysis so that the firm's compliance department and regulators can review whether the recommendation was in the investor's best interest and confirm that it was not inappropriately influenced by the desire to charge a commission or capture assets.

Firms that prepared to implement the Department of Labor fiduciary rule before it was overturned in court should already have designed compliance programs that meet this standard. Moreover, numerous technological tools were brought to market in response to that rule to support such a requirement. In some cases, an objective analysis is going to demonstrate that a rollover is improper, and firms need to be prepared to refrain from recommending a rollover in such instances. For example, few firms can compete with the low costs available to participants in the Thrift Savings Plan (TSP) and thus would find it difficult to justify a rollover that could easily increase the investor's annual costs by 30 to 40 times for similar products. In other instances, the firm will be able to document the benefits to the investor of a rollover, particularly when the firm has an attractive suite of retirement account options or the 401(k) plan in question is a substandard plan. This approach has the added benefit of creating an incentive for firms to compete based on the cost and quality of their products and services, which in turn has the potential to deliver significant benefits to investors.

II. Investment product-related conflicts

A. Explanation of the problem

Conflicts of interest can also arise as a result of payments investment products make, and practices product manufacturers engage in, to encourage firms and financial professionals to recommend their products rather than those of their competitors. Some of those conflicts, such as payments made to get on a firm's investment menu, may be present in advisory as well as brokerage accounts, particularly at dual registrant firms. Others are directly tied to transaction payments, and thus are associated exclusively with brokerage accounts. When financial professionals' pay and firms' profits vary significantly based on what investments they recommend, conflicts of interest are multiplied and magnified, and the policies and procedures firms adopt to address those conflicts must be adjusted accordingly.

These product-specific conflicts arise because of the stiff competition that exists among product manufacturers, who seek to encourage sales of their products over their competitors' by offering the most attractive compensation arrangement to the selling brokers. Such conflicts tend to be much more complex than the basic compensation-related conflicts discussed above, making them difficult for even financially sophisticated investors to understand or guard against. To illustrate, when a product manufacturer creates an investment product, the manufacturer decides whether to embed certain distribution-related costs in the product and how those costs should be structured. With a broker-sold mutual fund, for example, the mutual fund company decides both the amount of the sales load to be charged and how to structure that load; whether and how much to charge in 12b-1 fees; whether and how much to charge for recordkeeping through sub-transfer agency fees; whether and how much the fund's adviser should pay different broker-dealers in revenue sharing arrangements; and how much to pay to brokers in gross-dealer concessions for distributing their fund. It only gets more complicated from there. Different mutual fund companies adopt different distribution cost structures and varying levels of compensation paid to brokers who sell their products. And other investment products – such as annuities, structured products, and non-traded real estate investment trusts (REITs) and business development companies (BDCs) – have different cost structures from mutual funds, typically with even higher levels of compensation paid to broker-dealers who sell them.

The result is that brokers have a strong incentive to recommend the products that pay them the most, regardless of whether they are the best option for the investor. In practice, this means, for example, that a broker-dealer has an incentive to recommend a mutual fund that pays a higher share of the load rather than an available alternative that offers a lower payout, even if the alternative has a history of better performance or is otherwise a better match for the investor. Similarly, a broker-dealer has an incentive to recommend a variable annuity or structured product instead of a mutual fund, because those products pay so much more, even if a portfolio of mutual funds would achieve the same investment goal at lower cost and with greater liquidity and fewer risks.

Conflicts such as these are a major source of investor harm. Because costs associated with product-specific incentives are ultimately born either directly or indirectly by the investor, the products that are most lucrative for the broker are also typically those that are most expensive for the investor. Similarly, products that are hardest to sell, because they are less liquid or higher risk or suboptimal for other reasons, can overcome those disadvantages by offering higher compensation. As a result, these incentives can expose investors not just to higher costs, but also to higher risks or inferior performance. Because of the complexity of such conflicts, and the potential for investor harm, particularly rigorous policies and procedures are needed to reduce the likelihood that these incentives will taint recommendations.

B. Framework to appropriately address this problem

It should be patently obvious that conflicts of interest of this complexity cannot adequately be addressed through disclosure alone. Experience, and disclosure testing, tell us that most investors will never gain a sufficient understanding of such conflicts to give informed consent. And brokers who have strong incentives to act against their customers' interests are less likely to comply with a best interest standard. More rigorous policies and procedures are needed to ensure that these product-specific conflicts do not taint investment recommendations.

The good news here is that, while firms do not create these product-specific conflicts of interest, it is possible for them to eliminate or at least significantly reduce such conflicts. Some firms had begun that process in response to the DOL rule through the adoption of "clean shares" and other more product-neutral approaches to broker compensation. By removing all distribution-related costs from the products, clean shares in particular have the potential to eliminate incentives for broker-dealer reps to recommend funds based on their own financial interests rather than the investor's best interest. (Though some clean shares appear to be "cleaner" than others.) Other approaches to levelizing compensation across products, and basing broker compensation on the nature and extent of services provided rather than on the products sold, have the potential to provide a similar benefit at the individual rep level, though firms may continue to face compensation-related conflicts.

- **Levelizing compensation for similar products can better align interests of brokers and investors.** Where investment products have similar features and serve similar functions, broker-dealer firms could reduce product-specific conflicts by taking steps to ensure that the compensation that flows to the individual rep does not depend on the product recommended. For example, a broker-dealer would ensure that there is no incentive for the rep to recommend one mutual fund over another by providing level compensation for all mutual fund recommendations. One option would be to apply a level commission to load-waived A shares, as LPL announced it planned to do with its Mutual Fund Only Platform, an approach that reduces conflict-related incentives at both the firm and individual rep level. Another option is for firms to continue to distribute products that offer variable compensation, but to offer level compensation at the individual rep level for all similar products. In such cases, the firm neutralizes the conflict at the rep level but retains the conflict at the firm level, as well as the differences in cost to the investor. This approach to levelizing compensation for similar investments would apply equally to recommendations of annuities, for example, or any other class of investments. If firms are required to design policies and procedures to mitigate conflicts that are reasonably designed to ensure that the customer's interests come first, they may come up with additional approaches that achieve the same objective of minimizing product-specific conflicts.
- **Ensuring that variations in compensation are justified based on an objective analysis can help to reduce compensation-related conflicts of interest across different product lines.** While levelizing compensation for similar products can reduce incentives to recommend one mutual fund over another or one annuity over another based on compensation considerations, it doesn't eliminate the incentive to recommend those classes of investment products (e.g., variable annuities, non-traded REITs, and structured products) that offer the most generous compensation. Brokers have argued that differences in compensation are warranted by differences in the time it takes to analyze the products and explain their features to investors. But it is unquestionably the case that the higher compensation provided by these products largely explains why they feature so prominently in stories of abusive sales practices. To counteract this problem, broker-dealer firms should take steps to ensure that any variations in the level of compensation for different types of investments that flow to the individual representative are justified based on an objective analysis, in writing.
- **To the extent firms do not eliminate compensation-related conflicts, recommendations of higher compensating products must be backed by rigorous analysis documenting the basis for concluding that such recommendations are in the customer's best interest.** Firms that retain significant variations in compensation at the individual rep level will need to adopt particularly rigorous policies and procedures to ensure those conflicts don't inappropriately influence recommendations. Where the rep recommends higher paying products, particularly when those products also impose additional costs on the investor, this must include written documentation of the basis on which the rep determined that a particular recommendation is in the customer's best interest. The rep should have to explain, for example, how the particular product meets the investor's goals and needs, why the imposition of any additional costs provides value to the investor, and why the same objective cannot be accomplished more efficiently through other reasonably available investment products or strategies. For example, if a broker-dealer recommends that an investor purchase a variable annuity or a non-traded REIT, the broker-dealer should be required to provide an objective analysis documenting the investor's need for that particular type of investment and why it is a better option for the investor than other reasonably available investment products and strategies. If the rep can't support the recommendation, including why any added costs are justified, he should not be permitted to

make the recommendation. And the firm should adopt supervisory procedures to ensure compliance.

The benefits to investors of a more product-neutral approach to broker compensation are obvious. If investment products were forced to compete based on their own merits (cost and quality), rather than by compensating the broker, the best products would thrive, to investors' benefit. And, in a commission account based on clean shares, for example, the costs of brokerage services would be transparent and subject to market forces. These factors have historically led to much lower costs for investors, which likely explains why firms have been so reluctant to adopt clean shares now that the DOL rule no longer provides them with an incentive to do so. But there are benefits to firms as well from approaches that reduce product-specific conflicts. Firms that adopt such approaches are likely to face fewer compliance headaches under a best interest standard if incentives for non-compliance are reduced or eliminated. And firms that minimize product-specific conflicts should find it easier to justify their recommendations and easier to defend against claims that their reps placed their own financial interests ahead of the customer's best interests.

C. Conflicts that firms artificially create to drive specific conduct

A. Explanation of the problem

Conflicts of interest also arise when firms themselves create incentives to encourage and reward very specific behavior that is profitable to the firm, but harmful to investors. These types of conflicts aren't inherent to the broker-dealer or investment adviser business models, nor are they created by outside parties, as product-specific conflicts typically are. Rather, these conflicts arise when firms make a conscious decision to inject a variety of perverse incentives into a business model that, in all too many cases, is already rife with conflicts of interest in order to maximize their profits at customers' expense.

Artificially created incentives include, but are certainly not limited to, contests, quotas, bonuses, trips, or other special awards that firms use to reward individual reps for meeting certain sales targets. Such incentives may be used, for example, to encourage financial professionals to sell proprietary products over non-proprietary products or, at dual registrant firms, to steer prospective clients to high-cost managed accounts when they would be better served by a brokerage account. Artificially created incentives also include retroactive ratcheted payout grids, which disproportionately increase compensation for incremental increases in sales, creating enhanced risks for investors when reps approach the next level on the grid. What these incentives have in common is that none exist naturally or inevitably within the broker-dealer business model, and all are fully within the control of the firm. While not every such incentive is harmful, these incentives create problems for investors when the conduct that is most profitable for the firm is not in investors' best interest, because it inappropriately increases their costs, for example, or exposes them to unnecessary risks.

Moreover, these types of incentives are not limited to the broker-dealer business model. They may also arise in advisory accounts in the dual registrant context, where investment adviser affiliates often artificially create many of the same conflicts that are so prevalent in the broker-dealer space. In such cases, the investment adviser affiliate typically buries their various conflict disclosures deep in their Form ADV in legalese that few if any investors will read and even fewer will understand. As discussed above, that type of disclosure does not lead to informed consent and cannot substitute for a true best interest obligation.

B. Framework to appropriately address this problem

As with product-specific conflicts, an approach to these artificially created incentives that relies on disclosure alone would be totally ineffective at protecting retail investors from harm. Research has shown that simply disclosing conflicts does not enable investors to protect themselves from the harmful impact of those conflicts, particularly when the conflicts are complex and opaque, as is often the case here. Moreover, the whole point of many of these incentives is to drive specific behavior that benefits the firm, regardless of whether it harms investors. Where that is the case, the easy, logical solution is simply to eliminate the incentive.

The specific standard that the SEC should adopt to guide firms when deciding what artificially created incentives they must eliminate is whether the incentive would reasonably be expected to encourage recommendations based on factors other than the customer's best interest. If an objective analysis shows that an incentive would reasonably be expected to encourage recommendations that are not in the customer's best interest, it must be eliminated. The good news is that, because these incentives are not intrinsic to either the broker-dealer or investment adviser business models, they are the easiest of conflicts to eliminate. All it takes is the will to do so.

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In conclusion, the only way to ensure compliance with a meaningful best interest standard is to rein in harmful incentives that would otherwise taint advice. This requires firms to adopt strong anti-conflict policies and procedures that are tailored to the specific risks that different types of conflicts pose to investors' well-being. This framework for addressing common conflicts of interest among both broker-dealers and investment advisers is rigorous enough to protect investors' interests and flexible enough to work across a variety of business models.