



AFL-CIO Fund Democracy

consumer action

Education and advocacy since 1971

March 10, 2015

The Honorable Mary Jo White
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Dear Chair White:

We write on behalf of organizations that share the belief that protecting the interests of investors is crucial to the successful functioning of our financial system. The willingness of large numbers of working Americans to participate in our capital markets has given the U.S. economy, and the companies that turn to our markets to raise capital, an advantage that no other nation can match. Investors too have benefited from the ability to harness that economic vitality to help grow their retirement savings and fund other important long-term financial goals. But a seemingly unending series of investment scandals, financial crises, and securities firm abuses has undermined both the well-being of investors and the investor confidence that is so vital to our nation's economic health.

We are therefore concerned that the Securities and Exchange Commission – which has always prided itself on serving as “the investor’s advocate” – appears in recent years to have strayed from its primary focus on its investor protection mission. This inadequate attention to investor concerns has been evident in Dodd-Frank Act and JOBS Act rules that seem to prioritize minimizing industry costs over maximizing investor protection. It can also be seen in a disappointing lack of progress on or attention to other important public and investor issues in

such areas as corporate governance,¹ derivatives reform,² private equity,³ and market structure.⁴ Many of our organizations have previously written to express our views on these issues.⁵ We do not intend to repeat those concerns here.

Instead, the purpose of this letter is to identify a host of areas where current regulations are not effectively serving the needs of average *retail* investors and where Commission action is badly needed. Our organizations view the full range of investor protection issues as crucial to the fairness, stability, and efficient functioning of our markets. The retail focus of this letter, however, reflects the fact that it has been some time since a comprehensive agenda of retail priorities has been clearly communicated to (or by) the Commission. This letter is intended to fill that gap. Moreover, while we recognize that the Commission faces a challenging regulatory agenda, including with regard to the other investor protection issues mentioned above, we nonetheless believe the Commission can no longer afford to relegate these retail investor protection priorities to a back burner.

Policies to Improve Regulation of Investment Professionals

Nothing is more important to the protection of average, financially unsophisticated investors than effective regulation of the broker-dealers and investment advisers they rely on to assist them with investment decisions. Research has shown that most retail investors prefer to invest through financial professionals and that they rely heavily on their recommendations. Yet few areas of the securities markets are as inadequately regulated. Investor advocates have been calling for regulatory reforms in this area for nearly three decades. Although the Commission has studied the issue and acknowledged the need for regulatory action, it has as yet failed to take concrete steps to improve regulatory protections in this area. The following are among the key areas where our organizations believe reforms are needed to ensure that investors receive the protections they expect and deserve when dealing with investment professionals.

Fiduciary Duty – Investors have a reasonable expectation that the “advice” they receive from financial professionals will be designed to serve their best interests. That is after all one of the key features that distinguishes advice from a sales pitch. Since at least the mid-1980s, however, the Commission has adopted policies that allow broker-dealers to market themselves to unsuspecting investors as trusted advisers without requiring them to meet the fiduciary standard appropriate to that role. As a direct result, investors may receive “advice” from brokers to

¹ Priorities include reproposing a universal proxy access rule, completion and implementation of strong rules on executive compensation, and other issues affecting the fairness of shareholder votes

² Priorities include the implementation of strong and effective rules regarding the trading, reporting, and risk management of security based swaps, where the SEC lags far behind the CFTC in fulfilling its Dodd-Frank Act mandates.

³ We are particularly concerned by the continued absence of major enforcement actions by the Commission following what the SEC Director of Compliance Inspections and Examinations described as “violations of law or material weaknesses in controls over 50 percent of the time” uncovered during examinations of private equity fund managers

⁴ Priorities include effective action to deal with high frequency trading, dark pools, and other threats to the integrity of equity markets.

⁵ Recently, for example, several of our groups wrote to the Commission to express concerns with regard to the selection of members of the newly created market structure working group. See, [here](#).

purchase investment products and services that compensate the broker handsomely but that expose the investor to excessive costs, unnecessary risks, or substandard performance.

Despite extensive study of the issue, and although investor advocates have consistently identified this as the single most important step the Commission can and should take to improve protections for average investors, the Commission has still not taken concrete steps to address the problem. It is time for the Commission to adopt one of two simple solutions: 1) prohibit broker-dealers from holding themselves out as advisers unless they are regulated accordingly or 2) adopt a uniform fiduciary standard designed to ensure that brokers and advisers alike are required to put the interests of their clients first when offering personalized investment advice. Adopting a rule, while an essential first step, is not enough however. The Commission must also enforce the standard in a way that holds broker-dealers and investment advisers alike accountable, not simply for disclosing conflicts of interest, but also for acting in the best interests of their customers despite any such conflicts.

Pre-Engagement Disclosure – The single most important investment decision most investors will ever make is the selection of a financial professional to rely on for investment recommendations. Indeed, this is the last real investment decision most investors will make. Once they have chosen a financial professional, most will follow that professional's recommendations without performing any significant additional research regarding the recommended investment products or strategies. As noted above, this is the sort of relationship of trust that demands fiduciary protection. Yet current rules do not even ensure that investors receive the basic information necessary to make an informed choice among financial professionals. While disclosure alone cannot reasonably be expected to eliminate investor confusion regarding the different roles of brokers and advisers, and disclosure is not a substitute for effective regulation, improved disclosure is nonetheless an essential component of comprehensive reform in this area.

Recognizing the need for improved disclosure, the Dodd-Frank Act mandates that the Commission adopt a pre-engagement disclosure document to assist investors in selecting a financial professional. However, the Commission does not appear to be actively pursuing rulemaking in this area. Instead, the effort appears to have become bogged down in a broader consideration of the regulations that apply to broker-dealers and investment advisers. The Commission should be actively engaged in developing a clear, easy-to-use disclosure document that covers the basic topics investors need to understand to make an informed choice among financial professionals.

Compensation Conflicts – Brokerage firms have adopted compensation practices that create significant and unnecessary conflicts between the interests of their sales representatives and the interests of their customers. The Dodd-Frank Act requires the Commission to examine compensation and other business practices that create conflicts of interest between investors and the broker-dealers and investment advisers they rely on for advice. Where that examination uncovers evidence of particularly harmful conflicts, the Dodd-Frank Act directs the Commission to act to ban or limit the practices that create the conflicts. While the Financial Industry Regulatory Authority has begun to comprehensively examine conflicts of interest within the firms it regulates, we are unaware of any steps the Commission has taken to fulfill this Dodd-

Frank Act mandate. Given the role that financial inducements play in encouraging broker-dealers to act in ways that put their own interests ahead of those of their customers, Commission attention to this issue is in our view overdue. Moreover, given significant evidence that disclosure alone offers an ineffective remedy with regard to conflicts, the Commission should seriously consider whether investors would be best served if certain compensation practices were either banned or severely limited.

Compensation Disclosure – Investors too often find it difficult to discern how much, or even how, they pay for the services of financial professionals. While investment advisers are required to provide up-front disclosure regarding their compensation practices, broker-dealers are not. Moreover, as the Commission itself found when conducting its Dodd-Frank mandated financial literacy study, many investors do not appear to make good use of the information they currently receive, nor do they understand how various compensation practices could affect their interests. While the Commission has in the past considered certain product-specific cost disclosures, we believe it can and must do more to consider how it could develop disclosures to better to convey to investors the costs they pay for the services of financial professionals and the conflicts that these compensation practices may create. We urge the Commission to begin work immediately on developing disclosures to provide investors with straightforward information about costs and conflicts associated with the services provided by financial professionals. In developing those disclosures, the Commission should engage in comprehensive testing to ensure their effectiveness in promoting informed investor decision-making. As noted above, while disclosure alone is not sufficient, it is an essential component of a comprehensive reform.

12b-1 Fee Reform – One way that brokers obscure the costs that investors incur for their services is by charging for those services through 12b-1 fees rather than through up-front commissions. While there is nothing inherently wrong with charging for services in incremental payments, this practice suffers from several important short-comings. Because 12b-1 fees are not considered commissions, they are not subject to FINRA commission limits. Because the fees are buried within the administrative fee charged by mutual funds and annuities, investors often fail to understand how much they are paying or what they are paying for through these fees. Early in this administration, the Commission developed a generally sound proposal for 12b-1 fee reform. We urge the Commission to resurrect this project and move forward with rulemaking without further delay.

Forced Arbitration – In order to do business with a broker-dealer, investors are typically required to sign away their right to take disputes to court. Instead, they are forced to arbitrate their disputes through an industry-run system. The Dodd-Frank Act gave the Commission authority to ban or limit the use of forced arbitration clauses in brokerage accounts. Unlike the Consumer Financial Protection Bureau (CFPB), which has been studying arbitration clauses in consumer financial contracts, the Commission has apparently not yet taken steps to determine whether limitations on forced arbitration clauses would be appropriate or whether other reforms of the securities arbitration process are warranted. As a first step, the Commission should conduct the kind of analysis of investors' experience in arbitration and attitudes toward forced arbitration that would enable it to adopt an informed policy position on the issue.

Policies to Improve Regulation of Investment Products

Our securities laws are founded on the premise that investors who are provided with adequate disclosures will be able to protect their own interests through informed investment decision-making. This premise has been challenged in recent decades both by the growing participation of financially unsophisticated investors in our markets and by the dramatically increased complexity of many of the investment products that are sold to retail investors. Meanwhile, research, including the Commission's own financial literacy study, has provided disturbing evidence that a significant majority of investors are unable to make effective use of the disclosures they receive. Vast improvements can and should be made to investment product disclosures. The Commission should also do more to make those disclosures meaningful by reporting regularly to the public on market practices and performance in areas such as fees, so that investors have more adequate tools to put individual investment disclosures in a meaningful context. However, we question whether disclosure alone will be sufficient to address all of investors' product-related concerns. One solution, as discussed above, is to ensure that financial professionals are required to make recommendations that serve the best interests of their customers. But the Commission should also consider whether certain types of investments simply shouldn't be sold to unsophisticated retail investors and how best to draw that line. The following are among the key efforts the Commission should undertake to strengthen protections for investors with regard to the investment products they purchase.

Risk Disclosure – Perhaps no single concept is more important for investors to understand than the risks associated with their investments. Yet typical risk disclosures consist of little more than a laundry list of the types of risks an investor might face. They tell the investor little or nothing about the relative riskiness of the investment compared with other comparable alternatives. Nor do they typically provide information that is specific to the investment's stated goal. In other words, an investment that is billed as appropriate for investors seeking current income typically does not provide specific information that would enable the investor to assess the degree or nature of risks that could threaten the reliability of that income stream. The Commission's one recent effort in this area with regard to risk illustrations for target date funds, while well intended, suffers from serious short-comings.⁶ We urge the Commission to work with other regulators, behavioral economists, and other disclosure experts to undertake a major exploration of the best ways to convey investment risks to unsophisticated investors and then to incorporate those findings in its disclosure requirements.

Fee Disclosure – One of the biggest risks investors face is that they will pay excessive costs for their investments, losing out on tens or even hundreds of thousands of dollars in potential gains on long-term investments as a result. In order to help combat this risk, investors need to receive clear, consistent, and comparable cost information for all the investment products and services they may purchase. Here again, the Commission should work with other regulators, behavioral economists and other disclosure experts to determine the appropriate content and best format for such disclosures. The focus should be on conveying the information in a manner that maximizes the likelihood that investors will fully understand the potential long-term impact of such costs on their investment returns.

⁶ Short-comings in the target date fund proposal are outlined in the recommendation of the SEC's Investor Advisory Committee.

Disclosure Timing – The disclosures investors receive about the investments they purchase too often arrive after the purchase, too late to be incorporated in the purchase decision. For many years, efforts to promote pre-sale delivery of disclosures were opposed on the grounds that it imposed undue costs and delays on securities transactions. Today, however, technological advances have made it possible to deliver information electronically virtually instantaneously and at very little cost. Indeed, electronic delivery mechanisms make it possible to deliver disclosures not just at the point of sale, but at the point of recommendation. Investors have expressed a strong preference for getting disclosures in advance of the sale. The Commission should resurrect its long-abandoned initiative to improve the timing of disclosures. In doing so, however, it should apply that approach uniformly across all investment products and services and focus not just on the point of sale, but on the point of recommendation, as the appropriate timing for such disclosures.

Disclosure Format – Regulators in other jurisdictions have made extensive progress in studying how the presentation and format of disclosures can significantly improve investor comprehension. While the Commission has taken some modest steps toward promoting layered disclosure, it has failed to take full advantage of the potential of the Internet to dramatically alter the way we present information to investors.⁷ Where the Commission has fallen significantly behind is in incorporating the findings of behavioral economics and testing of various disclosure designs to maximize disclosure effectiveness. Given evidence from the Commission’s own financial literacy study that current disclosures of all types are remarkably ineffective in conveying the desired information to retail investors, improving disclosure design and testing should be prioritized. Moreover, testing disclosures to ensure their effectiveness is important for another reason; it helps to identify areas where disclosure alone does not offer adequate protection to investors and where additional regulatory protections are therefore needed.

ETFs – Since the Commission first permitted the creation of exchange-traded funds through an exemption from the Investment Advisers Act, well over a trillion dollars have been invested in these funds. ETFs, which were originally conceived as plain vanilla, index-tracking investments, can offer significant benefits to retail investors. In recent years, however, the Commission staff has approved through ad-hoc exemptive orders new and exotic versions of ETFs, many of which pose significant risks that are likely to be poorly understood by unsophisticated retail investors. For example, Commission staff has permitted ETF providers to: create their own indices just so they can create an ETF to track those indices, create inverse and leveraged ETFs, and even create actively managed ETFs. Most recently, the SEC approved a form of ETF that allows investors to be provided with current per share net asset values (NAVs) for which the fund has no legal responsibility, which effectively repeals one of the most important requirements for such funds. Moreover, the SEC has allowed investors to trade on the basis of these purportedly current NAVs, notwithstanding that the NAVs have no necessary relationship to investors’ ultimate transaction price, which will not be set until the end of the day. As ETFs have grown in complexity, the Commission appears never to have conducted the kind of thorough analysis of the regulatory regime governing ETFs necessary to ensure that it offers

⁷ The Commission’s one recent policy proposal in this area, included in the crowdfunding rule proposal, would revise the definition of electronic delivery in a way that dramatically reduces the likelihood that investors would receive or review required disclosures. This is antithetical to investor interests.

appropriate protections for retail investors. This kind of comprehensive review should consider whether disclosure alone is a sufficient safeguard, or whether certain conditions should be placed on the types of ETFs that can be created and marketed to retail investors.

Exotic Investments and Structured Products – Issuers are distributing increasingly complex and exotic investment products to retail investors, including structured notes and securitized products that contain derivatives exposures reminiscent of those that proved so damaging to major banking institutions in 2008. These products often have high fees and frequently depend on multiple reference assets in ways that create extraordinarily complex payoff structures that retail investors do not have the capacity to model. Multiple academic studies have raised serious questions about why certain retail structured products would ever be purchased by a rational investor.⁸ Both FINRA and the SEC have issued multiple warnings to brokers about the need for greater supervision regarding sales of these products. But the time has come to ask whether stronger controls are needed. However, enforcement efforts regarding the abusive sales practices associated with complex, high-fee products continue to fail to place sufficient responsibility for such practices with the broker-dealers that profit from them at the expense of investors. Ultimately, certain products may simply be inappropriate for retail investors. And, if complex products are sold, then clear limitations should be put on the way they are presented to investors. Certainly, although disclosure alone has proven ineffective in this area, private funds should not be permitted to take advantage of registration exemptions to sell such products without even this minimal form of investor protection.

Accredited Investor Definition – Today, our nation’s private securities markets have outpaced the public markets due in large part to sales of securities under Regulation D. By restricting sales to accredited investors, Regulation D seeks to ensure that these securities are marketed to investors who are able to fend for themselves without the protections afforded in the public markets. It has long been apparent that the current accredited investor definition does not effectively identify a class of individuals with access to information, the sophistication to understand the risks and merits of such offerings, or the wealth to withstand potential losses. Despite a clear authorization in the Dodd-Frank Act to update the definition and a mandate to study it, the Commission has been slow to act. This issue has taken on new urgency in the wake of rulemaking to permit general solicitation in these once “private” offerings. Given the central role that the accredited investor definition plays in defining the line between our public and private markets, it is crucial that the Commission update the definition to ensure that it serves its intended regulatory function.

Conclusion

In urging this renewed focus on a retail investor protection agenda, we recognize that the Commission already faces a crowded rulemaking docket that includes many vitally important issues including a host of other issues viewed as priorities by investor advocates. However, we are also aware that the Commission has found the resources for other discretionary projects

⁸ The dark side of financial innovation: A case study of the pricing of a retail financial product, *Journal of Financial Economics*, Volume 100, Issue 2, Pages 227-247. Brian J. Henderson, Neil D. Pearson. Hens, Thorsten and Rieger, Marc Oliver, Why do Investors Buy Structured Products? (February 10, 2009). EFA 2009 Bergen Meetings Paper. Available at SSRN: <http://ssrn.com/abstract=1342360> or <http://dx.doi.org/10.2139/ssrn.1342360>

where it perceived a need, most notably its comprehensive disclosure review project focused on S-1 and S-K disclosures. Given the vital role that average investors play in our markets and the overall economy, and the serious short-comings that exist in the regulatory protections they receive, it is time in our view for these issues to be prioritized. We look forward to working with you on developing a revitalized investor protection agenda that would help to rein in abusive industry practices, promote sound investment decision-making, and restore investors' confidence that they can safely turn to our financial markets to save for retirement and fund other long-term financial goals. That would be good for investors, for capital formation, and for the overall health of our nation's economy.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Lisa Donner
Executive Director
Americans for Financial Reform

Mercer Bullard
President and Founder
Fund Democracy

Linda Sherry
Director, National Priorities
Consumer Action

Bartlett Naylor
Financial Policy Advocate
Congress Watch
Public Citizen

Heather Slavkin Corzo
Director, Office of Investment
AFL-CIO

cc: The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner