



Consumer Federation of America

June 15, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. 4-761
Rulemaking Petition to End the Commission's "Backdoor" Regulation of 12b-1 Fees

Dear Secretary Countryman:

I am writing on behalf of the Consumer Federation of America¹ to voice our strong opposition to the anti-investor rulemaking petition recently submitted to the Commission by the Financial Services Institute (FSI), the American Securities Association (ASA), the Competitive Enterprise Institute (CEI), and the New Civil Liberties Alliance (NCLA). With its absurd claim that the Commission is engaged in a "backdoor" effort to ban receipt of 12b-1 fees by investment advisers, the rulemaking petition is entirely without a factual basis. Its attack on the Commission's laudable efforts to enforce well-established obligations for investment advisers to act in their clients' best interests and provide full and fair disclosure of material facts shows a disturbing disregard for what it means to be a fiduciary acting in a relationship of trust and confidence. And its recommended approach to addressing compensation-related conflicts would be a farce if it weren't so potentially harmful.

Coming as it does just as Regulation Best Interest (Reg. BI) is due to take effect, the petition's message that the Commission can only bring enforcement actions for violations of explicit rules suggests that these groups' real goal goes well beyond watering down investment advisers' disclosure obligations. If the Commission were to adopt the tortured logic on display in this rulemaking petition, it would be unable to bring enforcement actions for violations of principles-based rules without first going through a separate notice-and-comment rulemaking process to define each example of non-compliance as an explicit violation of the standard. Clearly, the effect, and presumably the intent, of this petition is to ensure that neither the Investment Advisers Act nor Reg. BI is enforced in a way that would require firms to limit the

¹ Consumer Federation of America (CFA) is a nonprofit association of more than 250 national, state, and local pro-consumer organizations. It was established in 1968 to advance the consumer interest through research, advocacy, and education.

harmful impact of conflicts of interest on the recommendations they make, to act in their customers' best interests, or even to clearly disclose the costs and conflicts associated with their business practices.

- **The claim that the Commission is engaged in a backdoor campaign to ban 12b-1 fees is entirely unfounded.**

The rulemaking petition is founded on the baseless argument that the Commission's Share Class Selection Disclosure Initiative (SCSD Initiative) and its Frequently Asked Questions (FAQs) regarding disclosure of compensation-related conflicts of interest by investment advisers effectively "create a rule" banning receipt of 12b-1 fees by advisers. In reality, of course, the Commission has simply been engaged in enforcing well-established and long-recognized fiduciary obligations under the Investment Advisers Act, including the obligations to act in the best interests of the client and to clearly disclose on the ADV Form all material facts necessary to enable potential clients to make an informed choice among advisory firms. For firms that appear to be struggling to comply, the FAQs serve to clarify how to satisfy the obligation to disclose compensation-related conflicts of interest and related business practices with sufficient clarity and detail that a typical retail investor could understand not only that a conflict exists but what effect that conflict might have on the advice rendered. The SCSD Initiative provided an opportunity for firms with a history of noncompliance to come into compliance while avoiding the harshest penalties their noncompliance could have garnered.

It is both notable and disturbing that it doesn't seem even to occur to petitioners that the conduct of firms caught up in the Commission's enforcement actions constituted a violation of their fundamental fiduciary duty as investment advisers to act in the best interests of their clients. These firms were recommending higher cost share classes of mutual funds to clients who qualified for a lower cost share class inside advisory accounts for which they already charged a separate (and often hefty) fee to compensate them for their services. Petitioners clearly know that recommending higher cost share classes erodes investors' returns. They acknowledge as much in the rulemaking petition. ("[W]ith lower per-investor costs, come higher per-investor earnings.") Their casual dismissal of any fiduciary obligation under the Advisers Act to recommend the best available option to their clients shows a disturbing disregard for what it means to be a fiduciary, acting in a relationship of trust and reliance. It also doesn't bode well for how they are likely to treat their new "best interest" obligation under Reg. BI in brokerage accounts where the conflicts of interest are likely to be both more extensive and more intense.

Instead of acknowledging their fundamental fiduciary obligations, petitioners focus their attention and their ire on the Commission's enforcement of the Advisers Act disclosure obligations. Specifically, they object to the Commission's insistence on the clear and explicit disclosures necessary to enable investors to understand the nature and potential impact of the conflict of interest or business practice being disclosed, in this case the conflicts associated with share class recommendations. Here again, there is nothing new or unprecedented in the Commission's insistence on full and fair disclosure of material facts. The authority of the SEC to require investment advisers to provide such "full and fair" disclosure has been unassailable since

the 1963 Supreme Court decision in *SEC v. Capital Gains Research Bureau, Inc.*² That case specifically addressed the authority of the SEC to demand disclosures when investment advisers have a “pecuniary interest” that could “consciously or unconsciously” influence their advice.

In affirming the Commission’s authority to demand such disclosures, the court emphasized that it is not enough for disclosures to be accurate, they must also be complete. In this regard, the decision notes that “what is required is ‘a picture not simply of the show window, but of the entire store . . . not simply truth in the statements volunteered, but disclosure.’”³ This is directly relevant to the disclosure issue at the heart of this rulemaking petition. Specifically, petitioners want to be allowed to fulfill their ADV disclosure obligations with regard to their share class selection practices by disclosing only that they sometimes recommend share classes of funds that charge a 12b-1 fee, and that this creates a conflict of interest. They don’t want to have to disclose that they sometimes (or always) recommend the higher cost share class even when a lower cost option is available. In short, what petitioners are urging the Commission to accept are disclosures related to share class selection and other compensation-related conflicts that present “a picture of the show window,” while obscuring the “entire store.”

As the Commission made clear when it amended the ADV Form in 2010, the purpose of the amendments was to improve the ability of average, retail investors to make an informed choice among advisory firms. It stated, “We believe these amendments will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms’ personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms’ services.”⁴ Toward that end, it made clear that, “advisers must provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest the adviser has and the business practices in which it engages, and can give his or her informed consent to the transaction or practice that gives rise to the conflict or to reject the transaction or practice.”

Clearly, the disclosure approach advocated by petitioners does not satisfy this standard. On the contrary, if the petitioners’ approach to disclosure were adopted, investors could not easily distinguish the many firms that address this share class selection conflict by recommending the share class that is best for the customer, or otherwise manage the conflict in investors’ best interests, from those that do not. But such differences in business practices clearly constitute a material difference that reasonable investors would want to weigh in selecting an investment adviser. Moreover, without that information, investors would not be able to give informed consent to or reject the practice, another clear violation of basic fiduciary obligations under the Advisers Act.

² *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) <https://bit.ly/30DXnuM>. (The decision directly addresses the concern that “whenever advice to a client might result in financial benefit to the adviser—other than the fee for his advice—that advice to a client might in some way be tinged with that pecuniary interest [whether consciously or] subconsciously motivated. . . .”; *also*, “An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving ‘two masters’ or only one, ‘especially . . . if one of the masters happens to be economic self-interest.’”)

³ *Id.*, citing Shulman, *Civil Liability and the Securities Act*, 43 Yale L. J. 227, 242.

⁴ Securities and Exchange Commission, *Amendments to Form ADV, Final Rule*, Release No. IA-3060, File No. S7-10-00, July 28, 2010 <https://www.sec.gov/rules/final/2010/ia-3060.pdf>.

It should be equally clear that neither the SCSD Initiative nor the FAQs have the effect of banning receipt of 12b-1 fees by investment advisers. Although the number of firms that failed to comply with this most fundamental of Advisers Act fiduciary duties is shockingly large, it still represents a small portion of the overall population of SEC-registered investment adviser firms. While a majority of these firms likely dealt with the issue by eschewing 12b-1 fees altogether and thus avoiding the conflict, the Commission's actions do not dictate that approach. Other dual registrant firms where the conflict was present reportedly dealt with that conflict in one of several ways that were acceptable to the Commission: 1) by recommending the lower cost share class, despite the conflict, when that was the best option for the customer; 2) by rebating the 12b-1 fees to clients; or 3) by providing fulsome disclosure.⁵ This includes two options that permit the receipt of 12b-1 fees by investment advisers – when the share class that charges the fee is the best available option for the investor and when the adviser discloses the practice with sufficient clarity that the investor can make an informed choice to permit or reject the practice.⁶

In short, there is absolutely no basis for petitioners' claim that the SCSD Initiative and FAQs "create a rule" banning receipt of 12b-1 fees by investment advisers. Because the premise of the rulemaking petition is false, the rest of the argument about supposed procedural violations by the Commission is irrelevant.

- **Petitioners' proposed "solution" would write the fiduciary duty out of the Investment Advisers Act.**

The firms caught up in the Commission's SCSD Initiative, like the members of FSI and ASA, are largely dual registrant firms. Evidence suggests that a root cause of their compliance problems may be a tendency to bring a broker-dealer mindset to their compliance with Advisers Act fiduciary obligations. Certainly, this broker-dealer mindset is very much on display in petitioners' recommended rulemaking approach, which seeks to absolve advisers of any obligation to act in their clients' best interests, or even clearly disclose practices that conflict with clients' interests, and to instead shift onto clients the responsibility for protecting themselves. This not only makes a mockery of the fiduciary obligations that apply in a relationship of trust and reliance, it runs counter to everything the Commission has sought to achieve in raising the standard of conduct that broker-dealers owe their retail customers.

The petitioners seem to misunderstand a central purpose of ADV Form disclosures, which is to assist investors in making an informed choice among investment adviser firms. In keeping with this purpose, advisers are required to provide the ADV to potential clients before or

⁵ What You Don't Know Can Hurt You, speech by Stephanie Avakian, Co-Director, Division of Enforcement, Securities and Exchange Commission, Nov. 5, 2019 <https://www.sec.gov/news/speech/speech-avakian-2019-11-05>. "And I should note that while the Initiative did identify numerous disclosure failures, the firms that participated in the Initiative represent a small fraction of the overall registered adviser population. Some firms had fulsome disclosure. Other firms chose not to take 12b-1 fees and did things like rebate the fees or credit the fees back to clients. And still others chose to recommend the lower-cost share class."

⁶ We are frankly skeptical that ADV Form disclosures of this nature would lead to informed consent, particularly when those disclosures are buried in a lengthy document that few investors are likely to read or understand. It remains to be seen whether Form CRS will be more successful in drawing attention to practices, such as these, that put the investor's interests at risk.

at the time of entering into an advisory relationship.⁷ In the ADV, the adviser is required to provide full and fair disclosure of material facts that a reasonable investor would need to know to make an informed choice among advisers. This specifically includes sufficient detail about conflicts of interest to enable the client to understand the “potential effect” of such conflicts on the “firm’s services.” Clearly, the fact that a firm recommends higher cost share classes when a lower cost option is available is a material fact that reasonable investors would want to know.

Under petitioners’ proposed approach, however, clients would not receive this key information about relevant compensation-related conflicts until *after* they had entered the advisory relationship, and then only if they went searching for the information themselves in the prospectuses for funds recommended by the adviser. Specifically, petitioners urge the Commission to “acknowledge that compensation disclosures in a prospectus are the equivalent of compensation disclosures in Form ADV Part 2.” They double down on this approach by urging the Commission to adopt “a clear statement” that: “Customers have a duty to inform themselves about the features of particular mutual funds and share classes within those funds, as long as the information is readily available and clearly disclosed (e.g., in a prospectus).”

Nothing could more clearly illustrate the extent to which petitioners view their members as salespeople, rather than advisers, than this attempt simultaneously to shift disclosures from the ADV to transaction-specific documents and to shift responsibility onto clients to determine whether the adviser is acting in their best interests. Since, as a practical matter, the client would not know what prospectus to comb through until *after* advice had been rendered, this approach would eliminate the investor’s ability to incorporate the information about compensation conflicts into their selection of advisory firms. As noted above, however, whether a firm recommends the share class that is best for the client or the one that is more remunerative for the adviser is something a reasonable investor would want to know before selecting an adviser. Petitioners would deprive them of that opportunity.

In some of the enforcement actions brought as part of the SCSD Initiative, the Commission has cited firms not just for violating their disclosure obligations, but also for violating their duty of best execution. We commend the Commission for taking such actions, which give substance to the Advisers Act fiduciary duty to act in the best interest of clients which disclosure alone could not fulfill. Petitioners seek to eliminate the possibility of future such actions and to do so, not just with regard to share class selection, but also with regard to any other action where advisers recommend investments that place their interests ahead of client interests. They would achieve this through a sweeping proposal to eliminate advisers’ duty to obtain best execution. Petitioners back that attack on the Advisers Act fiduciary duty with a proposal to allow disclosure to substitute for avoidance of even the most harmful of conflicts. While the Commission has generally accepted disclosure to satisfy firm’s obligation to address conflicts of interest, it has appropriately left open the possibility that conflicts that cannot be adequately disclosed would have to be avoided. Petitioners would eliminate that possibility, leaving investors vulnerable to complex conflicts whose impact they cannot reasonably be expected to understand.

⁷ SEC, General Instructions for Part 2 of Form ADV, <https://www.sec.gov/about/forms/formadv-part2.pdf>.

Finally, despite their purported support for principles-based standards, petitioners seek to replace the Advisers Act’s principles-based disclosure standard with explicit rules making clear “exactly what forms of compensation are or are not disclosable.” But, as the Commission has noted elsewhere, and as the transformation of 12b-1 fees into a primary mechanism for compensating intermediaries clearly illustrates, compensation practices evolve over time. If the Commission were to adopt the rigid, rules-based approach petitioners are advocating, it would be forced to revise those rules constantly in what is almost certain to become a fruitless effort to keep pace with changing industry practices.

In short, if the petitioners’ preferred regulatory approach were adopted, there would be nothing left of the principles-based fiduciary standard for investment advice. The Commission should therefore reject this petition in its entirety.

- **This rulemaking petition is a backdoor attack on the Commission’s authority to enforce principles-based standards.**

Despite its apparent focus on compensation-related conflict disclosures, the real question at the heart of this rulemaking petition is whether the Commission can enforce principles-based standards. These include not just the Advisers Act fiduciary duty targeted by this rulemaking petition, but also central components of Reg. BI that require brokers to act in customers’ best interests, mitigate conflicts, and clearly disclose costs and conflicts. If the Commission were to adopt the tortured logic on display in this petition, it would be unable to bring enforcement actions for violations of those standards without first engaging in rulemaking to define each instance of abusive conduct as an explicit violation of the standard. That would render non-existent the principles-based protections these conduct standards are intended to provide.

It is worth noting that petitioners enthusiastically supported Reg. BI not in spite of, but because of, its principles-based approach. In its comment letter, for example, FSI praised the standard’s principles-based approach for providing firms with the “flexibility” to “tailor their practices to their business model and clients” and “to manage conflicts as appropriate to their business model.” Meanwhile, ASA supported the rule text’s “principles-based approach,” but objected to guidance provided by the Commission in the preamble on how it expected to interpret those principles-based standards. Both groups strenuously opposed efforts by us and others urging the Commission to clarify the rule’s key requirements to act in customers’ best interests and mitigate conflicts. In light of their demands for explicit rules in the current rulemaking petition, their support for principles-based standards rings hollow.

Indeed, this rulemaking petition strongly suggests that FSI and ASA’s support for Reg. BI’s principles-based approach was based not on its “flexibility,” as FSI claimed, but on their conviction that the principles-based standards would be unenforceable. In fact, this rulemaking petition is best read as a shot across the Commission’s bow, intended to dissuade it from adopting the tough enforcement approach needed to deliver on Reg. BI’s investor protection promise. The fact that these groups’ members apparently don’t view the Advisers Act fiduciary obligation as imposing any obligation to do what is best for the client, and seek to ensure that it does not, doesn’t bode well for their approach to Reg. BI compliance in brokerage accounts, where they are likely to face even more extensive incentives to act in ways that are not in their

customers' best interests. Their resistance to more than boilerplate disclosure of conflicts, and their effort to move key information from the ADV Form to transaction-specific disclosures, suggests that their compliance with Reg. BI and Form CRS disclosure requirements is likely to be cursory at best.

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For all of the reasons detailed above – because the premise of the rulemaking is false, because the proposed regulatory approach would erase investment advisers' fundamental fiduciary obligations, and because the advocated approach would effectively eliminate the Commission's ability to enforce principles-based standards, the Commission should reject the petition in its entirety. Instead, we urge the Commission to draw two very different lessons from this rulemaking petition:

- 1) Firms that embrace the regulatory approach advocated here demonstrate such a fundamental misunderstanding of what it means to be a fiduciary and to act in customers' best interests that they will require special scrutiny from the Office of Compliance Inspections and Examinations when it comes time to examine their implementation of Reg. BI.
- 2) If firms are not willing to provide clear disclosures with regard to their conflicts, such that investors can understand the potential impact of the conflict, the only recourse for the Commission will be to use its authority to limit or ban conflicts and business practices that are harmful to investors. Congress gave the Commission that authority with regard to broker-dealers and investment advisers alike, and it should not hesitate to use it.

The Commission has done a laudable job of highlighting problems with firms' share class selection practices and disclosures. It should now build on that success both by expanding its attention to other compensation-related conflicts in advisory accounts and by bringing that same vigorous approach to its enforcement of Reg. BI. Only if it does so will investors receive the enhanced protections promised by the Commission when it adopted its revised conduct standards.

Respectfully submitted,



Barbara Roper
Director of Investor Protection

cc: Chairman Jay Clayton
Commissioner Hester M. Peirce
Commissioner Elad L. Roisman
Commissioner Allison Herren Lee