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SEC Investor Roundtables Reveal Investors Often Do Not Understand Form CRS

“What we are finding out...is if you handed this to your lawyer, oh, this makes a lot of sense” ...

“No. I am a lawyer.”

- SEC Chairman Jay Clayton and Investor Thirteen
July 9, 2018, University of Miami

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Executive Summary

On April 18, 2018, the Securities and Exchange Commission (SEC) released a proposed Form CRS Relationship Summary that aims to increase clarity of investment professionals’ business models for investors. Form CRS is a hypothetical 4-page disclosure document that highlights the differences between broker dealers and registered investment advisors.

SEC Chairman Jay Clayton has set a high standard for Reg BI and Form CRS. He has said they should match reasonable investor expectations, maintain choice, address investor confusion, and offer “clear answers.” Does Form CRS meet this standard?

The SEC’s investor roundtables suggest the answer is, “no”. Even highly educated investors with careers in the financial, legal, and writing professions say the language in Form CRS is “poorly written,” “ambiguous,” and “need[s] more clarity.” Lawyers have difficulty making sense of it.

Assistant Director to the SEC’s Investment Adviser Regulation Office, Sara Cortes says, “[Y]ou need to tell people about [your conflict], and you need to tell people about it in a way...that’s sufficient that they can understand it.”¹ 41% of investors who spoke at the largest Investor Roundtable expressed dissatisfaction, views suggesting that Form CRS did not meet this standard. This whitepaper contains excerpts from all six roundtables of ordinary investors objecting to how Form CRS is written.

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¹ Washington, DC Investor Roundtable, July 12, 2018, <https://www.sec.gov/comments/s7-07-18/s70718-4194466-172808.pdf>, at 15.

Houston, June 4, 2018 ²

“How are you going to be able to put fee information into that form...[so] that it has any meaning? ... Why is it too difficult to [have brokerages and advisory fees outline their fees]?”

Are you going to be able to put fee information into that form to a degree that it has any meaning? For example, those of us who have brokerage agreements with large brokerages, they may have hundreds of different fund families that each have their own individual fees. And all I can see, visualize, is seeing, "fund families may have additional fees," something very general. I don't know how that really affects me.

...Compare that to whenever you buy a house. Prior to your closing, you will have a closing statement that clearly identifies every dollar and where it is going to. Why shouldn't brokerages and advisory fees have the ability to take a transaction, one account, and outline these are going to be the fees that you will either incur at the time of closing the transaction, ongoing, or at sale? Why is it too difficult to do something like that? And it's not something you can do on a four-page document.

Investor Nine, at pgs. 29-30

“Advisers are adept at ... not putting [answers] in writing.”

A lot of advisers are pretty adept at answering a question verbally but not putting it in writing...I've heard the stories of how they dance around it and [do] not really [address] the question.

Investor Two, at pgs. 49-50

Atlanta, June 13 ³

“I'm not sure I understand totally...what the broker's obligation to me is under the best interest rule versus the investment adviser's under the fiduciary rule.”

“I'm not sure I understand totally or with any real understanding if I'm dealing with on a particular transaction what the broker's obligation to me is under the best interest rule versus the investment adviser's under the fiduciary rule how it kind of – how that may or may not differ or how they're going to deal with me on an individual transaction. For instance, if I buy a mutual fund and there are a couple of mutual funds that are equally suitable for me but may have different fees, under the best interest can a broker sell any of those to me? Is that consistent with that?”

Investor Four, at pg. 42

² Memorandum of June 4, 2018 Houston Roundtable Regarding Standards of Conduct for Investment Professionals, Available at: <https://www.sec.gov/comments/s7-07-18/s70718-4144931-172001.pdf>

³ Memorandum of June 13, 2018 Atlanta Roundtable Regarding Standards of Conduct for Investment Professionals, <https://www.sec.gov/comments/s7-07-18/s70718-4144932-172001.pdf>

Miami, July 9 ⁴

“This is supposed to be a very plain English document. It was written by lawyers.”

SEC’s Lourdes Gonzalez, at pg. 55

“But if you had to have this, this is not clear. This is not well written...[T]his is the sort of thing where my brain shuts down. Maybe it's age... I am a lawyer... And a professional writer.

Investor Thirteen, at pgs. 55-56

“It is not clear. It is poorly written. I mean, we are college graduates but we are also professional writers and educators. Can't understand it. ... I think people, if they are given an idea of the actual monetary amount of the fee, sort of like a concrete example. When they're talking to an adviser, you can hand them this. This doesn't mean much to them.”

Investor Eight, at pgs. 55-57

“What we are finding out through these town halls is if you handed this to your lawyer, oh, this makes a lot of sense.”

Chairman Clayton, at pg. 56

Washington DC, July 12 ⁵

“The information is generally very valuable, but I was very confused and actually put off by the lack of context.”

I think that the information is generally very valuable, but I was very confused and actually put off by the lack of context. And what Chairman Clayton had to say provided that context for me. Which is, what I thought a fiduciary was is not what, in the industry, a fiduciary is. And I think saying that very clearly is crucial, because when I read all of this it was, frankly, with a jaundiced eye saying why are they muddying the distinction between suitability standard and a fiduciary standard...So I think that – putting that context in there, that Mr. or Ms. Consumer – what you think of as a fiduciary standard is not what the industry thinks it is.

Investor Six, at pg. 17

⁴ Memorandum of July 9, 2018 Miami Roundtable Regarding Standards of Conduct for Investment Professionals, Available at: <https://www.sec.gov/comments/s7-07-18/s70718-4168880-172060.pdf>

⁵ Memorandum of July 12, 2018 Washington, DC Roundtable Regarding Standards of Conduct for Investment Professionals, <https://www.sec.gov/comments/s7-07-18/s70718-4194466-172808.pdf>

Philadelphia, July 17 ⁶

“The vast majority of retail investors really don’t have enough knowledge to understand what this form is...People don’t read four pages.”

I have been doing pro bono work on investor education for 20, 25 years. The vast majority of retail investors really don't have enough knowledge to understand what this form is...So to the extent that you can have a brief summary that actually talks about what the conflicts are, what type of an account it is and what are the fees specifically for the services offered, that kind of summary on page one will actually help investors really understand. Because people don't read four pages.

Investor Six, at pg. 19

Denver, July 25, 2018 ⁷

“[W]hat is the difference between ‘fiduciary’ and ‘best interest,’ if there is [one], and...why use two different terms? ...[T]his industry is bombarded with these terms, and I think that’s part of the problem with investors.”

“So I have a question and then sort of an observation. So my question is, you know, where you talk about the term "fiduciary" and then you're talking about "best interest", and we're using two different terms for what I'm hearing you guys say is very similar, if not identical concepts. And so it's kind of a two-fold question. First is what is the difference, if there is, and second is, why use two different terms? Because I find this industry is just bombarded with these terms, and I think that's part of the problem with investors is if there was just one terminology that people can just rely on and this is it, it would make things a lot simpler versus, you know, having to be a compliance expert or a regulator or -- and I hate to say even people in the industry don't even know the terms.

Investor Six, at pgs. 59-60

Investors Just Do Not Understand Form CRS

The SEC’s proposed 4-page hypothetical disclosure seeks to address investor confusion by communicating important information about how brokers and advisers differ. In addition to identifying specific investor concerns from all six roundtables, the Institute also further reviewed the transcript of the July 12 Washington DC Roundtable for a sense of investors’ general satisfaction and approval. This was the largest of the six roundtables with 38 investors attending. We found that of the 17 investors who are recorded speaking at the roundtable, seven investors either:

⁶ Memorandum of July 17, 2018 Philadelphia Roundtable Regarding Standards of Conduct for Investment Professionals, <https://www.sec.gov/comments/s7-07-18/s70718-4168820-171878.pdf>

⁷ Memorandum of July 25, 2018 Denver Roundtable Regarding Standards of Conduct for Investment Professionals, <https://www.sec.gov/comments/s7-07-18/s70718-4201139-172822.pdf>

- (1) Did not understand something about Form CRS;
- (2) Believed others would not understand something in it; or
- (3) Were dissatisfied with its' language (i.e. use of term 'best interest' or purposeful omission of the word 'fiduciary')

Seven of 17 investors at this SEC roundtable expressed significant dissatisfaction with the disclosure. Dissatisfaction due to either misunderstanding the content or disagreeing the content was correct. The question becomes whether this 41% (7 of 17) failure rate, the rate that this group of investors failed to master the material, is acceptable. What about other analyses of Form CRS's effectiveness?

Independent usability testing conducted on behalf of AARP, Consumer Federation of America (CFA), and the Financial Planning Coalition also indicate that Form CRS leaves much to be desired.⁸ The testing found that participants:

- “[D]id not understand disclosures regarding the differing legal obligations that apply to brokerage and advisory accounts”;
- Were confused about what was meant by a fiduciary standard and had mixed understanding of what ‘best interest’ meant
- “[V]iewed the CRS as portraying brokerage accounts in a more favorable light than advisory accounts” in terms of which business model had to act in the customer’s best interest;
- “[W]ere deeply confused by disclosures regarding fees and costs”; and
- [T]hought conflicts would not impact them.

The study summarized its research by concluding that,

“[D]espite favorable testing conditions that required participants to read the documents more carefully than most would on their own, few participants were able to consistently comprehend the information within a single section of the CRS. Fewer still were able to integrate and synthesize the information provided in the document as a whole.”

Conclusion

Form CRS fails to address investor confusion of how broker dealers and investment advisers differ. It fails to effectively communicate key distinctions, such as compensation and the nature and scope of conflicts of interest. Its language, is written by lawyers and, as Chairman Clayton seems to suggest, for lawyers. Or, some lawyers. Investors, even those who have advanced technical degrees in law or finance, expressed difficulty comprehending the material. (TBC)

⁸ Independent Testing Shows SEC’s Proposed Customer Relationship Summary Form May Add to Investor Confusion, September 12, 2018, <https://press.aarp.org/2018-9-12-Independent-Testing-Shows-SECs-Proposed-Customer-Relationship-Summary-Form-May-Add-Investor-Confusion>