PIABA Report: Recommendations To Improve And Enhance The SEC Best Interest Standard For Investors (August 7, 2018)

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I. Introduction/Executive Summary

On April 18, 2018 the Securities and Exchange Commission ("SEC") released "rulemakings and interpretations designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers while preserving access to a variety of types of advice relationships and investment products."[3] The SEC's proposed "best interest" standard for securities broker-dealers and their associated persons (collectively "brokers") needs significant changes in order to protect the brokerage and retirement accounts of investors while remaining consistent with the SEC's intent. This report provides 15 specific, detailed recommendations to improve and enhance the Rule.

There is an overwhelming need for a strong, investor centric best interest standard. Americans are woefully unprepared for retirement and meeting other financial goals. Decades of conflicted advice and high fee investments by brokerage firms directly led to this crisis. Half of all Americans have less than $10,000 in savings, and nearly half of the oldest Baby Boomers are at risk of not having sufficient retirement resources to pay for basic retirement expenses and healthcare costs.[4] The Center for Retirement Research at Boston College estimates that our "retirement income deficit" is $6.6 trillion. That number represents the gap between the pension

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[3] See SEC website https://www.sec.gov/news/press-release/2018-68

[4] S. Comm. on Health, Education, Labor, and Pensions, 112th Cong., The Retirement Crisis and a Plan to Solve It (2012).

and retirement savings that American households have today and what they should have today to maintain their standard of living in retirement.

II. Specific Recommendations and Enhancements

a. The Proposed Rule Must Provide Specific Standards Regarding the Broker's Best Interest Obligations

The Rule includes three general obligations: (1) the Duty to Avoid and/or Mitigate Conflicts of Interest; (2) the Duty of Care; and (3) the Duty of Disclosure. The final rule should expressly state that a broker must comply with all three of the foregoing obligations in order to comply with the Rule. The language of the release suggests that this is the SEC's intent but the standards for meeting these three obligations must be clarified in a manner that reflect the realities of the broker-customer relationship.

1. The Conflict of Interest Obligation

The Conflict of Interest Obligation would require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to: "(a) identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and (b) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations."[5]

Recommendation #1: The Rule needs to go further and also prohibit certain "financial incentives" altogether. The SEC suggested eliminating compensation incentives within a product line.[6] FINRA has examined in the past whether differential compensation structures should be prohibited with respect to proprietary products.[7] FINRA also considered whether product specific sales contests should be prohibited.[8]

Significant problems associated with sales contests remain in the securities industry. For example, Scottrade is alleged to have conducted sales contests in 2017 which "perversely incentivized Scottrade agents to bring in new assets from customers, including through the rollover of retirement assets," as well as "make recommendations and referrals to its investment advisory program in order to qualify for particular prizes."[9] Such contests "could be reasonably expected to cause Scottrade agents to make recommendations in their own best interests rather

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[5] SEC Release No. 34-83062 at 406.

[6] *Id*. at 182.

[7] NASD Notice To Members 99-81, *Salesperson Compensation Practice,* at 607 (Sept.1999), http://www.finra.org/sites/default/files/NoticeDocument/p004080.pdf.

[8] NASD Notice to Members 05-40, *Sales Contests and Non-Cash Compensation* (June 2005) and FINRA Reg. Notice 16-29, *Gifts, Gratuities and Non-Cash Compensation Rules* (August 2016).

[9] Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, *In the Matter of: Scottrade, Inc.*, Docket No. E-2017-0045 at 4 (Feb. 15, 2018).

than the best interests of their customers."[10] Firms used other improper financial incentives as well. In 2017, Morgan Stanley consented to a $1 million fine for utilizing incentive programs for initiating lending relationships with Morgan Stanley Private Bank.[11] Notwithstanding Morgan Stanley's internal prohibition against sales contests, the firm allowed the incentive program to proceed.[12]

Senator Elizabeth Warren highlighted the sales practices of a number of firms within the annuity industry which created conflicts of interest because of the incentives provided to sell their products.[13] Many firms offered lavish vacations to high end resorts around the world to the top sellers. For example, one firm provided a week-long trip to Playa Del Carmen, Mexico to the top 15 annuity agents.[14] Another held its "Leaders' Conference," for the broker and a guest, at the Westbury Hotel in Dublin, Ireland.[15] The Rule must be crafted in a manner that would eliminate conduct that carries with it these types of conflicts of interest.

Recommendation #2: The Rule should specifically prohibit compensation structures which would incentivize a broker to: recommend a proprietary product or recommend one type of product line over another; and/or which would reward the sale of certain products within a product line. Such practices put the broker's interests at odds with the customer's interests, and should not be permitted. This includes a specific prohibition on sales contests which improperly incentive the sale of particular products or encourage behavior at odds with the best interests of the customer. Other compensation and bonus structures within firms appropriately reward advisors for a job well done without putting pressure on advisors to sell more of a particular product or providing them with a financial incentive to do so.

Recommendation #3: The disclosure of fees, charges and compensation associated with a recommendation must be clear and simplified so that they are understandable. Currently, a customer needs to comb through lengthy prospectuses (often several of them if multiple products are recommended) in order to ascertain the fees and charges associated with the recommended investment or investment strategy. Even then, it is not always clear how those fees and charges impact investment performance or how they compare to the fees and charges of other available investments. Customers should be provided with clear and concise information that fully and fairly discloses the specific charges the customer will incur as a result of the particular recommendation, prior to or at the time the recommendation is made. In addition, the broker should provide a clear and understandable explanation of other lower cost investments which are available, and why the higher cost investment is being recommended.

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[10] *Id.*

[11] Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, *In the Matter of: Morgan Stanley Smith Barney LLC*, Docket No. E-2016-0055 (Apr. 7, 2017).

[12] *Id.*

[13] Senator Elizabeth Warren, *Villas, Castles, and Vacations* (Feb. 2017).

[14] *Id*. at 4.

[15] *Id* at 3.

Implementing these types of changes would protect investors like Robert and Janet Pettigrew who met their broker after hearing his radio show. The broker often talked about alternative investments on his show, touting them as providing safe and secure income without the volatility of stocks. As Mr. Pettigrew had significant health problems, he was concerned about his ability to provide for his wife in retirement. Mr. Pettigrew reached out to his broker to ask for his help managing the couple's modest savings. The broker ultimately recommended a number of "alternative" investments, which are illiquid, non-traded investments into private companies, including Real Estate Investment Trusts and Business Development Companies (BDCs). These investments are highly speculative. They were represented as "safer" and "more diverse" than the stock market. The broker did not mention the lucrative fees such investments pay to firms and brokers. The investments had up-front costs and fees of 10 – 15%, a significant portion of which is passed along to the brokerage firm and its brokers. The investments were recommended because of the massive fees and commissions which created a financial incentive to recommend them regardless of the risks associated with them.

2. The Care Obligation

The Care Obligation requires the broker to exercise reasonable diligence, care, skill, and prudence to: (a) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (b) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (c) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile."[16]

The Care Obligation embodies many of the principles of FINRA's "Know Your Customer Rule" and FINRA's "Suitability Rule." The SEC must clarify that the FINRA Rules are affirmed and expressly incorporated by reference into the Rule, so as to avoid any argument that the SEC's proposed Rule has less stringent requirements than the current FINRA Rules.

The Care Obligation requires that the customer's investment profile, including "the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker-dealer or associated person" must be considered.[17] Customer due diligence is paramount to satisfy the duty of care. Usually, customer information is recorded on a form when a new account is opened. Firms are required to send this information to a customer within 30 days of account opening, and no less frequently than every 36 months thereafter.[18] However, there is often little documentation as to how and when the firm or the broker obtained the customer information contained in the profile.

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[16] SEC Release No. 34-83062 at 405-06.

[17] *Id*. at 407.

[18] 17 CFR 240.17a-3(17)(i)(B)(1).

It is not uncommon for the customer to sign boilerplate documents containing purported investment profile information, however inaccurate, without review or discussion because they trust the broker and believe he or she has truthfully completed the documents and is acting in their best interest. Sometimes the customers sign the forms with the information left blank, and it is then filled in by an assistant who does not have all the information or has incorrect information. All too often, firms use new account documents with blatantly inaccurate customer information, not written in the customer's handwriting or not provided by the customer at all, in an effort to blame the customer for the firm's bad advice.

Recommendation #4: The burden of ensuring accurate recording of customer information should be on the broker and/or firm. The opening account documentation regarding the customer's information should be completed in the customer's own handwriting to the extent possible, and brokers should be required to verbally explain what is in the customer profile and keep a record of the conversation that is acknowledged by the customer. For example, the broker should talk to the customer about what having "extensive investment experience" means. It should not mean simply that the customer has had a brokerage account for a long time, but that the customer has had experience in analyzing and making independent investment decisions. In addition, there should be a discussion as to what it means to have an aggressive investment strategy with a high tolerance for risk of loss, and why such a high-risk strategy is in the best interest of the customer. A discussion of what is meant by an investment objective of "growth" is also appropriate. Many customers do not understand that "growth" often means investments in equities which carry more risk. Most customers assume "growth" means their accounts will grow.

Recommendation #5: Brokers must be required to take reasonable steps to verify that the financial information provided by the customer is accurate. The Care Obligation should require the broker to obtain and review documents to verify the customer's income and/or net worth. These could include brokerage account statements, pay stubs, or IRS forms that report the customer's income. The rule should require the broker to review the information with the customer verbally and in writing at account opening on a periodic basis, and whenever the broker may become aware of a material change in the customer's circumstances that could affect liquidity needs, time horizon, or risk tolerance. Such reviews should be documented and maintained as part of the firm's books and records.

Recommendation #6: The Rule must clarify that product due diligence goes further than reviewing a prospectus or a brochure or asking a few questions of the product wholesaler, which is often a process contaminated with its own conflicts of interest unrelated to the broker. Product due diligence is critical to satisfy the duty of care. This form of inquiry is contaminated with its own conflicts of interest, as the individuals answering inquiries about a product, the wholesalers or issuers, are often focused on their own interests and not the interests of the ultimate customer. As stated by FINRA, "In general, however, a broker-dealer 'may not rely blindly upon the issuer for information concerning a company,' nor may it rely on the information provided by the issuer

and its counsel in lieu of conducting its own reasonable investigation."[19] The Rule should require independent investigation to comply with the reasonable basis inquiry obligation.

Recommendation #7: The Rule must require that brokers have an understanding of the risks and rewards of the recommendation, which "would generally involve consideration of factors, such as the costs, the investment objectives and characteristics associated with a product or strategy (including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions), as well as the financial and other benefits to the broker-dealer."[20] The Rule explains that consideration of the costs associated with the recommendation is a central requirement under the Care Obligation and, therefore, an enhancement of the broker-dealer's existing obligations.[21] To the extent a broker recommends a "more expensive" security or investment strategy, the broker must have a reasonable basis for the recommendation, *i.e,.*, the recommendation is justified given the characteristics or features of the security or strategy and the customer's profile and investment objectives.[22] Unfortunately, that language is not expressly stated in the text of the Rule defining the Care Obligation, or anywhere else in the Rule itself. It should be. The rule simply includes a vague reference to consideration of "risks and rewards."[23] The SEC must also include in the Care Obligation an express reference to the requirement that a broker consider the cost of the recommended transaction or strategy (and disclose those actual costs to the investor as discussed above). If there are less expensive alternatives available, the disclosure should include an explanation to the customer of why the recommended security transaction or investment strategy is nevertheless in the customer's best interest given other factors associated with the recommendation.[24]

Recommendation #8: The Rule must make it explicitly clear that brokers cannot satisfy the Care Obligation merely by providing the customer with a prospectus or offering document. Otherwise, brokers may ignore their best interest duty by attempting to improperly shift the burden to the customer to assess the merits and risk of the investment. Such behavior happens all too frequently, and undermines the purpose of the securities laws, which were intended to eliminate the "buyer beware" environment that existed prior to their enactment.

Implementing some of these changes would help protect investors like Donna Gamble, 58 years old, with a high-school education. When her stockbroker, affiliated with Madison Avenue Securities, transferred her account to another firm the broker completed the account application paperwork showing Ms. Gamble as an investor with a six-figure income and extensive investment experience, seeking an aggressive investment strategy, and having a high tolerance for risk. None of this was true. Ms. Gamble signed the paperwork without question or discussion

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[19] FINRA Notice To Members 10-22, *Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings* (April 7, 2010)

[20] SEC Release No. 34-83062, at 143.

[21] *Id*. at 135, 143.

[22] *Id.* at 56-57.

[23] Proposed §240.15l-2(ii)(B), 17 CFR Part 240, Release No. 34-83062, at 406.

[24] SEC Release No. 34-83062, at 56.

because she trusted her stockbroker. The firm sent her a 40-page "welcome" packet that included her profile information, and informed Ms. Gamble to contact her broker with questions or corrections. Overwhelmed by the sheer volume of paperwork, she did not review it with the incorrect information. After the stockbroker lost most of her money through imprudent, high risk investments, Ms. Gamble filed a FINRA arbitration claim. The central argument of the firm's defense was her false customer profile, which had given them free rein to act contrary to her best interest.

3. The Disclosure Obligation

The Disclosure Obligation requires the broker to "reasonably disclose to the retail customer, in writing, the material facts relating to the scope and circumstances of the relationship with the customer, including all material conflicts of interest that are associated with the recommendation."[25] The crucial issue is what constitutes "reasonable disclosure." The Rule, as currently written, suggests that the duty of disclosure could be discharged by simply providing the customer with a form, the Customer Relationship Summary ("Form CRS").

It is highly unlikely that any single form can provide effective disclosure to retail customers. Numerous studies illustrate that cognitive biases and lack of financial literacy, among other factors, greatly diminish the effectiveness of written disclosures.[26] Retail customers often receive voluminous written materials when engaging in a securities transaction, including account opening documents, prospectuses, contracts and marketing materials. The volume of paperwork is equivalent to the documentation one receives when closing a real estate transaction. Retail customers frequently become overwhelmed by the information and will simply rely on what their broker tells them. In such cases the disclosure is no longer a resource for the customer to use in deciding on a specific recommendation, but instead, a "gotcha" disclaimer for the broker-dealer.

Simply presenting yet another document to a customer, in addition to the many documents the customer already receives, will not be sufficient because of the volume and complexity of the documents, and the customers' natural inclination to trust what is stated to them verbally rather than what they are able to discern from reading voluminous, difficult-to-understand documents. This does not mean that it is impossible to satisfy a disclosure obligation, but rather the obligation cannot be satisfied solely by presenting the customers with an additional document like a "Form CRS."

Recommendation #9: The appropriate way to discharge the disclosure obligation is to require the broker to have a verbal conversation with the customer in which the broker explains the relationship, any potential and actual conflicts, how the broker is paid, and the features, benefits, and risks of the recommendation in a way that is understandable to the customer. This conversation should then be confirmed by a letter or email from the broker documenting the

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[25] *Id.* at 405.

[26] PIABA August 11, 2017 Comment Letter to Chairman Clayton's Request for Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers, at 18-19 (citations omitted).

discussion, which is signed or confirmed as being accurate by the customer and retained in the customer's file. The procedure described above is one that is already followed by several brokers and advisors. It is also consistent with "Engagement letters" that are utilized by other professionals to set forth and confirm the nature, scope, conflicts and fees associated with the relationship. Adoption of this procedure would ensure that the relevant information is not only disclosed, but heard, and that it is presented to the customers uncluttered by layers of distracting documents.

Recommendation #10: The SEC must explicitly state in the final Rule that the Disclosure Obligation extends to the recommendation of a transaction. Brokers must be required to disclose the risks, benefits, and ramifications of the recommendation in a way that is understandable to the customer. This duty cannot be sufficiently discharged with documents because many customers 1) do not realize that their brokers are failing to provide them with the necessary information, and/or 2) have difficulty understanding the documents. Requiring a documented verbal conversation will ensure that the customers truly understand the recommendations.

The disclosure should make it clear that a broker cannot disclaim its duties under the other two obligations of the Best Interest Rule – the Care Obligation and the Conflict of Interest Obligation. The disclosure should also make it clear that the rights and obligations of the parties are governed by applicable state and federal law and industry rules.

There cannot be a "one size fits all" document that is used to satisfy the disclosure obligation. Use of a standard form in those states that already impose a mandatory fiduciary duty on brokers could be construed as overriding that state's laws governing the broker's duties, which does not appear to be the Commission's intent.[27] In addition, use of one standard form fails to recognize that the scope of the broker's obligations and the level of disclosure required to ensure customer understanding will vary depending upon the customer and the relationship. For example, the relationship that a customer has with a full service brokerage firm will be different than the relationship a customer has with an online brokerage firm that only offers self-directed accounts. Similarly, the communication that is required will be more extensive for a complex product such as a variable annuity than it is for a Treasury Bond. The standard for disclosure should not be handing a customer an additional boilerplate document but rather making reasonable efforts to talk to the customer about the relationship, the fees, and the recommendations in a manner that is understandable to the customer.

b. The Rule Must Clarify that the Best Interest Obligation Can Arise Even Before A Specific Securities Recommendation Is Made

The Rule states that the best-interest standard of conduct arises "when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer". While clearly the best interest standard should always arise when a broker recommends a securities transaction or investment strategy involving securities, as currently written the Rule is overly restrictive because it could be construed to mean that the best interest standard under this rule does not apply to any other financial recommendation, regardless of the circumstances.

[27] Also see discussion in Section II (d) below.

Such a result ignores the reality that brokers sometimes recommend other financial courses of action preceding the recommendation of a particular security transaction or investment strategy in order to earn the client's trust and cause the client to entrust their assets to the broker for management.

A prime example of such a scenario is when a broker recommends to a prospective client they retire early and/or elect a lump sum payment in lieu of a defined benefit pension which is then turned over to the broker for investment. The broker has a clear financial incentive to recommend such a course of action. That recommendation can have a significant impact on a customer's retirement years, especially when the advice was fraught with conflicts and the customer's interests were subordinated to the broker's financial interests.

Certain financial recommendations, including recommendations to take a lump sum in lieu of a pension, although not securities recommendations directly, are a necessary precursor to a broker obtaining control of a customer's assets, which can then be invested through the broker. Those recommendations must trigger the same duties as the specific securities recommendations which inevitably follow. That is already the law in California.

Brokers do not merely pick investments or devise investment strategies. On the contrary, brokers often purport to offer retirement planning advice and/or a wide spectrum of financial advice and services. This is borne out by firm advertising. In a study conducted by PIABA in 2015, PIABA examined the websites of nine different brokerage firms, including Allstate, UBS, Morgan Stanley, Berthel Fisher, Ameriprise, Merrill Lynch, Fidelity, Wells Fargo, and Charles Schwab. PIABA found that the firms' advertising presents the image that the firms are doing far more than simply recommending a specific investment or investment strategy.[28]

Ameriprise:
Personalized advice and recommendations on an ongoing basis
Perhaps the best thing about working with a personal financial advisor is that your financial plan is custom made for you. The financial advisor you choose to work with knows all about you. When and if you experience a life change, your priorities shift or you have a pressing financial question, you can contact your advisor for information and financial advice that's meaningful to you. You may meet a few times during a year and have several discussions. Your advisor will make every effort to be available to you when needed.[29]

Wells Fargo:
The center of the Wells Fargo homepage features the statement: "Helping Clients Succeed Financially. We provide advice and guidance to help maximize all elements of your financial life, whenever and however you need it." A prospective client who clicks on the "Why Invest With Us" tab will find the following statement under the "Our

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[28] *See* PIABA, *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* (Mar. 25, 2015) (the "PIABA Study"), available at https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf.

[29] *Id.* at 11.

Advisors" heading: "A Financial Advisor can provide the advice and guidance you need to focus on your short- and long-term goals while navigating life's financial opportunities and turning points. Start planning now for the future. Choose a Financial Advisor from the firm that lives and breathes a client-centered approach to advice."[30]

Charles Schwab:
The homepage of the firm's website features the question: "How will you help me with my financial goals?" The answer, in big, bold font: "A Schwab Financial Consultant can help you create a plan tailored to your needs." It continues: "It starts with a conversation and a fresh perspective, discussing your long- and short-term goals. We evaluate your current investments then create specific recommendations." The website describes the benefits of meeting with a financial consultant this way: "Your Financial Consultant can work with you to create a holistic plan with specific investment recommendations and a clear explanation of the benefits and risks….Your plan will reflect your priorities, from retirement income and estate planning to insurance and debt management. And you can meet regularly to keep your plan up to date as your life evolves."[31]

Recommendation #11: The Best Interest Rule should: a) always apply to recommendations of any securities transaction or investment strategy involving securities to a retail customer; and b) also apply in any situation where the broker offers generalized retirement planning, financial or investment recommendations to a prospective customer which is designed to encourage the customer to open an account with the firm and/or to bring assets to the firm for investment including, but not limited to, recommendations to take early retirement, elect a lump sum in lieu of a defined benefit pension, refinance a property to use the equity in order to make an investment, and/or recommendations to meet with a broker from the firm.

c. The Rule Must Clarify that a Broker's Best Interest Obligation May Extend Beyond the Point of Sale Under Certain Specified Circumstances

The Rule provides that the broker's duties under the best interest standard will end after the consummation of the recommended transaction, but brokers should have an on-going duty where they are continuing to be compensated for the transaction after the purchase has occurred. Such investments include managed money and investments which pay commission trails such as variable annuities and mutual funds. Periodic monitoring of recommended investment strategies to ensure that they remain in the customer's best interest should be required because client circumstances, and what is in their best interest, often change over time.

The same is true for brokers who are receiving commission trails for selling variable annuities and/or mutual funds. The reason why variable annuity issuers pay trails is because variable annuities are long term investments which require ongoing management, including repositioning of sub-accounts based on the clients' needs, adding or terminating riders, determining when an income rider should be utilized, updating beneficiaries, and multiple other services. Similarly, mutual funds are long-term investments which require ongoing management, including the

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[30] *Id.*

[31] *Id.* at 7.

repositioning of assets within fund families. The management of a variable annuity or mutual fund, and the payment to a broker for such management, does not end when the customer purchases the product. The broker's duties to a customer should not end with the purchase. The same duty of disclosure, duty of care and duty to mitigate and avoid conflicts of interest should apply for as long as the broker is continuing to be compensated for that recommendation.

Recommendation #12: Under the Rule, there should be a continuing duty on the part of the broker to periodically assess a recommended investment strategy to determine whether it remains in the customer's best interest. Customers often maintain their accounts with a broker for years and even decades. During that time, a customer's investment profile can change, sometimes dramatically. Likewise, the investment strategy that will be in the customer's best interest can also change. For example, a customer who initially invested while employed but has since retired will most likely need a more conservative investment strategy than what was originally recommended. Similarly, a customer who was single when he/she opened her account but has since gotten married and had children is likely to have different objectives and risk tolerances.

An investment strategy cannot satisfy the best interest rule unless there is a periodic assessment and update of the customers' situation. Many firms require brokers to update the clients' investment profile on a periodic basis ranging from every 1-3 years. However, these periodic updates are not required by the Rule. Requiring such review, every one to three years when the investment profile is reviewed, and a documented assessment of whether the investment strategy continues to be in the customer's best interest will ensure that the customer's best interests and needs continue to be met, without imposing too onerous a burden on the industry.

Recommendation #13: The Rule must provide that the Best Interest Standard will remain in effect for as long as the broker is continuing to be compensated as a direct or indirect result of the recommendation including, but not limited to, the period during which the broker is receiving commission trails for selling the recommended product.

d. The Rule Must Respect State Sovereignty and be Treated as the Minimum Level of Consumer Protection

The majority of American investors believe their brokers to be their fiduciaries as is evidenced by the thousands of breach of fiduciary duty cases filed each year by investors.[32] Many of these investors find out, once in an arbitration forum, that their brokers did not consider themselves their fiduciaries and did not think they were required to act in their client's best interests. Some states have enacted stronger protections for their investors than others and those states must be able to retain those protections regardless of the enactment of a federal Best Interest Rule. Similarly, states which want to enact stronger protections in the future should be allowed to do so.

The Rule, as drafted, is ambiguous on those points and requires clarification. The Rule indicates, in footnote 43, that it is not intended to supersede the body of case law holding that brokers who

[32] *See*, FINRA Dispute Resolution Statistics, available at http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics.

exercise discretion or control over customer assets owe customers a fiduciary duty. A footnote is not sufficiently robust to make it clear to the securities industry that the Rule does not alter fiduciary duties that exist under current state law, or prevent states from imposing higher standards in the future. This is especially true because the Rule explicitly states in the body that: "Regulation Best Interest would not alter a broker-dealer's existing obligations under the Exchange Act or any other applicable provisions of the *federal* securities laws and rules and regulations", but makes no mention of state statutes and common law which currently impose a fiduciary duty on brokers.[33]

For example, in California, it is a long-settled rule that a stockbroker owes a fiduciary duty to his or her customer.[34] Further, the existence of a broker's fiduciary duty in California does not depend upon a showing of special facts, such as whether or not the broker serves as an investment advisor or controls the account, or whether the customer was "sophisticated", or whether the account was discretionary. Under California law, all securities brokers are fiduciaries, without exception.[35] Missouri courts have also uniformly held or stated that a stockbroker owes a fiduciary duty to his customer.[36] In South Dakota, its Supreme Court held that securities brokers owe a fiduciary duty to the investors who employ them. [37]

Recommendation #14: The Rule must make it clear that states are free to create and enforce a higher standard of conduct on brokers. This clarification is necessary for several important reasons. Although the SEC may create a best-interest rule for the financial industry, it cannot, as an administrative agency of the federal executive branch, create a rule that interferes with a State's interest in protecting its citizens from tortious conduct. Therefore, the SEC should clarify that the Rule will not be a substitute for state law, and that it cannot be used to argue that states cannot legislate within the same arena or enforce more stringent requirements. A Rule which overrides states' power in this regard would be unconstitutional because it would impede a key tenet of states' rights, exceed the scope of the SEC's rulemaking powers under the Dodd-Frank Act, and over-extend the reach of the Rule.

States should retain the right to enact more stringent rules if its legislators or judiciary conclude that an enhanced level of investor protection is warranted based on the needs of the state. That has been the law for over fifty years. No reason has been advanced to change this right, let alone a compelling reason. If states are unable to legislate to increase investor protections, then broker behavior that arguably meets the standards imposed by the Rule may still lead to investors not

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[33] Those States include California, Florida, Missouri, Pennsylvania, South Carolina and South Dakota.

[34] *Ashburn v. AIG Financial Advisors, Inc.*, 234 Cal. App. 4th 79, 100-101 (2015); *Brown v. Wells Fargo Bank, N.A.*, 168 Cal. App.4th 938, 961(2008); *Duffy v. Cavalier*, 215 Cal. App. 3d 1517, 1539-1540 (1989); *Hobbs v. Bateman Eichler, Hill Richards, Inc.*, 164 Cal. App.3d 174, 201 (1985); *Twomey v. Mitchum, Jones, & Templeton, Inc.*, 262 Cal. App. 2d 690, 698, 708-710, 720-722 (1968).

[35] *Duffy, supra,* 215 Cal. App. 3d at 1534, 1539-1540.

[36] *E.g. Leuzinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 396 S.W.2d 570, 575 (Mo. Banc 1965); *752 Mercantile Trust Co. v. Harpe*r, 622 S.W.2d 345, 349 (Mo.App.1981); *Roth v. Roth*, 571 S.W.2d 659, 668 (Mo.App.1978).

[37] *Dinsmore v. Piper Jaffray*, 593 N.W.2d 41 ¶19 (S.D. 1999)

being completely protected from predatory sales tactics which are not addressed by the proposed Rule. Moreover, prohibiting state action in this arena may prevent states from being able to legislate as industry practices evolve in reaction to the Rule. These concerns are not idle speculation. The industry regularly contends in FINRA arbitrations in states like California that state law standards of conduct do not apply.

The securities industry will seek to use the Rule to argue that they no longer owe a fiduciary duty to investors in California and other states which impose a fiduciary duty and that this duty has been supplanted by the Rule. It is therefore crucial the Rule does not displace the important system of state regulation and common law that currently exists. In states where there is a higher duty than that proposed by the SEC, those citizens should be able to rely on the heightened standards.

Recommendation #15: The SEC must make it clear that the Rule does not preempt existing or future state statutory and common law which creates stronger protections for investors within their own jurisdictions. This can be easily accomplished with the following proposed language: "Regulation Best Interest would not alter a broker-dealer's existing obligations under the Exchange Act or any other applicable provisions of the federal securities laws and rules and regulations, or any applicable state statutory or common law which imposes a higher standard of conduct than Regulation Best Interest."

III. Conclusion

After a lifetime of hard work, people deserve the opportunity to earn their financial independence. But for millions of investors, the dream of a secure retirement and meeting other financial goals is slipping out of reach. Many will find that they cannot afford basic living expenses. Any financial crisis will put an enormous strain on families, communities, and the social safety net. PIABA's 15 proposed changes to the SEC's Best Interest Standard will make the difference in actually providing meaningful protections for investors in order to achieve their investment and retirement goals. Failing to make these additions and modifications will further perpetuate the status quo of allowing Wall Street brokerage firms and brokers to peddle high cost, conflict laden investments and investment strategies.