FINRA
Financial Industry Regulatory Authority

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Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File Number 4-606
Study Regarding Obligations of Brokers, Dealers and Investment Advisers

Dear Ms. Murphy:

The Financial Industry Regulatory Authority (FINRA) staff [1] submits this letter in response to the Commission's request for comment to inform its study required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or the legislation) regarding the obligations of brokers, dealers and investment advisers. Among other things, the Commission requests comment on the effectiveness of current regulatory standards of care for broker-dealers and investment advisers when providing personalized investment advice to retail customers; the differences between those standards and whether any such differences result in regulatory gaps in the protection of retail investors; the impact of applying to broker-dealers the standard of care imposed by the Investment Advisers Act of 1940 (Advisers Act); and the examination and enforcement resources devoted to broker-dealers and investment advisers by their respective regulators.

Foremost, FINRA strongly supports a uniform standard of care for broker-dealers and investment advisers when providing personalized investment advice to retail customers. The two financial business models offer different complements of services, and a retail customer may find that one model is better suited to his or her particular circumstances

1 As the largest non-governmental regulator for all securities firms doing business with the public in the United States, FINRA oversees nearly 4,700 brokerage firms, about 167,000 branch offices and more than 635,000 registered securities representatives.

Created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange, FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. FINRA has approximately 2,800 employees and operates from Washington, DC, and New York, NY, with 15 District Offices around the country.

The comments provided in this letter are solely those of the staff of FINRA; they have not been reviewed or endorsed by the Board of Governors of FINRA. For ease of reference, this letter may refer to "we," "FINRA" or "FINRA staff" interchangeably, but these terms refer only to FINRA staff.

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and objectives. However, FINRA believes that no matter where a retail customer chooses to obtain investment advice, the standard of care applied to the investment professional should be the same: a fiduciary duty to act in the best interests of the customer without regard to the professional's financial or other interests.

In advocating this uniform standard of care, we note that the fiduciary standard is derived from common law agency principles of trust and confidence and can be applied differently depending on the nature of the relationship and dealings between the parties. This is because the common law permits the principal and agent to define by agreement the scope of the agent's duty to the principal, including any circumstances where the agent may have a permissible conflict. The Advisers Act effectively implements, and defines limits to, the scope of the agency relationship between an investment adviser and a customer. It requires, among other things, upfront disclosure of conflicts on Form ADV and prohibits certain conduct, such as principal trading without trade-by-trade customer consent, where a conflict is deemed too pronounced to be cured by disclosure. Thus, the fiduciary duty owed by an investment adviser to a retail customer is not absolute, as the customer may consent to certain conflicts after disclosure.

FINRA urges the Commission to recognize these common law principles and legislative precedent in applying a fiduciary standard to broker-dealers. As explained below, the Commission should not merely export to broker-dealers the regulatory scheme applied to advisers under the Advisers Act or eliminate the broker-dealer exemption from that statute. FINRA believes those approaches fail to acknowledge the specialized role of broker-dealers as liquidity providers, could lessen competition for financial services and deprive investors of valuable information, such as research. Instead, the Commission should apply the fiduciary standard to broker-dealers in a way that respects the purpose of the enacting legislation and allows for the differences between the investment adviser and broker-dealer models.

FINRA therefore encourages the following. The Commission should make express that both investment advisers and broker-dealers owe a fiduciary duty to their retail customers when providing personalized investment advice. Rules to implement that standard should incorporate common law agency principles and require cogent, plain English disclosure at the time of account opening of permissible conflicts, describe in detail how the adviser or broker-dealer will manage those conflicts and prohibit conduct where conflicts are not attendant to acting in the best interests of the customer. Yet, the rules should also recognize the unique role of broker-dealers in the marketplace and preserve the more detailed rules currently applied to them that arguably raise the level of protection for retail customers.

We believe such a regulatory scheme is consistent with the intent of Dodd-Frank. To that end, we note that the legislation provides that any rules to implement a fiduciary standard may permit material conflicts to be disclosed and consented to by a customer. It further endorses differing application of the fiduciary standard to broker-dealers by excluding, for example, any requirement that a broker-dealer have a continuing duty of care or loyalty to the retail customer after providing personalized investment advice about securities.

We address in more detail below these and other issues on which the Commission requests comment. First, we discuss the legal regulatory gaps between the current regulatory schemes for broker-dealers and investment advisers and recommend an approach to bridge these gaps and to raise the standards applied in both channels. Second, we detail the considerable resources FINRA devotes to examination and enforcement of compliance with its rules and the securities laws by broker-dealers and explain how investment adviser oversight would benefit from the added layer of investment protection and resources of a self-regulatory organization (SRO). Third, we discuss the advantages of using the highly detailed sales practice prescriptions in broker-dealer regulation to augment a fiduciary standard. We also explain the practical differences in the application of the standards of care provided to retail customers by broker-dealers and investment advisers. Finally, we consider the impact of applying the Advisers Act standards to broker-dealers or eliminating the broker-dealer exemption from the definition of investment adviser.

Legal Regulatory Gaps

Both the broker-dealer and investment adviser regulatory schemes offer effective protection for retail customers, but they employ different approaches and standards. And while both rely substantially on disclosure as a means of transparency and investor protection, FINRA believes a gap exists with respect to the scope, timing and manner of such disclosure. This is especially problematic given that many retail investors, due to increasingly blurred business models, cannot distinguish between what constitutes advisory services versus brokerage services – a finding of the RAND Corporation's earlier report on practices of broker-dealers and investment advisers.[2]

FINRA believes that the overall level of protection for retail customers can be elevated by bridging these gaps and employing the detailed requirements of broker-dealer regulation as a valuable supplement to enhance and improve the fiduciary standard for broker-dealers. As discussed below, broker-dealer regulation, while lacking an express fiduciary duty, relies on a suitability standard and prescribes in far greater detail the conduct and supervision of those who provide investment advice to retail customers.[3]

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2 Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (2008) (the RAND Study).

3 FINRA's suitability rule is the core sales practice standard currently applied to broker-dealers when providing personalized investment advice to retail customers. The rule requires a broker-dealer, when recommending a securities transaction or strategy, to have reasonable grounds to believe the recommendation is suitable for the customer based on the customer's financial situation and needs. The rule further requires a broker-dealer, prior to execution of a recommended transaction, to make reasonable efforts to obtain information about a retail non-institutional customer's financial and tax status, investment objectives and other reasonably necessary information related to the recommendation. The particularized

Many of those conduct rules require particularized disclosures related to the applicable conduct, *e.g.*, the disclosure of conflicts unique to the production and distribution of research. However, there is no broker-dealer equivalent to the Advisers Act Form ADV, which requires upfront general disclosure regarding the nature of an investment adviser's business activities or relationships that could give rise to conflicts between the investment adviser and the retail customer, such as financial industry affiliations and compensation arrangements.

Accordingly, FINRA suggests that as a means to establish the contours of a fiduciary standard owed by a broker-dealer to a retail customer, the Commission require that broker-dealers provide such customers at account opening a Form ADV-like disclosure document that provides essential information about the nature of the broker-dealer's products and services, including any activities that could conflict with its duty to act in the best interests of the customer. The disclosure document should be in plain English, not so long or complicated as to negate its purpose, and allow retail customers to make an informed investment decision. It should set forth in sufficient detail those circumstances where a broker-dealer's interests are not aligned with those of the retail customer, such that the fiduciary relationship can be tailored to address those conflicts.

<u>Resources to Facilitate Improved Regulation of Broker-Dealers and Investment Advisers</u>

As discussed in greater detail below, FINRA believes that the fiduciary standard of care needs to be buttressed and given particularity by a robust and effective set of regulations that augment and deepen the reach of the federal securities laws and whose paramount purpose is protection of retail customers. FINRA believes that this level of regulation in furtherance of the fiduciary standard of care requires a rigorous and comprehensive examination and enforcement regime that is described in more detail below.

FINRA has a dedicated examination staff of more than 1,000 employees. Routine examinations are conducted on a regular schedule that is established based on a risk-profile model. This model permits FINRA to focus our resources on the sources that are most likely to harm investors. In performing its risk assessment, FINRA considers a firm's business activities, methods of operation, types of products offered, compliance profile and financial condition, among other things. FINRA also conducts targeted examinations based on information received included customer complaints, referrals from market surveillance staff and arbitrations. In 2009, we conducted approximately 2,500 routine examinations and over 8,000 targeted examinations in response to events such as customer complaints, terminations for cause and regulatory tips. Recent enhancements to the FINRA examination programs touch on investment adviser activity to the extent FINRA has jurisdiction; for example, identifying indications of problematic behavior with the opening of investment advisory accounts at broker-dealers and verifying

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requirements of the rule is well-established in case law and various regulatory notices and FINRA believes that its prescriptive requirements may be of value in buttressing the general standard of acting in the best interests of the client under the fiduciary standard of care.

compliance with custody requirements when firms have a higher level of control over customer assets, such as when acting as both adviser and broker to customers.

FINRA's enforcement program is equally comprehensive and is dedicated to vigorous and evenhanded enforcement of the Exchange Act and FINRA and MSRB rules. FINRA brings disciplinary actions against firms and their employees that may result in sanctions ranging from cautionary actions for minor offenses to fines, suspensions from the business and, in egregious cases, expulsion from the industry. FINRA frequently requires firms to provide restitution to harmed investors and often imposes other conditions on a firm's business to prevent repeated wrongdoing. In 2009, FINRA took 993 disciplinary actions, barring 383 individuals, suspending 363 others and expelling 20 firms. We levied fines against firms and individuals totaling nearly $50 million. In addition, we ordered firms and individuals to return more than $8.2 million in restitution to investors.

In sum, defense of a fiduciary standard of care, whether it be for a broker-dealer or investment adviser requires the dedicated oversight of significant regulatory resources. It is achieved in the broker-dealer channel due in large part to the existence of an SRO – FINRA – inserted as an additional layer of regulation subject to SEC oversight. As an SRO, FINRA can raise the standard of conduct in the industry by imposing enforceable ethical rules beyond those that federal statutes establish, thereby reaching conduct that might not be illegal, but nonetheless can undermine customer confidence and trust in their investment professional. Moreover, FINRA (and other SROs) are funded almost entirely by the securities industry – not federal taxpayers – yet FINRA's governance structure consists of a majority of non-industry representatives to ensure paramount focus on investor protection and guard against undue influence by the industry. The self-funding mechanism allows FINRA to dedicate a breadth of examination and enforcement resources that are not always available to federal agencies. FINRA believes that SRO oversight can provide escalated and valuable protections for customers regardless of the channel, *i.e.*, broker-dealer or investment adviser, and that the absence of an SRO for investment advisers has therefore resulted in a disparity in the scope and effectiveness of regulation between broker-dealers and investment advisers.

<u>Current Broker-Dealer Standards that Enhance a Fiduciary Duty</u>

In addition to mandating ethical standards, FINRA prescribes specific conduct related to those day-to-day operations of securities firms that most directly affect investors. We provide some examples of such rules below. FINRA believes these additional prescriptive rules have proven to be a valuable supplement to more principles-based sales practice standards that would exist in a regulatory regime that relies solely on a fiduciary standard of care. Consequently, while FINRA agrees that a fiduciary duty is an essential component to the standard of care for both broker-dealers and investment advisers, FINRA believes the added texture of prescriptive sales practice rules provides a higher standard of protection for retail and less sophisticated institutional customers.

Supervision Rules

The supervisory obligations imposed on broker-dealers are illustrative of the detailed standards applied to broker-dealers in the context of providing personalized investment advice and securities recommendations. FINRA rules require every firm to put in place a supervisory system reasonably designed to ensure compliance with the securities laws and highly particularized FINRA rules.[4] Firms must designate licensed supervisors to oversee each aspect of a firm's securities business and maintain written procedures for those supervisors to follow.[5] Firms further must test their supervisory systems at least annually and document and correct any deficiencies.[6] By comparison, the Advisers Act does not require licensed supervisors to oversee all aspects of the adviser's business. It requires only that an investment adviser maintain a compliance program, to be reviewed annually, that is reasonably designed to prevent a violation of the Advisers Act, which does not contain prescriptive sales practice rules, and to detect and address any violations that have occurred.[7] And rather than promulgate specific, enforceable ethical rules, the Advisers Act requires advisers to establish, maintain and enforce a code of ethics that sets forth, among other provisions, standards of business conduct that reflect the fiduciary obligations of the adviser and its supervised employees.[8]

Communications with the Public Rules

FINRA also imposes a detailed regulatory scheme to ensure that broker-dealers' communications with the public are not misleading. FINRA rules require that advertisements, Web sites, sales brochures and other communications present information in a fair and balanced manner, and FINRA maintains a dedicated staff to review communications for compliance. Some communications – those related to mutual funds, variable products and options, for example – must be filed with FINRA for review. In addition, FINRA staff spot checks other sales material and periodically conducts sweeps. FINRA's Advertising Department also investigates complaints related to communications with the public and refers matters to the Enforcement Department for disposition. In 2009, FINRA reviewed more than 96,700 pieces of communication and completed 449 investigations.

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4 *See* NASD Rule 3010.

5 *Id.*

6 *See NASD* Rule 3012.

7 *See* 17 CFR § 257.206(4)-7.

8 *See* 17 CFR § 275.204A-1.

Research Conflicts of Interest Rules

Beyond suitability, there also are more specific broker-dealer standards governing the provision of investment advice to retail customers. One example involves the regulation of conflicts in the production and distribution of research and public appearances by research analysts. Retail investors often rely on such research and recommendations expressed through various media outlets in making their investment decisions. FINRA rules therefore require clear, comprehensive and prominent disclosure of conflicts of interest in research reports and public appearances by research analysts and also impose structural proscriptions to ensure the independence of research analysts and objectivity of research.[9] Among other things, the rules require a broker-dealer to disclose if the research analyst or a member of the analyst's household has a financial interest in the securities he or she is recommending; similarly, the rules require disclosure of significant firm holdings in the securities of the subject company. The rules also require disclosure if the broker-dealer has an investment banking or other financial relationship with that subject company and even mandate that every research report be accompanied by a price chart that tracks a research analyst's recommendations and price targets against the stock price of the subject company. In addition, SEC Regulation Analyst Certification further requires research analysts to certify that views expressed in a research report accurately reflect his or her personal views and disclose whether the analyst received compensation or other payments in connection with those views or recommendations.[10]

While investment advisers also produce research and make recommendations in various communications and media appearances, there are no equivalent specific rules addressing objectivity and transparency in research or providing retail customers with more reliable and useful information. Instead, any such conflicts involving investment advisers are governed solely by the common law fiduciary standard and anti-fraud provisions of the Advisers Act.

Customer Order Handling Rules

Another area where broker-dealer regulation builds out the fiduciary standard is in the handling of customer orders. FINRA imposes a suite of rules to ensure that broker-dealers achieve best execution for retail customer orders and subordinate their own trading interests to those of the customers. Courts have recognized best execution as fiduciary duty applicable to both broker-dealers and investment advisers. FINRA rules require broker-dealers to discharge that duty by using reasonable diligence to find the most favorable price for a customer under prevailing market conditions.[11] The rules goes further, however, identifying factors to be considered as part of the reasonable diligence

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9 *See* NASD Rule 2711.

10 *See* 17 CFR § 242.500 et seq.

11 *See* NASD Rule 2320.

determination and delineating conduct that fails to satisfy the obligation.[12] In addition to this best execution obligation, FINRA rules further prohibit broker-dealers from trading ahead of customer market and limit orders.[13] These rules prohibit a member from trading a security on the same side of the market for its own account unless it fills the market order at the same or better price and from trading for in their own accounts at prices equal or superior to that of a customer limit order without first executing that order. Another FINRA rule prohibits a broker-dealer from trading in its own account to the detriment of a customer based on non-public material information of a pending block transaction.[14] Together, these rules unfold the fiduciary standard in a more specific manner that augments protection for retail customers.

Impact of Applying Investment Adviser Requirements on Broker-Dealers

FINRA believes it would be a mistake to either (1) impose the investment adviser standard of care and other requirements of the Advisers Act to broker-dealers or (2) eliminate the broker-dealer exclusion from the definition of "investment adviser" under Section 202(a)(11)(C) of the Advisers Act. Either of those options would negatively impact the availability of investment advice and services for retail customers, reduce competition in the financial services market and potentially disrupt existing relationships between retail customers and their brokers.

Broker-dealers provide an important liquidity function by buying and selling securities from their own account. The Advisers Act prohibits an investment adviser from acting as principal for his own account without disclosing to such client in writing the capacity in which he is acting before completion of the transaction and obtaining the consent of the client to the transaction.[15] Thus, if the Commission imposes on broker-dealers the identical investment adviser application of a fiduciary duty to retail customers, it would force broker-dealers to either cease providing investment advice to retail customers or forego one of the defining aspects of the broker-dealers model that significantly contributes to market liquidity and efficiency. Both of those repercussions inure to the detriment of retail customers: the former would reduce competition for financial services and might deprive customers of continued association with the financial professional or firm of their choice; the latter could reduce market liquidity and increase volatility and raise trading costs to retail customers. FINRA therefore believes it makes more sense to continue to permit brokers to provide investment advice incidental to their brokerage services, but require disclosure of the principal trading conflict in the account opening ADV-like disclosure form discussed above and further require broker-dealers to maintain

12 *Id.*

13 *See* NASD Interpretive Material 2110-2 and Rule 2111.

14 *See* NASD Interpretive Material 2110-3.

See Advisers Act § 206(3). This prohibition does not apply to any transaction with a customer of a broker-dealer if the broker-dealer is not acting as an investment adviser in the relation to the transaction.

information barriers between the trading desk and those providing investment advice to retail customers.

Similar consequences would flow if the Commission chooses to eliminate the broker-dealer exclusion under the Advisers Act. That action effectively would require any broker-dealer that provides investment advice to register as an investment adviser and be subject to the entirety of the Advisers Act, unless otherwise exempt. This approach would more clearly dampen competition in the financial services market by virtually eliminating the ability of retail customers to procure investment advice traditionally available in the broker-dealer channel. It could also reduce the sources of research available to assist retail customers to make more informed investment decisions. Broker-dealers currently produce substantial quantities of research for the benefit of retail customers. But if the Commission abolishes the broker-dealer exclusion, such research might constitute investment advice that would trigger registration under the Advisers Act, and broker-dealers might opt to cease production rather than risk violating the Act.

Either of these rulemaking options likely would generate a spike in registration under the Advisers Act by current broker-dealers and their associated persons. That result would carry its own ramifications. For one thing, it would impose additional regulatory costs and burdens on those new investment advisers, including additional state licensing, registration and examination requirements on some individuals. For another, the influx of investment advisers would further strain the Commission's already limited resources to examine the conduct of advisers.

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We hope these comments prove helpful as the Commission conducts its study regarding broker-dealer and investment adviser regulation, and we thank you for the opportunity to express our views on these important issues. Please contact me at (202) 728-8410 or Philip Shaikun at (202) 728-8451 if you have any questions.

Very truly yours,

Marc Menchel