Public Statement

Statement Regarding the SEC's Rulemaking Package for Investment Advisers and Broker-Dealers

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Today, the U.S. Securities and Exchange Commission adopted a package of regulatory items that will have a significant impact on American investors for years to come.[1] As the Investor Advocate at the SEC, my responsibilities include evaluating the impact on investors of Commission actions and making recommendations to the Commission. Over the course of this rulemaking initiative, I have worked actively behind the scenes to advocate for investors. My office also conducted objective research in an effort to support data-driven policymaking, and that research is cited extensively in the rulemaking package. Now that Commission action on these matters is concluded, I am making public my assessment of how these rules and interpretations will impact investors.

In summary, I believe Regulation Best Interest, while not as strong as it could be, is a step in the right direction because it is an improvement over the existing suitability standard for broker-dealers. However, what investors have gained in Reg BI has been undermined by what investors have lost in the Commission's interpretation of the fiduciary duty that applies to investment advisers. And while the new Form CRS relationship summary will provide useful information to investors about their particular financial professional and account, it likely will not achieve its original goal of preventing the financial harm that results from investor confusion about the differences between investment advisers and broker-dealers. Finally, while the interpretation of "solely incidental" presented an opportunity to sharpen the distinctions between broker-dealers and investment advisers, the interpretation merely serves to formalize the Commission's longstanding deference to broker-dealers who engage in conduct that is advisory in nature.

Despite my disappointment in some of the actions of the Commission today, my respect for the Commissioners and my colleagues on the Commission staff is undiminished. Many people worked very hard on these rules for multiple years, and the policy choices were not easy. I recognize that I have the freedom to review their actions solely from the perspective of investors' interests, while they must balance competing considerations.

1. The Commission has taken a step in the wrong direction in its interpretation of the fiduciary duty that investment advisers owe to their clients.

The Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Fiduciary Interpretive Release) gives very little weight to the single most important action of the Commission on this topic. Specifically, in General Instruction 3 to Form ADV Part 2, which is a portion of Form ADV that is used to

disclose information to investors about an adviser's services, the Commission instructs investment advisers as follows:

You are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, ***and***, at a minimum, make full disclosure of all material conflicts of interest between you and your clients. (Emphasis added.)

The Commission approved this instruction as part of its amendments to Form ADV in 2010.[2] However, buried within footnote 57, today's Fiduciary Interpretive Release brushes aside that action. The footnote asserts, in effect, that the prior Commission intended to capture the fiduciary duty described in *SEC v. Capital Gains Research Bureau, Inc*.[3] Thus, the phrase "seek to avoid" must have been intended to mean that an adviser must eliminate ***or*** disclose conflicts of interest.

I believe it is more likely that the prior Commission chose to build upon *Capital Gains* by requiring disclosure ***and*** conflict avoidance, as the plain language of General Instruction 3 indicates. In my view, then, the new Fiduciary Interpretive Release weakens the existing fiduciary standard by suggesting that liability for nearly all conflicts can be avoided through disclosure. I do not believe this is what an investor would reasonably expect from a fiduciary, nor does it align with the ways that real-world investment advisers tend to view (and describe) their fiduciary obligation.

Some have argued that Reg BI, which requires mitigation of conflicts, is now a more rigorous standard than the fiduciary duty that applies to advisers. If that is the case, it would be all the more important for the Commission to elevate the fiduciary duty for advisers, but the Commission passed up an opportunity to do so in the Fiduciary Interpretive Release. I believe the Commission could have chosen to augment the Form ADV instruction by outlining an expectation for advisers to mitigate conflicts of interest in a way that is comparable to the mitigation requirement for broker-dealers in new Reg BI.

2. Regulation Best Interest is an improvement over the existing standard of conduct for broker-dealers.

Reasonable people will differ on the utility of the new "best interest" standard of conduct and whether it is much, if any, improvement over the current suitability standard. From my perspective, Reg BI will improve upon the suitability standard in the following meaningful ways:

- Eliminating sales contests and requiring mitigation of other conflicts of interest that were permitted under the suitability standard;
- Requiring better disclosure about conflicts of interest;
- Requiring brokers to consider the costs to the investor of a recommended product and whether, in light of those costs and other factors, the recommendation is in the best interest of the customer; and
- Requiring more careful review of limited product menus.

In addition, the final rule, as adopted today, includes some important improvements over what was in the original proposal. For example, recommendations related to roll-overs and the selection of account types (brokerage or advisory) would be subject to the new standard, as well as an implicit recommendation to "hold" securities when a broker agrees to monitor a customer's account and subsequently makes no recommendation to buy or sell.

As a purely legal matter, I believe that most of the enhancements to the broker-dealer standard of conduct could have been accomplished through tweaks to the existing suitability rule or more stringent enforcement of it. As a practical matter, however, given the permissive application of the suitability standard over the years, it would be difficult for regulators to pivot abruptly and begin using that standard to address abuses that have been allowed to exist. The most appealing aspect of Reg BI, in my view, is that it gives the Commission and FINRA a "clean slate" with tools that could be used to address these abuses if there is adequate enforcement of the new standard.

The most worrisome aspect of Reg BI is that it will allow broker-dealers and their associated persons to market themselves as acting in the best interest of their customers. If Reg BI is not enforced rigorously enough to demand behavior that matches customers' expectations, then customers will be harmed by the new standard.

Overall, I believe Reg BI does give the Commission important tools to address unethical or abusive conduct in the brokerage business. In reality, though, the utility of Reg BI will depend upon how it is enforced by the Commission and FINRA.

3. The Form CRS relationship summary probably will fail to achieve its original objectives.

As proposed, the Form CRS relationship summary would have given investors a mix of information at the time they entered into a relationship with a financial professional. First, it would have required firms to give prospective clients some educational information that was designed to help them understand the basic differences between investment advisers and broker-dealers. It also would have required firms to disclose information about the services they provide, the fees for those services, and other matters such as conflicts of interest.

In today's action, the Commission has adopted a rule that will only require disclosure about the particular firm's practices, and it gives each firm broad discretion in the presentation of that information. The relationship summary will include no comparative or educational information—instead, it will merely point the investor to the Investor.gov website for more information about the differences between investment advisers and broker-dealers.

When Form CRS was released for public comment last year, Chairman Jay Clayton issued a public statement that outlined the objectives of the entire rulemaking package.[4] In this explanatory statement, the first item listed among the problems that prompted Commission action was "investor confusion regarding the differences between broker-dealers and investment advisers." The statement noted that the confusion could cause investor harm if investors fail to select the type of service that is appropriate for their needs. Accordingly, the relationship summary was intended to help investors understand what type of professional they were dealing with, as well as "what that means and why it matters."

Granted, the relationship summary, as adopted, contains important information about a particular firm. However, by stripping away the comparison to other choices that may be available to an investor, the information loses important context that would help the investor make an informed selection of a financial professional. Consider, for example, an investor who needs little advice and trades infrequently. The relationship summary delivered by an investment adviser will not alert that person to the fact that a brokerage account could potentially save her money while serving her needs.

Unfortunately, I do not believe a link to the Investor.gov website will effectively address the confusion in the marketplace. Investors who are inclined to do research can already discover the differences between investment advisers and broker-dealers with a simple web search. A keystone benefit of the relationship summary, as proposed, was that it would have placed this type of vital information directly in an investor's path at the time the investor was making a very important financial decision.

We have known for more than a decade that many investors do not understand the differences between investment advisers and broker-dealers.[5] Regrettably, I anticipate that the same confusion will exist a decade from now. While the relationship summary will contain useful information for investors, I believe it will fail to achieve its original objective of addressing the significant financial harm that results from investors being placed into accounts that poorly match their needs.

4. The Commission's interpretation of "solely incidental" gives official sanction to broker-dealers who engage in conduct that is very advisory in nature.

Sometimes legal gymnastics can lead down a path in which simple words with obvious meaning are interpreted in ways that would surprise an ordinary investor. Today's interpretation of "solely incidental" provides a glaring example.

The definition of an investment adviser is relatively straightforward. In general, an investment adviser is someone who engages in the business of advising other people about investments for compensation. But, the law provides that certain types of professionals, such as accountants and teachers, can provide incidental investment advice in connection with their normal jobs without being required to register as an investment adviser. Broker-dealers are given a similar exception from investment adviser registration if they give investment advice that is "solely incidental" to their brokerage business.

For many years, the SEC has given the words "solely incidental" almost no meaning. Broker-dealers have been allowed to engage in activities that look very much like the investment adviser business model. It is not surprising, then, that most investors don't understand the basic differences between investment advisers and broker-dealers.

In issuing its new interpretation of "solely incidental," the current Commission does not make clear what problem it is attempting to solve, but it fails to solve the well-known problem of investor confusion. In issuing this interpretive release, the Commission had an opportunity to help investors by brightening the lines between investment advisers and broker-dealers, but instead the Commission has formalized its longstanding acquiescence to the preferences of the brokerage industry.

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[1]The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. The views expressed herein are my own and do not reflect those of the Commission, the Commissioners or other members of the staff. In this Statement I have taken a legal position regarding the fiduciary duty of investment advisers under the Investment Advisers Act of 1940 that is contrary to the views of the Commission's Office of the General Counsel and Division of Investment Management. This legal position I have taken is also inconsistent with the interpretation and guidance adopted by the Commission on June 5, 2019.

[2] *See* Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010)

[3] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). The footnote also references an administrative proceeding from 1948, In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948).

[4] *See* Jay Clayton, Chairman, SEC, Public Statement, Overview of the Standards of Conduct for Investment Professionals Rulemaking Package (April 18, 2018), https://www.sec.gov/news/public-statement/clayton-overview-standards-conduct-investment-professionals-rulemaking.

[5] Siegel & Gale, LLC/Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures (Mar. 5, 2005), *available at* http://www.sec.gov/rules/proposed/s72599/focusgrp031005.pdf.