

Written Statement of Michael S. Pieciak
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and
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to the
U.S. House of Representatives Committee on Financial Services;
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
“Putting Investors First? Examining the SEC’s Best Interest Rule.”
March 14, 2019
Washington DC



Good Morning, Chairwoman Maloney, Ranking Member Huizenga, and members of the Subcommittee. I'm Michael Pieciak, Vermont Commissioner of Financial Regulation and President of the North American Securities Administrators Association ("NASAA").¹

NASAA members include state securities regulators who for more than 100 years have served on the frontlines of investor protection, safeguarding the financial futures of hardworking Americans, and assisting local businesses and entrepreneurs seeking to raise investment capital. Our unique position as the regulators closest to the investing public provides a window into the concerns of Main Street investors and small businesses.

My colleagues and I are responsible for enforcing state securities laws including investigating complaints, examining broker-dealers and investment advisers, registering certain securities offerings, and providing investor education programs to your constituents.

States are leaders in civil and administrative enforcement actions, as well as criminal prosecutions of securities violators. Our most recently compiled enforcement statistics reflect that in 2017 alone, state securities regulators conducted nearly 4,790 investigations, leading to more than 2,000 enforcement actions, including 255 criminal actions. Moreover, in 2017, among licensed financial professionals, NASAA members reported 150 enforcement actions involving broker-dealer agents, 187 actions involving investment adviser representatives, 120 involving broker-dealer firms, and 190 involving investment adviser firms.

I appreciate the opportunity to submit this written statement for inclusion in the record of today's hearing to examine the U.S. Securities Exchange Commission's ("SEC" or "Commission") Regulation Best Interest Proposal ("Proposed Rule" or "Reg. BI").

Elevating the Standard of Care for Broker Dealers

NASAA has long advocated for raising the standard of care applicable to broker-dealers. In the debate over legislative proposals that were ultimately enacted under Sec. 913 of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act ("Dodd-Frank Act"), NASAA supported the enactment of a fiduciary duty standard for broker-dealers when providing investment advice to customers.²

Unfortunately, eight-and-a-half years after the enactment of the Dodd-Frank Act, the suitability standard remains in place and broker-dealers are still not required to act in their client's best interest when making investment recommendations. This problem persists despite overwhelming evidence that many retail investors do not understand the differences between investment advisers and broker-dealers, find the different standards of care confusing, or are

¹ The oldest international organization devoted to investor protection, NASAA was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

² For example, see: NASAA's Letter to the House Financial Services Committee regarding the Investor Protection Act (Oct. 26, 2009), http://www.nasaa.org/wp-content/uploads/2011/07/10-27-09-NASAA_IPA_Letter102609.pdf.

uncertain about the meaning of the various titles and designations used by investment advisers and broker-dealers.³ In fact, retail investors expect that financial services professionals - both investment advisers and broker-dealers - will act in their best interests, or incorrectly believe that their financial advisers, including broker-dealers, are acting in a fiduciary type relationship.⁴

It is necessary to raise the standard of care applicable to investment professionals, to reflect the evolution of how financial advice is delivered to customers, where broker-dealers are acting as *de facto* investment advisers to such customers. Further, as a practical matter, such reforms stand to protect Main Street investors to the tune of \$17 billion or more in unnecessary costs annually.⁵

As I noted earlier, we are now eight-and-a-half years since the enactment of Section 913 of the Dodd-Frank Act and the SEC has published a proposal that, while not extending a fiduciary duty to broker-dealers, is aimed at raising the current suitability standard. As explained further in my statement, the benefit of a heightened standard of care should be a regulatory paradigm that enacts meaningful reform for the benefit of investors. It cannot be a conflicts disclosure regime, but should be one where the provider of advice must act in the best interest of the investor. While disclosing and managing conflicts of interest is an important component of any professional relationship, to truly raise the broker-dealer standard of care, the Proposed Rule must recognize that significant conflicts of interest cannot simply be disclosed. To this end, NASAA continues to emphasize that significant conflicts of interest must be prohibited.

Proposed Regulation Best Interest

³ Section 913 of Title IX of the Dodd-Frank Act required the Commission to conduct a Study regarding the obligations of brokers, dealers, and investment advisers. The required Study was completed by the SEC Staff and published in January 2011. The Study concluded that: *“The foregoing comments, studies, and surveys indicate that, despite the extensive regulation of both investment advisers and broker-dealers, retail customers do not understand and are confused by the roles played by investment advisers and broker-dealers, and more importantly, the standards of care applicable to investment advisers and broker-dealers when providing personalized investment advice and recommendations about securities. This lack of understanding is compounded by the fact that retail customers may not necessarily have the sophistication, information, or access needed to represent themselves effectively in today’s market and to pursue their financial goals. Retail investors are relying on their financial professional to assist them with some of the most important decisions of their lives. Investors have a reasonable expectation that the advice that they are receiving is in their best interest. They should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations.”* (See: Section 913 Report. P. 103. <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>).

⁴ Ibid. P. 93-113.

⁵ According to a 2015 analysis by the White House Council of Economic Advisers, *“Investment losses due to conflicted advice result from the incentives conflicted payments generate for financial advisers to steer savers into products or investment strategies that provide larger payments to the adviser but are not necessarily the best choice for the saver. Conflicted advice leads to lower investment returns. Savers receiving conflicted advice earn returns roughly 1 percentage point lower each year (for example, conflicted advice reduces what would be a 6 percent return to a 5 percent return) ... Thus, we estimate the aggregate annual cost of conflicted advice is about \$17 billion each year.”* See: https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

NASAA supports and appreciates the SEC's effort to raise the standard of conduct for broker-dealers. NASAA also supports the SEC's efforts beyond the Proposed Rule itself, including the SEC's proposals to address conflicts of interest, improve fee transparency, restrict the use of potentially misleading professional titles, and clarify investment adviser conflict of interest obligations.

We agree that the Commission should act to address investor confusion regarding the different roles of investment advisers and broker-dealers and should raise the current standard of care applicable to broker-dealer recommendations from suitability to a standard akin to the fiduciary duties owed by investment advisers.

Further, NASAA agrees that the Commission's approach of raising the standard for broker-dealers, while not weakening the current standard applicable to investment advisers, is the correct one. In essence, the Proposed Rule itself says that brokers have an overarching obligation to act in the best interests of their clients, which is very similar to the fiduciary duty that investment advisers owe to their clients. Fundamentally, that obligation should lead both brokers and investment advisers to recommend the best, most cost-effective investment options for their clients that are tailored to those clients' individual needs. This is not the case today, especially in the brokerage industry where financial incentives often rule the day.

Thus, NASAA believes that the Proposed Rule itself represents a first big step forward, and with some key modifications, forms the basis for a strong and effective final rule.⁶

NASAA recommends the following modifications, among others, to the Proposed Rule: (1) define the "best interest" standard, rather than allow the industry to comply with their own interpretation; (2) apply the standard to all investors with only minor exceptions; (3) apply the standard to recommendations regarding account type, since such decisions are part of an overall investment strategy; and (4) explicitly include the word "cost" as a factor that must be evaluated when making a recommendation, since costs have an adverse impact on investor returns.

Additional information about NASAA's perspective on the Proposed Rule, including how we believe the Commission should define the "best interest standard," as well as related SEC proposals,⁷ can be found in our comment letters to the SEC.⁸

⁶ The scope of this testimony does not include Form CRS. Congress should look to the comment file for our views. NASAA discussed its preliminary concerns with Form CRS in our first comment letter and suggested that the Form could be improved by, most preferably, overhauling and streamlining existing registration and disclosure forms for both broker-dealers and investment advisers rather than through an entirely new form. Unlike Reg. BI, however, CRS is a form that should be easier to change over time; our main priority right now is getting Reg. BI right.

⁷ Related proposals include the SEC's Proposed Form CRS Relationship Summary, Amendments to Form ADV, Required Disclosures, and Restrictions on the Use of Certain Names or Titles (File No. S7-08-18), and Standards of Conduct for Investment Advisers (File No. S7-09-18).

⁸ See: NASAA's Letter from President Michael Pieciak to Secretary Brent Fields (Feb. 19, 2019); and NASAA's Letters from then-NASAA President Joseph Borg to SEC Secretary Brent Fields (Aug. 7, 2018 and Aug. 23, 2018).

Proposed Guidance

NASAA's main concern at this stage relates to the SEC's interpretive guidance in the proposing release for Reg. BI and whether this guidance will be part of any adopting release. Industry participants rely on proposing and adopting releases in implementing SEC rules; these releases (sometimes referred to as "guidance" or "interpretive guidance") generally provide additional information and gloss for practical application of a rule. Therefore, it is paramount that the adopting release language supports the strongest interpretation of Reg. BI. The guidance in the proposing release appears to send conflicting messages and the wrong overall message to the brokerage industry regarding how industry participants should read the rule and ultimately change their practices to better serve investor interests.⁹ This is exactly the wrong message to send to such industry participants if the goal is to develop a standard that eliminates and mitigates conflicts such that investors receive the maximum benefit of their investments.

The SEC's Reg. BI guidance must be firm and unequivocal in that it intends to place investor interests first and recommendations to investors must be made without placing the financial or other interest of the broker-dealer ahead of their client. The message should be clear that self-serving incentives and conflicts are prohibited, and investors must be steered toward products that serve their best interest, which will most often be the best-performing, cost-effective products. Given that the text of the Proposed Rule contemplates meaningful reforms that benefit all investors, the SEC should close any misinterpretation that could allow the industry to continue business-as-usual and yet comply with the rule. Such an outcome would undermine the agency's rulemaking.

The following are examples of how such clarity could be better achieved for Reg. BI:

1. The adopting release should specify that sales contests, the most obvious of self-serving financial incentives for a broker, are inconsistent with the standard. The problem posed by these types of contests are blatantly self-evident; other countries recognize that and have banned them outright.¹⁰ Sales contests are a pernicious feature of brokerage sales activities, and by their very nature, require agents, consciously or not, to put their own interests ahead of customers. NASAA can envision no circumstances under which *any* sales contest would ever be consistent with a broker-dealer's duty under the Proposed Rule. Therefore, the SEC should declare such contests *per se* impermissible under its best interest conduct standard.
2. If not outright prohibited, revenue sharing arrangements between brokers and product manufacturers must be highly scrutinized for compliance with the final rule. Such agreements encourage brokers to offer and recommend to their clients more costly and poorer performing products as a result of higher payouts to the firm.

⁹ See: NASAA's Letter from President Michael Pieciak to Secretary Brent Fields (Feb. 19, 2019).

¹⁰ For example, the United Kingdom and Australia; see: https://www.rand.org/content/dam/rand/pubs/research_reports/RR1200/RR1269/RAND_RR1269.pdf.

3. Reg. BI should leave no room for preferential treatment of customers in the allocation of investment opportunities, such as initial public offerings. It should be clear that broker-dealers have no freedom to favor their richest or best-connected customers when allocating investment opportunities. Investment allocations should instead be made based upon objective, fair criteria that is immune from a broker-dealer's own business self-interest.
4. NASAA strongly disagrees that a broker-dealer could satisfy its "best interest" requirements by recommending securities from a limited menu of products without any comparison whatsoever to alternatives beyond such limited menu. Such an interpretation of a "best interest" standard is contrary to the standard of care articulated in the text of the proposed rule, which requires broker-dealers and associated persons to "exercise reasonable diligence" and "prudence" in recommending products.¹¹ We have urged the SEC to revise the language in the proposing release to make clear that broker-dealers and associated persons need to look outside the firm in considering factors such as cost, complexity, liquidity, and risk of readily available products and investment strategies that meet the customer's investment profile for purposes of making a best interest recommendation.
5. NASAA is also very concerned with language in the proposing release that appears to limit an investor's recovery rights under the new standard, and we believe the SEC should clarify that investors retain all their rights and remedies to seek redress for alleged violations of the conduct standard.
6. In all instances, moreover, the SEC should also provide clear fact pattern illustrations to demonstrate how Reg. BI will address and resolve the issues of conflicted advice.

Conclusion

Proposed Reg. BI is centered on the notion that broker-dealers will only make recommendations that are in the best interest of their client, and that such recommendations will be made without placing the broker-dealer's financial or other interest ahead of the interests of their client. This is what Main Street investors expect and want from their investment professionals – regardless of whether they are a broker-dealer or investment adviser.¹² Therefore, should the SEC adopt a final rule, it must ensure the final rule is true to its promise. Among other things, this means that the SEC must be explicit in both the text of any final rule and the adopting release about its expectation for meaningful reforms that benefit investors by requiring

¹¹ Proposed Regulation Best Interest, at 53-54.

¹² Congress should also be mindful of the likelihood that if the Proposed Rule is finalized, broker-dealers will undertake marketing campaigns heralding their obligation to act in the "best interest" of clients when recommending securities. This underscores the imperative that any such best interest standard be true to its label.

investment professionals to truly and consistently act in the best interest of their clients and customers.

Ultimately, Reg. BI is meant to better protect investors and align their expectations for the services and advice they receive from broker-dealers. Investors have waited nearly a decade for the SEC to enact a strong standard of care for investment professionals. The SEC can and should seize the present opportunity to align the promise of the Proposed Rule with results for investors.