Statement of Ken Ehinger
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On behalf of the Association for Advanced Life Underwriting (AALU)

Hearing on Current Regulation and Oversight of Investment Advisers and Broker Dealers

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
House Financial Services Committee

September 13, 2011

Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee, I am Ken Ehinger, President and Chief Executive Officer of M Holdings Securities, Inc.[1] I am testifying today on behalf of the Association for Advanced Life Underwriting (AALU), of which I am a member and M Financial Group is a strong supporter and partner. AALU appreciates the opportunity to testify before the Subcommittee on Capital Markets at this hearing on the current regulation and oversight of investment advisers and broker-dealers. We appreciate the Subcommittee's focus on the issues discussed in two Securities and Exchange Commission studies required by the Dodd-Frank Wall Street Reform and Consumer Protection Act: the Study required by Section 913 on Investment Advisers and Broker-Dealers,[2] and the Study required by Section 914 on Enhancing Investment Adviser Examinations.[3]

We do not support the SEC Staff recommendation in the Section 913 Study that broker-dealers should be subject to the legal standard of care under the Investment Advisers Act (Advisers Act). As two of the SEC's own Commissioners stated in their dissent to the Study, the SEC has offered no empirical evidence or any data that such a change would improve investor protection and has failed to assess the costs and impact of such a change, as required by Dodd-Frank.[4] We agree with the concerns expressed by the Commissioners that there is a risk that

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[1] As President and CEO of M Securities, Mr. Ehinger oversees all aspects of M Financial Group's Broker/Dealer and Registered Investment Adviser. Mr. Ehinger has a diverse background in the securities and insurance industries that spans more than three decades. Additional biographical information about Mr. Ehinger is attached to this statement.

[2] Study on Investment Advisers and Broker-Dealers (Jan. 21, 2011) [hereinafter *SEC Staff Study*], *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[3] Study on Enhancing Investment Adviser Examinations (Jan. 19, 2011) [hereinafter *Section 914 Study*], *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

[4] We note that the Department of Labor has proposed regulations (Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510), that would redefine the term "fiduciary" under the Employee Retirement Income Security Act (ERISA). While these proposed regulations have not yet been finalized, they could significantly expand the number of broker-dealers categorized as ERISA fiduciaries and could have a dramatic impact on the provision of investment advice and education to investors, particularly

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implementation of the SEC staff's recommended changes would result in investors having access to fewer products and services and paying more for the services and advice they do receive. The SEC should not proceed with a discretionary rulemaking in this area unless these flaws are remedied and it can objectively justify its recommended actions.

The need for an empirical basis and rigorous cost/benefit analysis in SEC rulemaking is critical, particularly in view of the SEC's recent experiences with rulemaking challenges in the D.C. Circuit Court of Appeals.[5]

I have spent most of my professional career working in businesses that are regulated by the SEC. It is in the interest of all of us who are regulated by the Commission to have a strong and respected regulator to police our markets and instill and enhance investor confidence, which is the foundation for capital formation and savings in the U.S. We understand the full Committee will be holding a hearing on these broader issues two days from now. We want to add our voice to those who are saying that the Commission, with its limited resources, simply has to focus on the most critical issues at hand. Engaging in a rulemaking to change a regulatory system, with respect to which investors – according to a survey commissioned by the SEC itself – have said they are satisfied, is a misplacement of priorities and resources.[6]

We believe a greater priority for the Commission should be to give further attention to problems acknowledged by the Section 914 Study of the lack of an effective inspection cycle for many investment advisers.[7] We support the focus given this matter by Chairmen Bachus,

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those who have varying types of investment accounts with the same institution or service provider (*see* Comment Letter from David J. Stertzer, Chief Executive Officer, Association for Advanced Life Underwriting, Dept. of Labor RIN 1210-AB32, February 3, 2011, *available at* http://www.dol.gov/ebsa/pdf/1210-AB32-157.pdf.). In the *SEC Staff Study*, the scope of these regulations in relationship to the SEC's work was not properly assessed, just one practical example of the lack of rigor inherent in the staff's analysis.

[5] Just this past July, the D.C. Circuit rejected the Commission's actions adopting its shareholder access rule. *See* Business Roundtable and Chamber of Commerce v. SEC, No. 10-1305 slip op. (D.C. Cir. Jul. 22, 2011), *available at* http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/$file/10-1305-1320103.pdf. According to recent reports, the SEC will not appeal this decision, seemingly acknowledging the Court's judgment about the Commission's lack of rigor in rulemaking.

[6] *See* Angela A. Hung *et al*., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[7] According to the Commission's most recent budget justification, the Commission oversees approximately 11,800 investment advisers and 5,400 broker-dealers. The Commission's budget justification states that 44% of all broker-dealers were examined by the Commission or an SRO in FY 2010, and the Commission expects that 45% of all broker-dealers will be examined by the Commission or an SRO in FY 2011 and 46% in FY 2012. Investment advisers are examined far less frequently. In FY 2010, only 9% of investment advisers were examined. The Commission has projected that in FY 2011 and FY 2012, respectively, only 11% and 13% of investment advisers will be examined. *See* U.S. Securities and Exchange Commission: FY 2012
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Garrett, and other Members, who have argued that the self-regulatory organization (SRO) model of supplementing SEC inspections of investment advisers with SRO exams is perhaps the only viable means to address this problem. There is a strong belief that the Financial Industry Regulatory Authority (FINRA) has the experience and capacity to carry out an effective regulatory and examination program for investment adviser examinations, as it currently does for broker-dealers.

Background and AALU's Participation in SEC Staff Study

AALU is a nation-wide organization of 2,000 life insurance agents and professionals who are primarily engaged in sales of life insurance used as part of estate, charitable, retirement, and deferred compensation and employment benefit services. Many of our members have served the same individual clients and their families for decades. Our customers are of primary importance to us and, for that reason, we work closely with them to understand their needs and objectives in connection with the insurance and investment products we are authorized to sell, within the framework of our contracts with carriers and other obligations under all of the laws and regulations to which we are subject.

All of our members are licensed insurance professionals; many are licensed in multiple states. Many of our members own their own insurance agencies, in some cases with multiple offices, and some of these agencies own or are affiliated with registered broker-dealers or investment advisers. Many AALU members are registered representatives of SEC/FINRA-registered broker-dealers and/or are investment adviser representatives of SEC-registered investment advisers. Our members therefore are subject to multiple layers of federal and state regulation and oversight. We believe we have a unique perspective on the effectiveness of regulation and oversight by various regulators, particularly with regard to sales of insurance-related products.

Many life insurance producers offer variable life insurance and variable annuities, in addition to what may be viewed as more traditional life insurance products. These bundled products offer consumers investment choices for their accumulating cash values – the variable element of the product – with separate guarantees from the issuer such as a guaranteed death benefit and lifetime income guarantees, which are important options for customers seeking to address their life insurance protection and retirement needs and which have been recognized as even more important in recent years of market volatility. It is the sale of these products that triggers broker-dealer registration and SEC, FINRA, and state securities regulation and oversight for those producers. Any major changes in SEC regulation of broker-dealers, such as changing current standards for broker-dealers to an investment adviser-type standard, would have a significant impact on these producers and could potentially affect their relationships with, and their ability to serve, their customers, particularly with regard to the range of products offered as well as the costs of those products. For this reason, AALU on August 30, 2010 filed extensive comments with the SEC in connection with its Section 913 Study, in order to educate the

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CONGRESSIONAL JUSTIFICATION - IN BRIEF (Feb. 2011), at 2, 22, *available at* http://www.sec.gov/about/secfy12congbudgjust.pdf.

Commission on the extent of current regulation of insurance producers who sell variable products.[8]

AALU's submission to the SEC explained, for example, that the design of variable life insurance products requires medical and financial underwriting in determining insurable interest that goes beyond the requirements for traditional securities products. The rigor and breadth of applications relating to these products requires an assessment primarily of financial and protection needs. This necessitates an analysis related to death benefit, cash values, tax advantages and costs. In each situation, the issuing insurance company is involved in determining the appropriateness of the product for the customer as it relates to risk selection and general suitability. In addition to the SEC's and FINRA's roles in the registration and sales of these products, state insurance commissions also regulate these products. Insurance producers/registered representatives who sell these products are subject to supervision by an SEC/FINRA-regulated broker-dealer and also subject to the terms of their contract with the issuing insurance company, which is subject to regulation by multiple state insurance regulators. Indeed, the scope and level of regulation is significantly higher for variable life insurance products than for other securities products under current law. However, the SEC Staff seemingly gave little weight to the extensive information provided by AALU and other insurance organizations[9] on the comprehensive and overlapping requirements of state insurance regulation and federal, state and FINRA securities regulation relating to variable products, under which insurance producers operate.

We believe consideration of the multiple layers of regulation and oversight of these variable insurance products, together with their product-specific disclosure and due diligence requirements, should have led the SEC Staff to conclude that no change in standards or further regulation is necessary, or at least to specify why, notwithstanding the current multiple and overlapping regulation of these products, a different, more subjective standard – the standard under the Investment Advisers Act – should be applied. We expressed strong concerns that applying such a standard, in addition to all of the existing regulatory requirements, could result in many insurance producers moving away from variable to fixed insurance products, limiting customer choice and increasing costs. The cost of meeting all regulatory and compliance obligations is already significant for all brokers, but especially insurance producers, due to levels of oversight and requirements that already exist. Our submission expressed our serious misgivings that an unwarranted change in the legal standard that requires increased time and compliance costs could render the delivery of this service too costly for insurance producers and the average customer, resulting in limited access to valuable insurance protection. However, the SEC Staff Study report did not acknowledge the comprehensive and overlapping regulation of insurance professionals.

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[8] *See* Comment Letter from David J. Stertzer, Chief Executive Officer, Association for Advanced Life Underwriting, File No. 4-606*,* Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2631.pdf.

[9] *See* Comment Letter from American Council of Life Insurers, Association for Advanced Life Underwriting, Financial Services Institute, Insured Retirement Institute, National Association of Insurance and Financial Advisors, and Securities Industry and Financial Markets Association, File No. 4-606*,* Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2532.pdf.

In addition, without any empirical evidence or data, the SEC Staff Study report dismissed concerns that the proposed regulatory changes would limit choice and access to financial products and services.[10] The report contained numerous statements by the Staff that it was seeking proof from commenters concerning the adverse effects of the proposed rule change, when the burden is, in fact, on the agency recommending the imposition of new regulations to conduct a cost/benefit analysis, which the SEC did not do.

In support of the Staff's position that the impact would be limited, the Staff cited letters from two organizations who have advocated for the rule change. The staff stated that the new standard would only apply to "personalized investment advice" – a term currently undefined but which the Staff made clear it intends to define as virtually any investment suggestions from a broker to a retail customer, including advice not to buy choices presented.[11]

The Staff then argued that concerns about the vagueness of the proposed new standard should be discounted, because the Commission or Staff will provide guidance to assist professionals.[12] Yet, at the same time, the SEC Staff Study report states,

> The Staff is of the view that the existing guidance and precedent under the Advisers Act regarding fiduciary duty, as developed primarily through Commission interpretative pronouncements under the antifraud provisions of the Advisers Act, and through case law and numerous enforcement actions, will continue to apply to investment advisers and be extended to broker-dealers, under the uniform fiduciary standard.[13]

In other words, it is the view of the SEC staff, as expressed in their report, that broker-dealers will be expected to abide by 70 years of Advisers Act precedent, including case law and SEC enforcement actions, in order to discern their responsibilities and legal liabilities under the proposed new standard.[14] The SEC Staff nonetheless said it believes, without providing

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[10] *See SEC Staff Study*, *supra* n. 2 at 161-162, simply citing SEC staff views rather than specific supporting data: "The Staff believes that its recommended uniform fiduciary standard recognizes the value of preserving investor choice with respect to the variety of products and services involving the provision of investment advice and how investors may pay for them. . . . The Staff believes that the recommended uniform fiduciary standard would not require that broker-dealers limit, nor would it necessarily result in broker-dealers limiting, the range of products and services they currently offered to retail investors. . . . The Staff believes that . . . the recommended uniform fiduciary standard would in and of itself, not adversely impact [the retail investor] populations' access to financial products and services."

[11] *Id.* at 123-127.

[12] *Id.* at 162.

[13] *Id.* at 111.

[14] The SEC staff appears to be taking a position in contradiction to even the Ranking Member of the House Financial Services Committee, who has supported a uniform fiduciary duty on broker-dealers and advisers. In a May 31, 2011 letter to SEC Chairman Mary Schapiro, Representative Barney Frank stated that "if Congress intended the SEC to simply copy the '40 Act and apply it

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empirical evidence, that retail access to broker-dealer services will not be adversely impacted and asks that broker-dealers defer to the staff to provide appropriate guidance at some point.

Life insurance enables individuals and families from all economic brackets to maintain independence in the face of potential financial catastrophe, helping relieve pressure on burdened public programs. It is unique in guaranteeing the delivery of financial security at precisely the moment it is needed, while contributing significantly to the nation's storehouse of savings and investment capital. As September is "Life Insurance Awareness Month," it is important to note that the life insurance industry, through permanent life insurance and annuities, provides 20% of Americans' long-term savings.[15] Two out of three American families – that's 75 million families – count on the important financial security that life insurance products provide. Unfortunately, despite this broad, positive impact, according to Congress, 68 million still "lack the adequate level of life insurance coverage needed to ensure a secure financial future for their loved ones."[16] We therefore believe any proposed change in regulation that could limit consumer choices and access to insurance products should meet a high burden with respect to the need for the changes. Clearly, the SEC did not meet that burden, nor did it do what Congress specifically asked it to do in conducting the Study.

Failure of the SEC to Conduct an Objective Assessment of Broker-Dealer and Adviser Regulation

During consideration of the legislation that ultimately became Dodd-Frank, SEC Chairman Schapiro made clear her support for a new fiduciary duty for brokers and dealers in a March 9, 2010 letter to former Chairman Dodd, stating, "I urge you to include a provision that would mandate a uniform fiduciary standard of conduct for financial services professionals providing investment advice about securities to investors." The SEC Chairman wanted no discretion left to the SEC, but, instead, asked that Congress mandate the standard. As this Subcommittee is aware, Congress decided otherwise, and the only mandates in Section 913 were: (1) a mandate to the SEC to conduct an objective and comprehensive study; and (2) a mandate to consider the study in writing any new rules relating to the standard of care for brokers, dealers, and investment advisers. The SEC was given discretion, but was not required, to write rules imposing a fiduciary standard, following the study.

Therefore, perhaps, it is not surprising that SEC Staff Study report recommended, with no empirical basis, that the fiduciary duty standard under the Advisers Act be applied to broker-dealers. According to the only two SEC commissioners who had not previously endorsed the imposition of a fiduciary duty, the Staff recommendation was made, "without adequate

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to broker-dealers, it would have simply repealed the broker-dealer exemption – an approach Congress considered but rejected." *Available at* http://www.advisorone.com/advisorone/files/ckeditor/Barney%20Frank%20Letter.pdf.

[15] American Council of Life Insurers calculations of survey data and Federal Reserve Flow of Funds data.

[16] S. Res. 211, 111th Cong. 2009; H. Res. 16, 111th Cong. (as agreed to in Senate on July 5, 2009 and in House on Sept. 29, 2009, respectively).

articulation or substantiation of the problems that would purportedly be addressed via that regulation, without adequate recognition of the risk that its recommendations could adversely impact investors, and with no justification for fundamentally changing the regulatory regime for broker-dealers and investment advisers."[17]

The Staff produced no data to suggest that the Advisers Act regulatory regime is in any way superior to the regulatory regime for broker-dealers under SEC and FINRA rules. By contrast, AALU's comment letter to the SEC pointed out in detail a variety of areas in which the regulatory regime applicable to broker-dealers is far superior to that applicable to investment advisers, including: the level of regulatory oversight and examinations; the legal requirements for internal supervision programs; the specific liability of supervisors, which is designed to assure that they vigorously supervise the activities of those subject to their supervision; the qualification requirements for salespersons/advisers and supervisors; requirements for training and continuing education; and the nature and totality of the regulatory requirements in furthering effective programs of supervision and oversight to protect retail customers.

If the goal of imposing upon financial intermediaries any legal duty – fiduciary or otherwise – is anything other than to create liability for the intermediary, it should be to protect investors through assuring appropriate broker and adviser conduct. Regulation should provide appropriate and effective guideposts. In other words, regulation should provide clear rules of conduct, from which a financial services organization can develop training for its employees, supervision of their conduct, procedures to achieve compliance, and measures by which they can audit their conduct. Regulators then can examine and measure financial services professionals against these rules and assess for compliance. Thus, the regulations should be (1) clear and understandable to the financial professionals to whom they apply; (2) capable of being measured and monitored by supervisory personnel who are held accountable for compliance (and which are, in fact, monitored by supervisory personnel); and (3) capable of being audited and enforced by regulators. This is the model FINRA follows. It is not the Advisers Act model, where the broad, amorphous fiduciary standard of conduct has evolved essentially from case law and SEC enforcement actions.[18]

Investor Confusion Can, and Should Be, Addressed More Effectively

The SEC Staff Study report's recommendation rests its conclusion about the need for a uniform fiduciary duty solely on concerns about investor confusion as to the specific legal duties of brokers, dealers, and investment advisers. The report focuses on a 2008 report by the RAND Institute for Civil Justice (RAND Report)[19] based upon a survey of investor and industry

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[17] *See* Statement by SEC Commissioners Kathleen L. Casey and Troy A. Paredes Regarding Study on Investment Advisers and Broker-Dealers, Jan. 21, 2011, *available at* http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

[18] *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963). *See also Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 17 (1979).

[19] *See* Angela A. Hung *et al*., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

perspectives on the role of broker-dealers and investment advisers. The RAND Report summarized its findings as follows:

> Overall, we found that the industry is very heterogeneous, with firms taking many different forms and offering a multitude of services and products. Partly because of this diversity of business models and services, investors typically fail to distinguish broker-dealers and investment advisers along the lines that federal regulations define.[20]

However, the RAND Report did not identify particular investor harm that occurred as a result of the confusion. Indeed, the RAND Report found:

> Despite their confusion about titles and duties, investors express high levels of satisfaction with the services they receive from their own financial service providers.[21]

AALU members believe our customers fully understand the role in which our members operate. Indeed, if there is any concern about the current level of disclosures, we believe many customers feel buried under the weight of required disclosure and account-related documents. Nonetheless, we support efforts, such as FINRA's Notice 10-54, to develop better and clearer disclosure for customers of broker-dealers.[22] Indeed, we believe the FINRA process offers the potential to give thoughtful consideration to the types of disclosures that investors would find most useful in making investment decisions and to simplify the information most relevant to consumers. For example, FINRA seems to be aiming for a simple document provided at the beginning of a customer relationship, with information about the roles, conflicts and services provided by a broker-dealer.

On this issue, the RAND Report also offers some critical insight. It referenced the "questionable value of disclosures" and reported that a majority of those interviewed by RAND's researchers expressed the view "that disclosures do not help protect or inform the investor, primarily because few investors actually read the disclosures."[23] Not surprisingly, many participants in the survey apparently complained, "[t]he way [disclosures] are written is not easily understandable to the average investor, and the information in disclosures is not sufficient."[24] Of course, we know that both the SEC and FINRA have heard this complaint year after year, over many decades, and yet regulators to date have not written the kind of rules that

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[20] *Id.* at xiv.

[21] *Id.*

[22] *See* FINRA Notice 10-54, *Disclosure of Services, Conflicts and Duties* (Oct. 2010) *available at* http://www.finra.org/Industry/Regulation/Notices/2010/P122361; Comment Letter from David J. Stertzer, Chief Executive Officer, Association for Advanced Life Underwriting, File No. 4-606, Aug. 30, 2010, *available at* http://www.sec.gov/comments/4-606/4606-2631.pdf.

[23] *See* Angela A. Hung *et al*., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, RAND Institute for Civil Justice, at 19, *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[24] *Id.*

would facilitate the type of simple, brief, "plain English" disclosures investors want and need. We believe this underscores the need for FINRA, together with the SEC, to develop and implement investor testing and investor education as part of the process of developing any new disclosure rules in this area.

Studies that (1) reflect investor confusion over legal duties that apply to financial professionals but also (2) show investor satisfaction about their own financial services provider point clearly to the need for more effective disclosures and investor education, not the need for wholesale changes in the legal standards.

In fact, the need for the SEC to gather additional data before considering major changes in SEC regulation of broker-dealers—such as changing current standards for broker-dealers to an investment adviser-type standard—is essential and vital, given current investor choices and behavior. According to a broad-based nationwide study by Oliver Wyman in October 2010, 95% of investing households surveyed utilize commission-based brokerage accounts to meet their needs, while only 5% of households use a fee-based advisory platform.[25]

Need to Address the Investment Adviser Inspection Gap

We believe the SEC, in its advocacy for a uniform fiduciary duty almost to the exclusion of other, more pertinent reforms, has misplaced priorities. The first step in protecting investors has to be to assure they are well informed. They need to be informed about the role in which a financial services professional operates. They should be informed about who regulates them and when they were last inspected by a regulator. They need to understand what their rights are if there is a dispute with the financial services professional. They need to understand conflicts of interest. The SEC should review current disclosures and consider changes where they believe disclosures are lacking as a first step.

Moreover, if investor confusion is to be the basis for new regulation, we submit that few investors understand that if their financial services professional is a registered broker-dealer, it is supervised by the SEC, FINRA, and state securities regulators, and likely is inspected approximately once every two years, but if the investor's financial service professional is a registered investment adviser it may be inspected only once every 10 years, according to the SEC's own budget projections.[26] Broker-dealers also employ significantly more internal resources, programs and procedures to comply with their responsibilities under Commission and FINRA rules, compared to investment advisers – a difference in regulatory requirements we also believe is unknown to most investors, who arguably would express concern if surveyed on this point. The level of internal broker-dealer resources committed to compliance, together with the industry's financial support of FINRA for its oversight of broker-dealers, is a significant multiple of government and private sector resources devoted to compliance on the investment adviser

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[25] Oliver Wyman, "*Standard of Care Harmonization, IMPACT Assessment for SEC* (October, 2010), at 4, *available at* http://www.sifma.org/WorkArea/DownloadAsset.aspx?id=21999.

[26] *See supra* note 7.

side. Yet we have been struck by the fact that neither the SEC nor fiduciary advocates have treated this issue of investor lack of knowledge with the same urgency as their campaign to impose a fiduciary duty on brokers. Commissioner Walter in her dissent to the SEC staff study under Section 914 made a strong case that the SEC's inspection program for investment advisers has significant gaps and that designating an SRO, which presumably would be FINRA, may be the only approach which can solve the problem.

AALU supports Chairman Bachus, Chairman Garrett, and this Subcommittee in focusing on the SEC staff study under Section 914, Enhancing Investment Adviser Inspections. The SEC's focus on a uniform standard of conduct has been a diversion from the need to address the disparity in regulatory oversight and inspections of broker-dealers and investment advisers and investors' expectation gap that registered investment advisers are subject to the most effective oversight. As the Commission is aware, some of the most dramatic failures in recent years on the retail brokerage/adviser side were not a result of the lack of rules governing financial professionals or the lack of a "fiduciary duty" of malefactors, but a failure of regulatory oversight.[27]

No standard of care is effective without a mechanism to monitor and enforce its application. The Commission and other regulators and self-regulatory organizations already devote the clear majority of their oversight and inspection resources to broker-dealers. An investment adviser who is compensated based on assets under management or fees for services and time can be just as likely to make an inappropriate recommendation to garner more assets as any commission-based broker. Devoting limited Commission resources to imposing a uniform standard of conduct for brokers, dealers and investment advisers should be considered only if and when the oversight, inspection, and supervision gap between broker-dealers and investment advisers is sufficiently addressed.

Imposing a broad, vague fiduciary duty on broker-dealers would provide no increase in investor protection

While under certain circumstances (such as when a broker has discretionary authority over a customer's account) a broker may be held to the legal standard of a "fiduciary," we believe Advisers Act regulation or a broad fiduciary duty standard has not provided superior investor protection for customers of investment advisers and would not provide a measurable increase in investor protection for retail customers of broker-dealers. In contrast, a regime for

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[27] *See, e.g., SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme,* SEC Press Release 2008-293, Dec. 11, 2008, *available at* http://www.sec.gov/news/press/2008/2008-293.htm, and the SEC Complaint and Orders referenced therein. *See also SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme,* SEC Press Release 2009-26, Feb. 17, 2009, *available at* http://www.sec.gov/news/press/2009/2009-26.htm; and the SEC complaint and Litigation Release No. 20901 referenced therein. *See also* David Stout, *Report Details How Madoff's Web Ensnared S.E.C.*, N.Y.TIMES, Sept. 2, 2009, *available at* http://www.nytimes.com/2009/09/03/business/03madoff.htm; Zachary A. Goldfarb, *SEC Suspected R. Allen Stanford of Ponzi Scheme 12 Years Earlier, Report Says*, WASH. POST, Apr. 17, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/04/16/AR2010041604891.html.

advisers that more closely resembles that for brokers and dealers would likely benefit retail customers, in view of the specificity of the rules and the strong examination program resulting from FINRA oversight.

For variable life insurance products sold by licensed insurance agents in particular, which are among the most highly-regulated products sold by the most highly-regulated financial services professionals, nothing under the Advisers Act regulatory scheme compares to the comprehensive and robust customer protections already in place: comprehensive due diligence with respect to the customer's needs and financial capacity; suitability assessment relating to both annuity and investment products; disclosures to customers about the investment product; transaction-by-transaction review and approval by the carrier/issuer; immediate and transaction-by-transaction review of each transaction by a broker-dealers' securities principal; and meaningful and effective oversight by as many as four different levels of regulators (and often involving multiple regulators at the state level). While we do not believe AALU members' clients are confused about the insurance producer's role and any potential conflicts, the SEC does not need to look to the Advisers Act or to a newly-created "best interest" standard under Dodd-Frank to address any confusion, should it be identified. The Commission and FINRA have ample other authority (authority existing both prior to and after enactment of Dodd-Frank) to require additional disclosures by brokers to their customers.

Even beyond highly regulated variable products, as discussed above, the Commission/FINRA regulatory and oversight regime for brokers and dealers – which is highly specific, proactive, capable of being monitored by supervisors (and is, in fact, monitored) and capable of being audited by regulators (and is, in fact, regularly audited by regulators) is superior to current regulation of investment advisers. In fact, we believe investors, if fairly surveyed, would choose a regime which provides specific rules of conduct to guide financial professionals, imposes liability upon supervisors for failing to meet robust supervisory requirements, and provides for periodic and robust regulatory oversight, over a regime in which a financial professional may have a legal "fiduciary" obligation but operates under the assumption that a regulator may audit its activities only once every 10 years. We believe any shift in regulation should be toward moving advisors in the direction of the more specific regulatory regime of broker-dealers to supplement the Commission's current inadequate regime for investment advisers. The comparative benefits of the broker-dealer regulatory and oversight regime over the current regime for investment advisers have been amply demonstrated.[28]

[28] Indeed, the SEC Staff Study report acknowledges the superior nature of broker-dealer regulation in a number of areas, particularly with regard to the lack of SEC substantive review of investment advisers' applications and lack of federal or SRO licensing and educational requirements for persons associated with investment advisers, but states that reforms to bring investment advisers up to the level of broker-dealers in these areas are not feasible at this time due to SEC resource constraints. *SEC Staff Study* report at 136-138.

Imposing an Advisers Act fiduciary duty standard or "best interest" standard could harm investors by reducing customer choice and access to financial services

The concept of "fiduciary duty" addresses the age-old agent monitoring problem (the lack of a principal's control over, and inability to continuously monitor, its agent) by imposing various duties and obligations enforced through the courts. The elements of the duty are principles-based, not rules based, and the duty is, by its very nature, after-the-fact liability creating.[29]

Many of our members operate under the implied fiduciary duty of the Advisers Act and under certain specific rules adopted by the Commission under the Advisers Act. But a general fiduciary standard is inappropriate as applied broadly to sales of securities products where the broker does not hold himself/herself out as an investment adviser and does not exercise discretionary authority. It is particularly inappropriate for bundled, self-contained products like variable life and variable annuities, which come pre-assembled with several investment choices and separate contractual guarantees from the issuer such as guaranteed death benefits and lifetime income guarantees. The range and features of these products makes it difficult to determine which product is "best" and, under a "best interest" standard, almost certainly would lead to increased litigation. Our members have a long history of being able to determine suitability – and we operate under FINRA and state insurance regulators' enhanced suitability standards for these products. However, determining what is "best" would be a highly subjective determination, opening a producer to second-guessing and liability, often years after the sale of a product.

- Is the best product in a rising market the one that is most aggressively allocated to equities? Some would argue that is the case.
- But, could the best product for the client that dies three years into the contract be the one with the highest death benefit?
- In a prolonged depressed equity market, is the product with the best income guarantee the most favorable to the client?

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[29] At a May 4, 2010 Senate Judiciary Subcommittee hearing, Professor Larry E. Ribstein, Associate Dean of the University of Illinois College of Law and an expert on fiduciary law, testified that "fiduciary duty is one of the most amorphous concepts in the law" – a concept developed through case law, predominantly at the state level. He stated that imposing such a duty "would result in massive uncertainty" and pointed to the lack of clarity after more than 40 years of litigation over the fiduciary standard in section 36 of the Investment Company Act, as well as the "ill-defined duty for investment advisers." At that same hearing, J.W. Verret, Assistant Professor of Law, George Mason University, testified about the difficulty of applying a fiduciary duty standard: "[U]nder a fiduciary standard and after the fact, it is too tempting to decide whether a decision was fair at the time it was made in light of how the investment ultimately performs." He noted, "[I]n administering fiduciary duty laws, it is nearly impossible to avoid being influenced by the perfect vision of hindsight." *See* transcript of Senate Hearing 111-835**,** Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?, *available at* http://judiciary.senate.gov/resources/transcripts/111transcripts.cfm.

- Which is the best product for clients when there are tradeoffs, such as one product with fewer investment choices and lower costs and another with higher charges but a wider range of investment choices?

The SEC Report Staff Study report says nothing about whether the staff considered how its proposed best interest test would apply to these products.

Thus, we believe the imposition of a broad new "best interest" or fiduciary duty standard inevitably will lead to uncertainty and litigation. In our view, this will influence many life insurance producers to withdraw from the sale of these products and reduce investor access to them.

Conclusion

AALU believes the current legal and regulatory standards of care for brokers and advisers are fundamentally sound and recognize the importance of delivering a range of choices to customers based on needs and costs. Well-publicized abuses and failures that led to the recent financial reform effort have not been related to the standards of care for brokers, dealers and advisers. Indeed, where there have been abuses and scandals, they in large part have been due to the failure of vigorous regulatory oversight and enforcement of existing standards, and not any identifiable weaknesses in the standards themselves. This problem will remain regardless of any changes to the standard. As a result, the focus should be on the process of ensuring that the standard appropriate to a defined customer relationship is met.

We also believe the issue of investor confusion is somewhat misdirected. There exist many choices and options in accessing financial services that may be "confusing" to customers without their becoming educated beyond their desire. Yet, these differences in product choices, costs and services are fundamental to a delivery system that allows people across all wealth and income levels to access the benefits of financial services in some form. The solution is not to eliminate potential confusion through homogenization, but to ensure understanding of the standard selected to meet their needs and the role in which a financial professional is serving them. We urge this Subcommittee to focus the SEC on what should be its real priority in protecting retail customers of financial professionals – assuring that investment advisers who hold themselves out as "fiduciaries" to their customers are effectively reviewed, at the same level of scrutiny as broker-dealer applicants, before they enter the business at all, and that they are inspected with the same level of intensity and frequency as broker-dealers.

We greatly appreciate the opportunity to testify in this important hearing. AALU looks forward to continuing to work with this Subcommittee on these critical issues.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Kenneth R. Ehinger	AALU

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.