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STATEMENT OF KEVIN CARROLL
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BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP AND CAPITAL MARKETS

HEARING ON: PUTTING INVESTORS FIRST?
EXAMINING THE SEC'S BEST INTEREST RULE

MARCH 14, 2019

Introduction

Chair Maloney, Ranking Member Huizenga and members of the Subcommittee:

My name is Kevin Carroll. I am a Managing Director and Associate General Counsel at the Securities Industry and Financial Markets Association ("SIFMA").[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets.

Thank you for the opportunity to submit SIFMA's views in connection with this important hearing. SIFMA supports strong, substantive conduct standards for broker-dealers ("BDs") that put the best interest of the client first.

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

SIFMA has a consistent and long-standing record of support for heightened conduct standards for BDs that enhance investor protection.

SIFMA has a consistent and long-standing record of support for heightened conduct standards for BDs. Our support predates the passage of the Dodd-Frank Act. In fact, over the past ten years, our written advocacy on this important issue has included Congressional testimony on five occasions (and now six) [2] seven comment letters to the SEC,[3] and one comment letter to FINRA.[4]

SIFMA's members support higher standards because their client relationships are their greatest asset. As a result, our members have a strong vested interest in acting in the best interest of their clients. Thus, it is fair to say that SIFMA's members represent *not only* the industry's interest *but also* – to a significant extent – the voice and best interest of investors generally.

[2] SIFMA testimony before the Senate Banking Committee (Mar. 10, 2009), available at http://www.sifma.org/issues/item.aspx?id=1510; SIFMA testimony before the House Financial Services Committee (Jul. 17, 2009), available at http://www.sifma.org/issues/item.aspx?id=1515; SIFMA testimony before the House Financial Services Committee (Oct. 6, 2009), available at http://www.sifma.org/issues/item.aspx?id=1519; SIFMA testimony before House Financial Services Committee (Sep. 13, 2011), available at http://www.sifma.org/issues/item.aspx?id=8589935390; SIFMA testimony before House Financial Services Committee (Jun. 6, 2012), available at http://www.sifma.org/issues/item.aspx?id=8589938957.

[3] SIFMA comment to SEC (Aug. 30, 2010), available at https://www.sifma.org/issues/item.aspx?id=22263; SIFMA & Oliver Wyman comment to SEC (Nov. 1, 2010), available at http://www.sifma.org/issues/item.aspx?id=21999; SIFMA & Oliver Wyman comment to SEC (Nov. 17, 2010), available at http://www.sifma.org/issues/item.aspx?id=22336; SIFMA comment to SEC (Jul. 14, 2011), available at http://www.sifma.org/issues/item.aspx?id=8589934675; SIFMA comment to SEC (May 4, 2012), available at https://www.sifma.org/issues/item.aspx?id=8589938634; SIFMA comment to SEC (Jul. 5, 2013), available at https://www.sifma.org/issues/item.aspx?id=8589944317; SIFMA comment to SEC (Jul. 21, 2017), available at https://www.sifma.org/resources/submissions/standards-of-conduct-for-investment-advisers-and-broker-dealers/.

[4] SIFMA comment to FINRA (Dec. 3, 2010), available at http://www.sifma.org/issues/item.aspx?id=22482. SIFMA's work product also includes two economic study reports quantifying the costs and expenses under various approaches, two reports providing a detailed roadmap for SEC rulemaking under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), a robust cost-benefit analysis, and proposed rule text.

SIFMA generally supports the SEC's Reg BI proposal because it significantly raises the bar from the current standards and incorporates fiduciary principles.

Consistent with our support for heightened standards, SIFMA generally supports the Securities and Exchange Commission's ("SEC's") proposed Regulation Best Interest ("Reg BI") and Form Customer Relationship Summary ("Form CRS").[5]

As a threshold matter, the SEC – as the primary, preeminent, federal securities regulator – is the right agency to lead in this area. The SEC has greater expertise and broader jurisdiction and authority over BDs than any other federal agency and the states. Thus, to best protect investors and avoid investor confusion, the most reasonable approach is to allow the SEC to promulgate a uniform, nationwide, heightened, best interest standard for BDs. Other federal agencies and states should defer to the SEC to avoid creating an uneven patchwork of laws that would be duplicative of, different than, and/or in conflict with the SEC's standard. Investors would derive the greatest benefit from a single, uniform, heightened standard for BDs that the SEC can enforce *not only* across the industry *but also* across the country.

With respect to Reg BI specifically, we support it because it significantly raises the bar from the current Financial Industry Regulatory Authority ("FINRA") suitability standard. For example, under Reg BI, recommendations must be *not only* suitable *but also* in the retail customer's "best interest."[6] That means that BDs cannot put their interests ahead of the interests of their retail customers.

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[5] *See* SIFMA comment letter to the SEC re: Reg BI (August 7, 2018), available at https://www.sifma.org/resources/submissions/regulation-best-interest-reg-bi/.

[6] Under FINRA Rule 2111 (the suitability rule), BDs are not explicitly required to make recommendations that are in the customer's "best interest," notwithstanding that FINRA guidance may suggest otherwise. *See* FINRA Reg. Notice 12-25 at pp. 3 – 4, available at https://www.finra.org/sites/default/files/NoticeDocument/p126431.pdf.

In addition, under Reg BI, disclosure alone is *not* enough to satisfy the standard. With respect to material conflicts arising from financial incentives, BDs must either eliminate, or disclose *and mitigate*, such conflicts of interest. The plain text of the proposed rule explicitly obligates BDs to either disclose *and mitigate, or eliminate*, such conflicts. Any interpretation to the contrary (as has been reported) is contrary to the plain text of the rule and the regulatory intent. This particular facet of Reg BI would effectively hold BDs to an *even higher* standard than the one that applies today to investment advisers ("IAs") under the Investment Advisers Act of 1940.

Moreover, Reg BI incorporates important fiduciary principles that are intended to maintain and enhance the *quality* of a BD's recommendation about a security to a retail client. Specifically, Reg BI would require a BD to exercise reasonable "*diligence, care, skill, and prudence*" in making recommendations. These fiduciary principles are the core of a BD's "Care Obligation" under proposed Reg BI.

Reg BI provides all of the same protections as the former Department of Labor fiduciary rule (the "DOL rule"), but would be even better than the former DOL rule because it applies to *all* retail customer accounts – not just retirement accounts, and because it's backed by the accountability mechanism of SEC enforcement.[7]

Finally, it is important to understand that, as compared to IAs, BDs today are generally subject to more extensive regulation and more frequent regulatory examination and enforcement by the SEC and FINRA.[8] Retail customers also enjoy the benefit of a private right of action

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[7] The former DOL rule would have applied *only* to retirement accounts (i.e., Individual Retirement Accounts ("IRAs")) and notably, the DOL has *no* enforcement authority over IRAs, which is solely within the purview of the Internal Revenue Service.

[8] *See* Morgan, Lewis & Bockius LLP, *Current Regulatory Regime Comprehensively Protects Investors and Preserves Investor Choice*, at p. 17 (March 2015), available at https://www.morganlewis.com/-/media/files/publication/morgan-lewis-title/white-paper/im_whitepaper_dolretirementinitiative_march2015.ashx.

against their BD through FINRA arbitration. When you couple Reg BI with the existing, robust regulatory regime for BDs, it becomes clear that the SEC is pursuing nothing short of a true best interest standard with real teeth.

SIFMA's support for Reg BI is not unqualified;
Reg BI requires certain improvements, clarifications
and modifications to ensure a workable final rule.

SIFMA's support for Reg BI is not unqualified. In fact, we spent forty-five of the fifty-four pages of our written comment to the SEC detailing how and why the Reg BI proposal needs to be improved, clarified and/or modified.

- For example, we explain that the term "retail customer" in Reg BI should be made consistent with the current definition of "retail investor" under FINRA rules,[9] and consistent with the definition of "retail investor" in Form CRS.
- We also explain that the term "material conflicts of interest" should be interpreted consistently with the long-established "materiality" standard set by the U.S. Supreme Court in *Basic v. Levinson*.[10]
- We asked the SEC to clarify the types of conflicts that may be "material conflicts of interest" and to clarify the obligation to mitigate conflicts in various contexts.[11]

[9] FINRA Rule 2210(a)(6) defines a "retail investor" as "any person other than an institutional investor." An "institutional investor," in turn is defined in Rule 2210(a)(4) to include, among others, any "institutional account." The term "institutional account" is defined in Rule 4512(c).

[10] *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (reaffirming the material standard set by the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)).

[11] *See* FINRA Report on Conflicts of Interest (Oct. 2013) (identifying financial compensation as the major source of conflicts of interest for financial advisors), available at https://www.finra.org/sites/default/files/Industry/p359971.pdf.

These are but a few of the several dozen recommendations we detailed in our written submission to the SEC. All of our suggested changes are intended to ensure Reg BI will be workable for our industry and will most effectively protect retail investors.

Although the costs of compliance with Reg BI would be significant, they are outweighed by the benefits to retail investors of a heightened conduct standard.

To be clear, the implementation costs of Reg BI and Form CRS would be significant for the industry.[12] That said, the benefits of a heightened conduct standard for retail investors make it a worthwhile investment for our members.[13] The benefits are clear and obvious: Reg BI would take the existing, well-functioning regulatory regime for BDs (i.e., the "good") and make it better. In doing so, Reg BI would directly enhance investor protection and contribute to a heightened sense of trust and confidence among investors in their financial service professionals.

Reg BI is explicitly designed to preserve investor access to transaction-based advice.

Reg BI *not only* represents a clear investor protection win *but also* takes pains to preserve investor access to transaction-based advice in brokerage accounts. The SEC recognizes that brokerage accounts – and brokerage advice – are valuable and worthy of preserving and promoting.[14]

BD accounts represent an important choice for retail investors – often the less expensive choice – and provide access to affordable advice, particularly for smaller and middle-income

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[12] *See* SIFMA comment to SEC (July 5, 2013) (providing cost-benefit data and analysis on heightened conduct standards for BDs), available at https://www.sifma.org/issues/item.aspx?id=8589944317.

[13] As we emphasized in our comment letter to the SEC, the costs of Reg BI would be manageable, provided that the final rules incorporate our critical, recommended changes and clarifications. *See* SIFMA comment letter to the SEC re: Reg BI (August 7, 2018) at p. 7, available at https://www.sifma.org/resources/submissions/regulation-best-interest-reg-bi/.

[14] *See* SEC Regulation Best Interest, Release No. 34-83062; File No. S7-07-18 at pp. 21, 37 – 41, available at https://www.sec.gov/rules/proposed/2018/34-83062.pdf.

buy-and-hold investors. Brokerage accounts are also generally more appropriate for investors who do not need or want to trade frequently, or who do not want to pay for ongoing advice and monitoring through an advisory account.

The evidence shows that commission-based accounts and fee-based accounts exhibit similar performance and returns.[15] According to account-level data, investors select the fee model (commission versus fee) that best suits their own needs and trading behavior. Investors who expect to trade often rationally choose fee-based advisory accounts, and those who do not trade often are likely to choose commission-based brokerage accounts.[16]

If the costs associated with maintaining commission-based brokerage accounts become too high for firms, then many investors would lose access to advice, because many commission-based account balances are too small for advisory accounts.[17] Using a conservative minimum account balance of $25,000, over 40% of commission-based accounts would be unable to open a fee-based account.[18] Using a $50,000 threshold, over 57% of accounts would not meet minimum balance requirements for fee-based accounts.

Losing access to advice would detrimentally impact individual investors because individual investors often make systematic errors when investing on their own.[19] Moreover,

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[15] NERA Economic Consulting, *Comment on the Department of Labor Proposal and Regulatory Impact Analysis* (July 17, 2015) ("NERA Analysis") at 10 – 11, available at https://www.sifma.org/wp-content/uploads/2017/05/nera-analysis-comment-on-the-department-of-labor-proposal-and-regulatory-impact-analysis.pdf.

[16] *Id.* at 6-7.

[17] *Id.* at 9.

[18] *Id.* at 12 (citing 76 Fed. Reg. 66136, 66151, Investment Advice – Participants and Beneficiaries (October 25, 2011), *available at* https://www.gpo.gov/fdsys/pkg/FR-2011-10-25/pdf/2011-26261.pdf).

[19] *Id.* at 13-16 (citing 76 Fed. Reg. 66136, 66153 – 54, Investment Advice – Participants and Beneficiaries (October 25, 2011), *available at* https://www.gpo.gov/fdsys/pkg/FR-2011-10-25/pdf/2011-26261.pdf).

households with access to advice and guidance save at roughly twice the rate of non-advised households, and exhibit better savings behaviors that leave them better prepared for retirement.[20]

Thus, Reg BI seeks to avoid imposing unnecessary or undue regulatory costs and burdens that might incentivize firms to:

- migrate brokerage accounts to fee-based accounts;[21]
- cease proving transaction-based advice in brokerage accounts; or
- discontinue service to brokerage accounts altogether.[22]

Reg BI affirmatively seeks to avoid these negative consequences because they would effectively reduce brokerage services, and thereby reduce access to advice and choice by retail investors. SIFMA strongly agrees with this approach.

Conclusion

Thank you, Chair Maloney, Ranking Member Huizenga and members of the Subcommittee for allowing me to present SIFMA's views. SIFMA and its members remain committed to being constructive participants in the SEC's rulemaking process to establish a best interest standard for BDs. We stand ready to provide any further assistance requested by this Subcommittee on this important topic.

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[20] Montmarquette, C., and Viennot-Briot, N. (2012), *Econometric Models on the Value of Advice of a Financial Advisor,* CIRANO, available at http://www.cirano.qc.ca/pdf/publication/2012RP-17.pdf.

[21] Most SIFMA members who serve retail investors are dually registered as both BDs and IAs, and thus offer both brokerage and advisory accounts, thereby giving investors choice about the level of service and how to pay for it.

[22] Similar unintended negative consequences were associated with the former DOL rule, where our industry experienced a significant migration of brokerage retirement accounts to fee-based account and a contraction of service offerings. *See* Deloitte, *The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors* (August 9, 2017), available at https://www.sifma.org/wp-content/uploads/2017/08/Deloitte-White-Paper-on-the-DOL-Fiduciary-Rule-August-2017.pdf; NERA Analysis, available at https://www.sifma.org/wp-content/uploads/2017/05/nera-analysis-comment-on-the-department-of-labor-proposal-and-regulatory-impact-analysis.pdf.