Written Statement of Harvey L. Pitt
Founder, CEO and Managing Director
Kalorama Partners, LLC and Kalorama Legal Services, PLLC

Before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the House Committee on Financial Services,

"Putting Investors First? Examining the SEC's Best Interest Rule"

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Chair Maloney, Ranking Member Huizenga, Members of the Subcommittee:

I. Introduction

I am Harvey Pitt, the Founder, CEO and Managing Director of the global strategic business consultancy, Kalorama Partners, LLC, and its affiliated law firm, Kalorama Legal Services, PLLC. Prior to founding the Kalorama firms, I was privileged to serve as the twenty-sixth Chairman of the Securities and Exchange Commission ("SEC" or "Commission"), from 2001-2003; I had previously served as the first Chief Counsel of the SEC's then Division of Market Regulation (today, the Division of Trading & Markets), from 1973-1974, and as the SEC's General Counsel, from 1975-1978.[1]

I am grateful for the opportunity to testify this morning on a subject of vital importance—the SEC's package of regulatory proposals regarding the standards of professional conduct to which securities professionals should adhere, for the benefit of their clients and customers.[2] At the request of the Committee's Chair,

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[1] My full curriculum vitae is attached to this Written Statement, as requested by the full Committee's Chair, and I do not repeat my background and experience here.

[2] In April 2018, the SEC issued a package of three proposed rulemakings and interpretations designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers, while preserving access to a variety of types of advice-obtaining relationships and investment products: Proposed Regulation Best Interest, Securities Exchange Act Rel. No. 83062 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/34-83062.pdf; Proposed Form CRS Relationship Summary; Amendments to SEC Form ADV; Required disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, Securities Act Rel. No. 83063 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/34-83063.pdf; and a Proposed Commission Interpretation Regarding the Standard of Conduct Applicable to Registered Investment Advisers, Inv. Advisers Act Rel. No. 4889 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/ia-4889.pdf (collectively, "Reg BI").

I also will offer my views with respect to draft legislation, with the short title of the "SEC Disclosure Effectiveness Testing Act" ("DETA").

I am appearing here today in my personal capacity, not on behalf of my Kalorama firms, their clients, or any of my Kalorama colleagues.[3] In addition, the views I present to this Subcommittee this morning have not been influenced, directly or indirectly, by any clients the Kalorama firms currently represent, or may have represented in the past.

II. Summary of Views

My views on the topics under review by this Subcommittee can be summarized as follows:

- Proposed Reg BI is an impressive, creative and well-planned effort by the Commission to put the interests of main stream investors first, by clarifying the standards of conduct expected of market professionals, and enhancing the quality of service investors have a right to, and should, receive from their securities professionals;

- The proposed Regulation should be seen as an initial step in bringing securities professionals into the twenty-first century, by placing a premium on substance, rather than labels;

- Unlike other rules the SEC has, in the past, adopted, the package of rules and interpretations constituting proposed Reg BI will warrant regular monitoring and, presumably, subsequent tweaking, as experience is gained in how Reg BI operates in actual practice;

- Reg BI creates a strong addition to the arsenal of protections already applicable to securities broker-dealers and investment advisers, and will materially raise the quality of service investors receive from their securities professionals, without sacrificing the ability of investors to choose which professionals, and what services, they seek to obtain;

- There are major differences in certain of the functions performed by securities broker-dealers, on the one hand, and SEC-registered investment advisers, on the other, which make it sensible for the Commission to avoid becoming mired in legal terminology; rather, the

[3] This written testimony reflects solely my own views, and was prepared and written solely by me, with research assistance from my Kalorama colleagues, working solely under my supervision. I have not received any compensation, in any form, either directly or indirectly, for my appearance here, or the views I express.

SEC has embraced a pragmatic and effective standard—putting the best interests of customers ahead of any potential significant profit interests of the firms that employ these securities professionals;

- **Most of the criticisms that have been raised against Reg BI reflect one or more of the following unfortunate deficiencies:**
  - **A misunderstanding of the actual terms of the proposal;**
  - **A misunderstanding of the study and efforts that went into the creation of the proposal;**
  - **Competitive concerns by investment-adviser only operations; and**
  - **The failure to recognize that the worst enemy of a good proposal is a "perfect one;" and**
- **The draft DETA is poorly-worded, and ill-advised; it would effectively engender only one result if passed at present—preventing the SEC from implementing the needed reforms incorporated within Reg BI.**

III. Reg BI[4]

As proposed, Reg BI would establish a standard of conduct for broker-dealers (and their associated account executives) who make recommendations to retail customers of any securities transaction or investment strategy involving securities to act in the "best interest" of the retail customer at the time the recommendation is made. Although there has been some criticism of the fact that the term "best interest" is not formally defined as part of the SEC's rulemaking, the Regulation makes clear that both the broker-dealer and any natural person interacting with the retail customer (usually, the "account executive" or "financial advisor") must make these recommendations without placing the financial or other interests of the firm, or the individual account executive, ahead of the interest of their retail customer.[5]

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[4] There are many useful summaries of the package of rules and proposed interpretations that comprise Reg BI. *See*, *e.g.*, Y. Lee, S. Nicolas & J. Toner, "*SEC's Standards of Conduct for Investment Professionals Rulemaking Package*, WILMERHALE (Apr. 2018), prepared for the Securities Industry and Financial Markets Association ("SIFMA"), available at https://www.sifma.org/wp-content/uploads/2018/04/WilmerHale-Summary-re-Reg-BI.pdf ("*WH Analysis*").

[5] *See* Securities Exchange Act Rel. No 83602, *supra* n. 2, at p. 8.

Moreover, the Regulation expressly provides that this obligation of putting the retail investor's best interest ahead of those of the brokerage firm or its account executive are satisfied if

- **The firm and its account executive reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, as well as all material conflicts of interest implicated by specific recommendations;[6]**

- **The firm and its account executive exercise reasonable diligence, care, skill, and prudence in making the covered recommendations;[7]**

- **The firm establishes, maintains and enforces written policies and procedures reasonably designed to identify and, at a minimum disclose, or eliminate, all material conflicts of interest that may be associated with the recommendations;[8] and**

- **The firm establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest that arise from the financial incentives applicable to such recommendations.[9]**

Significantly, and in my view appropriately, nothing in the proposed Regulation requires broker-dealers to recommend the least expensive or least remunerative securities or investment strategies, as long as the firm and its associated individuals comply with the disclosure, care and conflict of interest obligations that would be created by the Regulation. This is significant, because the mere fact that a brokerage firm, or an account executive, receive additional remuneration for pursuing certain strategies or securities does not, *ipso facto*, make the recommendation improper, unsuitable, or contrary to the best interests of the retail customer.

On the other hand, if a recommendation were primarily motivated by a broker-dealer or its individual account executive's self-interest, it would violate both the care and the conflict of interest obligations set forth in the

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6 *Id.*

7 *Id.*, at p. 9.

8 *Id.*

9 *Id.*

proposed Regulation.[10] The advantage of this structure is that it wisely avoids prohibiting transactions that may be financially advantageous to a retail customer, notwithstanding the fact that it could permit the brokerage firm and/or its individual account executive to receive additional remuneration from the remuneration that would be generated by alternative possible recommendations.

The proposed Regulation fits carefully into the existing panoply of regulations governing the conduct of broker-dealers and their individual account executives and, concomitantly, differs from recommendations of the SEC Staff Study regarding the obligations of brokers, dealers and investment advisers, undertaken in response to Dodd-Frank Act ("DFA") §913(b).[11] Instead of creating either a new standard for broker-dealers, or adopting wholesale the obligations and duties that have arisen under a separate regulatory regime that addresses a different type of advice relationship, the proposed approach adds to the current broker-dealer regulatory regime.[12] On the other hand, the proposed Regulation draws upon the similar duties of loyalty and care applicable to registered investment advisers, as those have been interpreted under the Investment Advisers Act of 1940 "(IAA").[13]

IV. Proposed Form CRS Relationship Summary

As part of its package comprising Reg BI, the SEC also would require both investment advisers and broker dealers to deliver a "relationship summary" to retail investors (Form CRS), in addition to current disclosures and requirements.[14] The new rules would require broker-dealers and investment advisers to file a proposed form CRS with the Commission as well as delivering it to new customer

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[10] *Id.*, at p. 58.

[11] The DFA was enacted and signed into law on July 21, 2010. *See* Pub. L. No. 111-203 (2010). Section 913 was codified at 15 U.S.C. §§78o, 80b-11. *See*, *e.g.*, T. Hazen, "*Stock Broker Fiduciary Duties and the Impact of the Dodd-Frank Act*," 15 N.C. BANKING INST. 47, 48 & n. 7 (2011). *See* SEC Staff, "*Study on Investment Advisers and Broker-Dealers*" (Jan. 2011), available at https://www.sec.gov/news/studies/2011/913studyfinal.pdf ("*Staff Study*"). The *Staff Study* had recommended a uniform standard for investment advisers and broker-dealers when providing personalized investment advice to retail investors. *See Staff Study*, at pp. v-vi, 109-110.

[12] In proposing Reg BI, the Commission stated that it was not eliminating existing broker-dealer obligations. *See* Securities Exch. Act Rel. No. 83062, *supra* n. 2, at p. 42. *See*, *e.g.*, *WH Analysis*, *supra* n. 4, at p. 3.

[13] *See* IAA §§206(1) and (2), 15 U.S.C. §§80b-6(1) and 80b-6(2). *See*, *e.g.*, *WH Analysis*, *supra* n. 4, at p. 5.

[14] *See* Securities Exch. Act Rel. No. 83063 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/34-83063.pdf.

or advisory client, and, when the nature of the relationship changes or involves different accounts, deliver it to existing customers and advisory clients. The generic forms must also be posted on each firm's website. To facilitate understanding of the new requirements, the Commission also provided sample disclosures, both for dual registrants and for standalone broker-dealers and investment advisers. In addition, the SEC proposed to bar registered broker-dealers and individual account executives from using the term "adviser" or "advisor" as part of the name or title, unless there is coverage for the firm or the account executives under the IAA.[15]

V. Proposed Interpretation of the Standard of Conduct for Investment Advisers[16]

As part of its Reg BI package, the SEC proposed to "reaffirm," and in some cases "clarify," certain aspects of a registered investment adviser's fiduciary duties.[17] The proposal noted that an investment adviser's fiduciary duties are not explicitly included or defined under the IAA, or in any of the SEC's rules, but have evolved under common law, and also are dependent on the precise nature of the relationship spelled out in the adviser's advisory contract.[18]

Among other things, the Fiduciary Duty Interpretation Release indicated that investment advisers owe their customers both a duty of care and a duty of loyalty, which include:

- An obligation to provide advice that is in the adviser's client's best interest;
- A duty to seek best execution when the adviser is responsible for selecting the executing broker-dealer;
- A duty to provide advice and monitoring over the course of the

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[15] This would, presumably, preclude the use of the very popular current title for individuals employed by brokerage firms of the title "financial advisor," unless there was dual registration for the firm or the individual as a registered investment adviser.

[16] *See* IAA Rel. No. 4889 (Apr. 18, 2018), available at https://www.sec.gov/rules/proposed/2018/ia-4889.pdf ("Fiduciary Duty Interpretation Release").

[17] *Id.*, at p. 5. The proposed interpretation would apply to all investment advisers, including those who are exempt from SEC registration. *WH Analysis*, *supra* n. 4, at p. 18.

[18] Fiduciary Duty Interpretation Release, *supra* n. 16, at p. 6.

relationship;

- A proscription of favoring its own interests ahead of those of its clients;
- A bar against favoring certain clients over others;
- Avoiding conflicts and fully disclosing the conflicts that do exist;
- Eliminating "grammatical fraud"—that is, if a conflict *does* exist, advisers cannot say that it *may* exist;
- Obtaining meaningful informed consent to potential conflicts, not including consent merely by inference; and
- Noting that, in some cases, disclosure may not be sufficient to cure a conflict.

VI. Draft DETA Legislation

As part of the Subcommittee's consideration of Reg BI, the Chair of the full Committee attached a copy of the Draft DETA legislation. While the appropriateness of investor/consumer testing in appropriate cases is a valuable adjunct to agency rulemaking efforts, this legislation is wholly unnecessary here, and in any event is poorly worded and would serve to obstruct legitimate efforts at SEC rulemaking.

In connection with its proposed Form CRS, the SEC's Office of the Investor Advocate engaged the RAND Corporation to conduct a nationwide survey and qualitative interviews of investors to gather feedback on a sample Relationship Summary.[19] Thus, whatever merits a disclosure effectiveness testing requirement might otherwise have, this legislation is superfluous here, since the Commission caused such testing to be performed in connection with these rules.

Beyond this, the proposed legislation is poorly worded, and would likely be used by those with different objectives to hamstring almost any rulemaking effort involving investor disclosures that the Commission may consider. The rules that are the focus of the Subcommittee's hearings today are an enormous and important step forward, and they do not deserve to be hamstrung by procedural

[19] *See* A. Hung, K. Carman, J. Cerully, J. Dominitz & K. Edwards, "*Investor Testing of Form CRS Relationship Summary*," RAND CORP. RESEARCH REPORT (Nov. 2018), available at https://www.sec.gov/about/offices/investorad/investor-testing-form-crs-relationship-summary.pdf.

questions regarding potential claims that, whatever investor testing occurred was inadequate or insufficient for some spurious reason.

Finally, I think it is important to note that, while consumer testing may be a useful adjunct to rulemaking, singling out the SEC as the sole financial services regulator that would be subject to this type of requirement is a poor way, in my opinion, to elevate the general standards of federal agency rulemaking. If these requirements make sense, they should be applicable to all financial services federal agencies, and not solely the SEC.

VII. Misguided Criticisms of the Commission's Rulemaking Package

As noted, many of the criticisms of the Commission's proposals reflect a fundamental misunderstanding of the substance of the Commission's proposals. For example, some have suggested that the proposed regulation does not do enough to *prevent* a broker's conflicts from tainting its recommendations, and the rule does not prevent brokers from creating incentives that put the firm's interests ahead of its clients' interests. In fact, if a recommendation were primarily motivated by a broker-dealer's self-interest, it would directly violate the Care and Conflict of Interest Obligations set forth in the proposed rule. Disclosure would not be enough, and conflicts arising from financial incentives must be mitigated or even eliminated completely.

Similarly, it has been suggested that the Commission's economic analysis was lacking, and therefore does not support its regulatory proposals. This claim misperceives the fact that the Commission had been studying this issue for almost eight years before it issued Reg BI, and the Commission evaluated each of the issues set forth in DFA §913. The resulting proposal reflects a remarkable effort to utilize all the information at the Commission's disposal to craft a rule that would surely benefit all investors.

VIII. Conclusion

As I noted at the outset, I appreciate this opportunity to address the Commission's Reg BI. I believe the Commission has done an outstanding job in crafting its proposed Regulation, and that, with the benefit of the thoughtful comments it has received, it will fine-tune its proposal and provide all investors with the kinds of protection they surely deserve.