Statement of Christine Lazaro
On behalf of the Public Investors Arbitration Bar Association (PIABA)
Before the New Jersey Bureau of Securities

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Thank you for the opportunity to speak here today. My name is Christine Lazaro and I am the president of the Public Investors Arbitration Bar Association. PIABA is a national bar association whose mission is to promote the interests of the public investor in securities arbitration; to make securities arbitration as just and fair as systematically possible; and to create a level playing field for the public investor in securities arbitration. PIABA has almost 400 member attorneys who practice across the country and have represented thousands of investors who have been harmed by inappropriate investment advice.

PIABA has long advocated for a true fiduciary standard for brokers, one which acknowledges the position of trust and confidence such individuals occupy when dealing with their clients. A true fiduciary standard would consist of:

- a duty of care which should include on-going monitoring and advice, when appropriate; and
- a duty of loyalty.

As you know, brokers are currently held to a suitability standard. A suitability standard only requires that a broker make recommendations "appropriate" for an investor based on that investor's profile. However, brokers will often have a wide range of products to choose from. Some products may seem similar but pay the broker varying levels of commission. Under the current standard, the broker may select the product from that collection which provides the greatest benefit to the broker. The broker is not required to disclose to the investor that there are lower cost products available, or that the broker's recommendation is driven by incentives for the broker which create conflicts of interest. While FINRA has long viewed the suitability rule as requiring that a broker's advice be in the investor's best interest,[1] the rule does not explicitly include such a requirement, and brokers continue to be influenced by conflicts of interest that incentivize the broker to act in his own best interests.

Unlike brokers, investment advisers are held to a "fiduciary standard." This fiduciary standard consists of two parts: a Duty of Loyalty and a Duty of Care.[2] The Duty of

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[1] *See* FINRA Rule 2111 (Suitability) FAQ, A7.1, available at http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.
[2] *See* Study on Investment Advisers and Broker-Dealers, SEC 22 (2011), *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

Loyalty requires investment advisers to act in their clients' best interests and to disclose all conflicts of interest.[3] The Duty of Care requires investment advisers to provide suitable investment advice after investigating a client's financial situation and investment objectives.[4]

There are circumstances when a broker will also be held to a fiduciary duty. For example, where a broker exercises discretion or special circumstances are present, the broker will be held to a common law fiduciary standard.[5]

While in most circumstances, a broker is not held to a fiduciary standard, brokerage firms continue to advertise that they will provide investors with services that most would consider fiduciary in nature. Firms encourage investors to trust them, saying they will provide advice and guidance, implying they are there for the long term. However, the firms do not make clear that they are actually providing episodic advice tainted by conflicts.[6] For example, on its website, Charles Schwab tells investors, "Let us help plan your financial future."[7] Wells Fargo advertises that "Our Financial Advisors are committed to providing you with top-notch service and attention that you expect and deserve."[8] Merrill Lynch says, "Your advisor will help guide you, making adjustments as your needs change."[9] These are not the words of mere salesmen. The firms are holding themselves out as trusted life-long partners, partners their clients can rely upon.

Although brokers hold themselves out as trusted advisors, they only remain subject to a suitability standard, not a fiduciary standard. Under the suitability standard, brokers are often incentivized to recommend certain products. For example, if a broker sells a non-traded REIT (real estate investment trust), he may earn substantially more money than if he sold an index ETF (Exchange Traded Fund). While both investments may generate income for a client, the non-traded REIT will have more risk and be potentially illiquid. The client likely will not understand that to generate the income, she has given

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[3] *Id.*

[4] *Id.* at 27–28.

[5] *See Leib v. Merrill, Lynch, Pierce, Fenner & Smith*, 461 F.Supp. 951, 953 (E.D.Mich.1978).

[6] Peiffer, Joseph C. and Christine Lazaro, Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty, Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard (March 25, 2015), available at https://piaba.org/sites/default/files/newsroom/2015-03/PIABA%20Conflicted%20Advice%20Report.pdf.

[7] Charles Schwab, Investing Based on Your Goals, available at https://www.schwab.com/public/schwab/investing/invest.html (last visited Nov. 11, 2018).

[8] Wells Fargo Advisors, Why Choose Wells Fargo Advisors, available at https://info.wellsfargoadvisors.com/form.aspx?type=wellsfargoadvisorspacket&cid=WFA140043903&intcid=WFA140043903 (last visited Nov. 11, 2018).

[9] Merrill Lynch, Working with Us, available at https://www.ml.com/working-with-merrill-lynch-financial-advisor.html (last visited Nov. 11, 2018).

up the ability to access her principal, and may be subject to a substantial amount of investment risk. The client has not asked these questions because she trusted the advice she received from her broker, believing that her broker would only put her in something if he believed that investment was best for her.

PIABA members have represented many investors who have been harmed by conflicted advice. For example, one New Jersey couple from Middlesex County, in their late forties, opened an account with a broker. They thought they were doing something responsible to help prepare them for retirement. The broker placed their funds in a combination of private placements, REITs, and other high risk alternative investments. The broker told the couple the investments were safe, and met their goals of preservation of capital and growth. The couple didn't know that, while the investments may have offered some potential for growth, they were highly risky. No doubt, the broker and his firm were not motivated by the interests of their clients, but rather by the substantial fees earned from these investments. Had the broker recommended truly appropriate investments, he would have earned much less. Unfortunately, the only person who benefited from this trading was the broker. Meanwhile, the couple lost a significant amount of their retirement savings.

Another New Jersey couple from Ocean Township opened several brokerage accounts. The couple has been married for over 50 years, and, after retiring, decided it was important to entrust their retirement savings, amassed after a lifetime of hard work, to a broker whom they could trust to take care of them. Unfortunately, once the broker had control of the couple's accounts, he purchased promissory notes and other private placements. The couple believed their broker had chosen investments which were safe, and would provide them with a steady stream of income. And, while the investments did generate some income, the broker never conveyed how much risk they had assumed. The broker benefited from the purchases, because he made substantial money every time he invested them into one of the private placements. However, in the end, the couple lost a substantial amount of their savings.

Unfortunately, these cases are all too common. Brokers recommend complex investments, claiming they are appropriate for the investors' growth or income investment objectives. While the investments may generate some potential for growth or income, they are often risky and illiquid. The brokers end up compromising their clients' needs by focusing on one aspect of their investor profiles. The brokers themselves are driven by incentives, directing their clients to investments that will pay the broker the most. This behavior can be prevented by adopting a true fiduciary standard, one that requires a broker to put the needs of his client ahead of his own.

We ask that the Bureau adopt a standard that recognizes the relationship of trust and confidence that exists between an investor and her broker. Such a duty should consist of a Duty of Care and a Duty of Loyalty.

The Duty of Care should replicate the duty that had been adopted by the Department of Labor as part of its Best Interest Contract Exemption. Brokers should be required to "act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the … investor, without regard to the financial or other interests" of the broker.[10]

Such a duty will continue to incorporate the requirement to provide suitable investment advice; however the advice should be the best possible advice given the circumstances. Investment costs must be a factor in determining what investment is best for a client, as should investment objectives, risk, and liquidity.

Moreover, we recognize that there are different business models, and that variances in the models may benefit some clients. Clients should have the option to pay commissions or asset based fees. However, how the client has paid the broker should not determine what that broker's duties are. Studies have shown that investors are confused about the level of monitoring they will receive from their brokers.[11] In is unfair that brokers can hold themselves out as "advisers," but not have to meet the expectations such a title creates. Unless a client is directing the trading in the account herself, a broker's duties should be continuous.

Additionally, brokers may be dually registered, acting as both a broker and an investment adviser, many times with respect to the same client. Investors do not understand that their broker may have one duty with respect to their brokerage account, and a separate and different duty with respect to their advisory account. Clients do not differentiate the accounts based on the duties owed; they differentiate the accounts based on the fees paid. They believe they are paying the broker in different ways for the same services, not bargaining for different services. Brokers who are dually registered should have an on-going duty of care.

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[10] See Best Interest Contract Exemption, Department of Labor, 81 FR 44773, 44784 (July 11, 2016), available at https://www.federalregister.gov/documents/2016/07/11/2016-16355/best-interest-contract-exemption-correction.

[11] See Final Report on Testing of Proposed Customer Relationship Summary Disclosures, AARP, Consumer Federation of America, and Financial Planning Coalition 12 (Sept. 10, 2018), available at https://consumerfed.org/wp-content/uploads/2018/09/testing-of-proposed-customer-relationship-summary-disclosures-report.pdf; Investor Testing of Form CRS Relationship Summary, SEC 46 (Nov. 2018), available at https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf.

Brokers should also be held to a Duty of Loyalty. Such a duty should require the mitigation or elimination of conflicts of interest. Incentives which encourage brokers to engage in conduct that they would not otherwise engage in should be prohibited. Brokers should not be paid differential compensation that is dependent on the product recommended. Commissions should be leveled so that the incentive to recommend one product over another is eliminated. Regardless of whether the broker recommends a REIT, a mutual fund, or an annuity, the broker should be paid the same fee. This will ensure that a broker is considering the needs of his client, rather than his own wallet. Additionally, sales contests should be prohibited. There is a significant amount of misconduct flowing from sales contests because brokers are paid to sell particular products. Such behavior encourages a broker to put his own interests ahead of his client's. It should be clear from any rulemaking that such conduct is unacceptable.

Investors turn over their life savings to brokers. Of course, they trust their brokers, believing that their brokers are acting in their best interests, not understanding that the brokers may be faced with incentives that challenge their ability to do what's best for their clients. Brokers should be held to a higher standard, one that ensures they will put their clients' interests first. Brokers should be held to a true fiduciary standard.

Thank you for the opportunity to speak to you today. The gap in standards between investment advisers and brokers is harmful to investors. We applaud the Bureau for looking into this issue and look forward to working further with the Bureau as it considers the adoption of a fiduciary duty for brokers.