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August 30, 2010

Elizabeth M. Murphy

Secretary

U.S. Securities and Exchange Commission

100 F Street, NE

Washington, DC 20549-1090

RE: "Study Regarding Obligations of Brokers, Dealers and Investment Advisers," File No. 4-606

Dear Ms. Murphy,

LPL Financial Corporation ("LPL Financial") is pleased to respond to the request for comment[1] of the Securities and Exchange Commission (the "SEC" or "Commission") for the study required under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). LPL Financial is an independent broker-dealer with over 2,500 employees and offices in Boston, Charlotte, and San Diego. LPL Financial and its affiliates offer proprietary technology, comprehensive clearing and compliance services, practice management programs and training, and independent research to over 12,000 independent financial advisors and financial advisors within banks and credit unions. Additionally, the company supports over 4,000 financial advisors who are affiliated and licensed with insurance companies with customized clearing, advisory platforms and technology solutions. Dually registered as an investment adviser and a broker-dealer, LPL Financial provides both advisory and brokerage services to its clients and has extensive experience with the two regulatory regimes.

LPL Financial believes that harmonization of the standard of conduct applicable to investment advisers and broker-dealers providing the same service to retail clients, namely personalized investment advice about securities, is an important and worthwhile step. Securities professionals providing the same service to retail customers should be held to the same standard

[1] "Study Regarding Obligations of Brokers, Dealers and Investment Advisers," SEC Release No. 34-62577; IA-3058; File No. 4-606 (July 27, 2010) (the "Request for Comment").

of care and the same best practices; investors should not have to navigate the intersection of two regulatory regimes in order to understand the scope of the applicable protections. The focus of the analysis should be consumer protection and enhanced transparency to the retail client.

Existing pre-conceptions surrounding the investment advisory and brokerage regulatory regimes should not dictate the starting point for the study or the Commission's analysis. Without regard to licenses, form of compensation, or labels the goal should be to integrate standards of conduct to devise a uniform standard clearly defined and understood by the retail client receiving personalized investment advice.

LPL Financial hopes that at the conclusion of this study, the Commission will use the authority provided by Section 913 to promulgate rules under the Securities Exchange Act of 1934 (the "Exchange Act") and the Investment Advisers Act of 1940 (the "Advisers Act") to establish a uniform standard of care.

In addition, LPL Financial believes that the statutes and rules that govern investment advisers and broker-dealers should be harmonized more generally. This letter will review some of the most important disparities that LPL Financial perceives between the two regulatory regimes. LPL Financial respectfully requests the Commission take these comments into account in conducting the study of the need for enhanced examination and enforcement resources for investment advisers as mandated by Section 914 of the Dodd-Frank Act.

I. Legal or Regulatory Gaps, Shortcomings or Overlaps

The broad issue posed by the Commission in the Request for Comment is "whether there are legal or regulatory gaps, shortcomings or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers [and] investment advisers…that should be addressed by rule or statute."[2] As described in greater detail below, LPL Financial believes strongly that the Exchange Act and the Advisers Act impose different duties on registered broker-dealers and investment advisers respectively. The boundaries between broker-dealers and investment advisers have blurred since 1940. After 1975, broker-dealers began providing more investment advice to clients as they were no longer constrained to charging fixed commissions. Many firms also began to provide both brokerage and advisory services as dual registrants subject to both the Exchange Act and the Advisers Act. Nonetheless, the two separate regulatory regimes have remained, imposing different requirements for similar activities.

Although the Advisers Act does not contain express fiduciary duty provisions, Section 206 of the Advisers Act is a general antifraud provision. The Supreme Court has held that this

[2] Request for Comment, at 2-3.

antifraud provision imposes fiduciary duties on investment advisers.[3] The SEC has interpreted Section 206 to require an investment adviser to disclose to its clients all material facts about the adviser relationship. The SEC has further interpreted the section to impose a duty on an investment adviser to act only in the best interest of its clients, which requires that the investment adviser place the interests of its clients above its own interests when a conflict may be present. In some instances, the SEC has said that the investment adviser must disclose the existence of any conflict and obtain the client's consent to the relevant arrangement. In other instances, it appears to be sufficient for the adviser to have made general disclosure about the conflict in its Form ADV disclosures to its clients.

In addition to these general principles, the Commission has developed a number of practices required of investment advisers based on their status as fiduciaries. For example, the SEC closely regulates the allocation of orders for new issue securities or other limited supply investment opportunities by registered investment advisers. The SEC has also said that investment advisers have an affirmative obligation to vote proxies on securities held by their clients. Additionally, the SEC has used the fiduciary duty to impose other responsibilities on investment advisers, such as a duty to provide only suitable investment advice and a duty to provide full and fair disclosure to clients when recommending affiliated service providers.

While the Exchange Act contains antifraud provisions that are substantially similar to Section 206 of the Advisers Act, courts have not found that these provisions necessarily impose a fiduciary duty on broker-dealers. Instead, the nature of a broker-dealer's duty to a customer depends on its relationship with and the services it provides to that customer. When broker-dealers provide brokerage services only to clients, they are not held to a fiduciary duty.[4] When broker-dealers also provide investment advice, they may be subject to a fiduciary duty, depending on the nature of their relationship with the customer.[5] Courts evaluate the totality of the circumstances to determine the nature of the relationship between the broker-dealer and the customer, including the customer degree of sophistication; the course of conduct between the parties; and the broker-dealer's past activities as an investment adviser.[6] In addition, courts and the SEC have found that broker-dealers have a fiduciary duty to customers when acting in a position of trust and confidence, such as by exercising discretionary authority to purchase or sell securities for a customer's account.[7]

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[3] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (finding that investment advisers have fiduciary duty to clients).
[4] See, e.g., Levitin v. PaineWebber, Inc., 159 F.3d 698, 707 (2d Cir. 1998) ("Under New York law, `[a] broker does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities.'" (citations omitted)), cert. denied, 525 U.S. 1144 (1999).
[5] See, e.g., Romano v. Merrill Lynch, 834 F.2d 523, 530 (5th Cir. 1987).
[6] See, e.g., Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 516-518 (Colo. 1986).
[7] See, e.g., SEC v. Zandford, 535 U.S. 813, 823 (2002) (sale of customer's securities and unauthorized use of proceeds for broker's own benefit constituted fraud and breach of fiduciary duty where customer trusted broker to make discretionary transactions in customer's best interest).

Broker-dealers are subject to rules requiring fair dealing and just and equitable principles of trade. The Commission has adopted rules under the Exchange Act establishing, among other things, investor protection, net capital and record-keeping requirements for broker-dealers. FINRA enforces numerous conduct rules, which require member broker-dealers to buy or sell a security at a price that is fair, meaning reasonably related to the current market price; to limit markups so they generally do not exceed 5% of the current market price; and to provide "best execution," meaning using reasonable diligence to ascertain the best market for the security and buying or selling in that market so that the price to the customer is as favorable as possible under prevailing market conditions. In addition, FINRA rules require member broker-dealers to have a reasonable ground for believing a recommendation to a customer is suitable for that customer as to his or her portfolio, financial situation and needs.

In short, investors would benefit from greater clarity regarding the duties owed to them by broker-dealers and investment advisers. Investment advisers are fiduciaries while broker-dealers may or may not be, based on the circumstances of their relationships with particular customers. Broker-dealers are held to a different standard of conduct when they do not provide investment advice and when they do not act in a position of trust and confidence. Broker-dealers are subject to specific rules regarding their conduct that may not apply to investment advisers. In these circumstances, investors find it difficult to form an understanding of the applicable standard of care.

II. Elements of a Rulemaking Addressing the Standards of Care for Brokers, Dealers and Investment Advisers

LPL Financial believes the common standard of care for brokers, dealers and investment advisers should be based on the fiduciary principles under the law of agency. When a financial services firm provides personalized investment advice to a retail customer, the individual retains a measure of control over the relationship. The individual enters into a contract directly with the firm, receives periodic account statements to monitor the account and the firm's activities, and has the ability to terminate the relationship. In instances involving non-discretionary accounts, it ultimately is the investor's decision whether to implement the advice of the investment adviser or broker-dealer. This relationship is like the relationship between an agent and principal, where an agent consents to act on behalf of the principal and the principal has the right to control the agent's acts.[8]

Following the law of agency, LPL Financial recommends that the Commission define the scope of the common standard to require firms to act loyally for the client's benefit in all matters connected with the relationship, using the same care, competence and diligence that a prudent person would exercise in similar circumstances. The Commission should permit the parties to agree to define the scope of the duties of a broker-dealer or investment adviser in an agreement

[8] See, e.g., Restatement (Third) of Agency Sec. 8.01, cmt. B (2006).

at the beginning of the relationship, and to consent to specific arrangements before or after the conduct occurs, as appropriate. A broker-dealer or investment adviser would have a duty not engage in the following without the client's consent:

1. Materially benefitting from transactions conducted on its behalf or from the use of its position;
2. Dealing with the client as or on behalf of an adverse party in a transaction connected with the relationship;
3. Competing with the client or assisting or taking action on behalf of the client's competitors before the relationship between the client and the firm is terminated; and
4. Using the client's property or confidential information for its own purposes for the purposes of a third party.

When obtaining consent from the client, the broker-dealer or investment adviser would be required to act in good faith and to disclose all material facts that the intermediary knows, or has reason to know, would reasonably affect the client's judgment. Additionally, the intermediary would have to deal fairly with the client.

This standard of care would apply to the provision of all personalized investment advice to retail clients, including discretionary advice, non-discretionary advice and financial planning. The application of the standard, however, would differ for each and the Commission would delineate by rule the parameters of the duty. In a discretionary account, a broker-dealer or investment adviser is responsible not just for generating advice but also is charged with making and implementing investment decisions and monitoring the client's account. A firm providing discretionary advice would be subject to a fiduciary duty while providing all of these services.

In contrast, intermediaries providing non-discretionary advice, including financial planning, focus solely on providing investment advice to a customer and do not make ultimate decisions of whether to make an investment. Broker-dealers may or may not be asked to execute trades to implement the non-discretionary advice after it is given. Nor are persons providing non-discretionary advice generally responsible for monitoring the day-to-day activities of a non-discretionary account. Broker-dealers and investment advisers providing non-discretionary investment advice should not have an obligation to monitor the information that may affect the client's portfolio, monitor the investments in the client's account, keep the client informed of developments that may affect the client's investments, or offer any other on-going advice. Broker-dealers and investment advisers providing a financial plan should be able to limit the scope of their services to the creation and delivery of the plan by the terms of their agreement with the client. Finally, the Commission should clarify that an intermediary that provides both brokerage and investment advisory services owes the duty of care only with respect to those accounts for which it provides personalized investment advice to retail customers.

The Request for Comment invites comment on the "potential impact of eliminating the broker and dealer exclusion from the definition of 'investment adviser' under Section 202(a)(11)(C)" of the Advisers Act.[9] LPL Financial believes this would have unintended and disruptive consequences. As the regulatory regime under the Advisers Act is generally less burdensome, it would induce broker-dealers to give up their Exchange Act registrations. This would require significant reallocation of regulatory resources. It also could limit consumer choices, as discount brokerage services and incidental brokerage transactions could become scarce and more expensive. The Dodd-Frank Act appropriately eschewed this outcome by instead providing the Commission with regulatory authority to establish a uniform standard of care for broker-dealers and investment advisers.

III. Harmonization of Regulations Applicable to Broker-Dealers and Investment Advisers

LPL Financial urges the Commission to use the Section 913 study regarding the standards of care for brokers, dealers and investment advisers, and the Section 914 study of regulatory resources for investment advisers, as an opportunity to review comprehensively the different regulatory requirements for SEC-registered broker-dealers and investment advisers providing similar services. As described in greater detail below, registration as an investment adviser entails less regulatory oversight and fewer financial responsibilities than registration as a broker-dealer. LPL Financial is concerned that subjecting broker-dealers to a fiduciary standard without addressing the regulatory disparities could lead firms and individuals to give up their broker-dealer and registered representative licenses and offer advisory services exclusively. This would have the unintended consequence of reducing investor protection, as fewer resources would be available for oversight of these firms and personnel. There is also a potential to limit access to product or services if brokerage services are not available. LPL Financial believes the SEC should act to harmonize where appropriate the regulatory requirements for securities professionals performing similar services, namely the provision of personalized investment advice to retail customers.

Under the current regulatory regimes, broker-dealers generally are subject to more comprehensive oversight and more frequent on-site inspection than are investment advisers. To cite a few examples of the discrepancies, a broker-dealer must maintain licensing for the firm's agents; ensure registered personnel pass qualification examinations and participate in continuing education programs; maintain minimum net capital; obtain a fidelity bond from an insurance company; and obtain audited financial statements. Investment advisers are not subject to any of these important investor protection requirements. Extending certain requirements to investment advisers, such as membership in a self-regulatory organization, would require Congressional action. The Commission has statutory authority, however, to implement other elements of regulatory harmonization. LPL Financial believes the SEC should bring these requirements as

[9] Request for Comment at 5.

closely into alignment as possible by amending existing rules and adopting new rules under the relevant statutes.

Following are examples of steps the SEC could take to promote harmonization of regulation of broker-dealers and investment advisers providing personalized investment advice to retail customers:

- Harmonize the registration process and requirements for broker-dealers and investment advisers to the extent possible;
- Require broker-dealers and investment advisers to provide new customers with a uniform plain English disclosure brochure explaining the various services offered to clients, the nature of the firm's relationships with clients, the capacity in which the firm is acting when providing each service offered (adviser vs. broker-dealer); material conflicts of interest, and material relationships;
- Require that all recommendations by a broker-dealer or investment adviser be suitable based on information about the client's goals and objectives;
- Establish advertising and sales literature standards that are applied according to the types of services provided, beyond the existing Advisers Act antifraud standard;
- Require the same recordkeeping requirements for broker-dealers and investment advisers under the Exchange Act and Advisers Act respectively, with the same time periods and the same types of records that must be kept.
- Require investment advisers to maintain licensing for the firm's personnel and require those registered personnel to pass qualification examinations and participate in continuing education programs.
- Require investment advisers to maintain minimum net capital standards.
- Require investment advisers to obtain audited financial statements and fidelity bonds.
- Establish parallel, equally vigorous and frequent regulatory examinations of investment advisers and broker-dealers.

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As the Commission and Congress have recognized, investors are confused by the current regulatory schemes, which impose different duties and requirements on federally registered broker-dealers and investment advisers. In addition, dually-registered firms experience difficulties from overlapping regulations that impose different requirements for similar activities. Harmonizing the standard of conduct applicable to broker-dealers and investment advisers providing personalized investment advice to retail customers would reduce this confusion and promote investor protection. At the same time, the SEC should use its authority to harmonize the regulatory requirements for broker-dealers and investment advisers. This would ensure that securities professionals performing the same service are subject to an equivalent degree of oversight and investors receive an equivalent measure of protection.

LPL Financial appreciates the opportunity to comment on these important issues and would be pleased to enter into a further dialogue with the Commission and its staff. Please contact me at (617) 897-4340 regarding any questions raised by this letter or to discuss these comments in greater detail.

Sincerely,

Stephanie L Brown

Stephanie L. Brown

APPENDIX

ANSWERS TO QUESTIONS POSED IN REQUEST FOR COMMENT

Question 1.

[Comment on] the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association, and other Federal and State legal or regulatory standards.

As discussed above, the effectiveness of the existing standards of care for brokers, dealers, investment advisers and their associated persons is undermined by the discrepancies regarding the different duties imposed by the Exchange Act and the Advisers Act and by the resulting confusion experienced by retail investors. Each statute provides separate and distinct obligations designed to address the different services provided by broker-dealers and investment advisors. Investors find it difficult to form an understanding of the applicable standard of care, rendering those standards less effective as a means of investor protection.

Question 2.

[Comment on] whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protections of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.

As discussed above, there are gaps in the standards of care for retail customers receiving personalized investment advice about securities. Investment advisers are fiduciaries while broker-dealers may or may not be, based on the circumstances of their relationships with particular customers. Broker-dealers are subject to specific rules regarding their conduct that may not apply to investment advisers. These gaps should be addressed by rule to the extent possible and by statute if necessary.

Question 3.

[Comment on] whether retail customers understand that there are different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers in the provision of personalized investment advice about securities to retail customers.

As independent studies have corroborated, retail investors find it difficult to form an understanding of the applicable standard of care when receiving personalized investment advice about securities. The licensing distinctions and different regulatory regimes are not meaningful to retail investors.

Question 4.

[Comment on] whether the existence of different standards of care applicable to brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers is a source of confusion for retail customers regarding the quality of personalized investment advice that retail customers receive.

While retail customers may not be confused about the quality of personalized investment advice they receive, they are confused about the standard of care owed to them by different securities professionals and about what practices are permissible.

Question 5.

[Comment on] the regulatory, examination, and enforcement resources devoted to, and activities of, the Commission, the States, and a national securities association to enforce the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers when providing personalized investment advice and recommendations about securities to retail customers, including –

(A) the effectiveness of the examinations of brokers, dealers, and investment** advisers **in determining compliance with regulations:
(B) the frequency of the examinations; and
(C) the length of time of the examinations.

Brokers and dealers have a well established SRO, FINRA. Examinations by FINRA occur regularly and with a frequency determined by the size, complexity, and risk profile of the broker or dealer.

There is no SRO for investment advisers and the examination process is bifurcated between the states and the SEC on the basis of assets under management by the investment adviser. Further, the frequency of examination has varied greatly on the basis of resources among the federal and state investment advisory regulatory authorities.

More frequent, in depth examinations by skilled examiners is essential to effective regulatory oversight. The examination program for investment advisers should be evaluated and enhanced in connection with the SEC study. To the extent an SRO is a necessary component of a rigorous examination program the SEC should evaluate establishment of a SRO and the possible delegation of examination authority to FINRA for dual registrants.

Question 6.

[Comment on] the substantive differences in the regulation of brokers, dealers, and investment advisers, when providing personalized investment advice and recommendations about securities to retail customers.

As discussed above, there are many substantive differences in the regulation of broker-dealers and investment advisers when providing personalized investment advice to retail customers. While investment advisers are fiduciaries, broker-dealers may or may not be based on the circumstances of their relationships with particular customers. For example, investment advisers may be required to make disclosure of relationships with affiliates and conflicts of interest that are not required of broker-dealers. Conversely, FINRA enforces numerous conduct rules applying to its member broker-dealers, such as limitations on markups, AML rules and best execution obligations that may not apply to investment advisers. FINRA rules require member broker-dealers to have a reasonable ground for believing a recommendation to a customer is suitable for that customer as to his or her portfolio, financial situation and needs. This requirement has not been as clearly defined in the regulations that apply to investment advisers.

Question 7.

[Comment on] the specific instances related to the provision of personalized investment advice about securities in which –

- ***(A) the regulation and oversight of investment advisers provide greater protection to retail customers that the regulation and oversight of brokers and dealers; and***
- ***(B) the regulation and oversight of brokers and dealers provide greater protection to retail customers than the regulation and oversight of investment advisers.***

We have attached two memoranda that address differences in the regulation and oversight of investment advisors, brokers, and dealers and that recommend areas of harmonization. There are fundamentally different services provided by these types of financial services professionals that require differences in regulation and oversight.

A thoughtful and in depth consideration of the different services and products offered through advisory and brokerage relationships is necessary to the development of a uniform standard of conduct. The existing regulatory regimes each has its own strengths that should be maintained and potentially extended to the services provided by advisors, brokers, and dealers, respectively.

By way of illustration, the required disclosure of conflicts of interest and the delivery of a brochure to a potential client describing services, investment skills, regulatory record, pricing for services, and conflicts of interest, among other information points, is a strength in the advisory regulatory regime.

In the brokerage arena, the existence of detailed supervisory requirements and guidelines as to suitability determinations that are examined for and enforced by an SRO are vital to the brokerage regulatory regime.

Last, and certainly not least, the licensing and membership application process for advisers versus brokers or dealers differs dramatically. We strongly recommend adopting more exacting registration requirements for investment advisers that mirror the FINRA membership process.

Question 8.

[Comment on] the existing legal or regulatory standards of State securities regulators and other regulators intended to protect retail investors.

We engage in business as a FINRA member and SEC registered investment adviser in all 50 states. Although uniformity is a long standing goal of NASAA, it is an ongoing endeavor. Regulatory resources vary state to state leading to substantially different levels of oversight. It is important that uniform minimum levels of regulation and examination be established among the states. To the extent the SEC can assist in establishing and promoting uniform and strong state oversight of brokers, dealers or advisers registered at the state level, it should do so. Protection of retail investors should not vary on the basis of home address. It appears the Dodd-Frank Act provides the SEC authority to do this.

Question 9.

[Comment on] the potential impact on retail customers, including the potential impact on access of retail customers to the range of products and services offered by brokers and dealers, of imposing upon brokers, dealers and persons associated with brokers or dealers –

> ***(A) the standard of care applied under the Investment Advisers Act of 1940 for providing personalized investment advice about securities to retail customers of investment advisers, as interpreted by the Commission and the courts; and***
> ***(B) other requirements of the Investment Advisers Act of 1940.***

It is fundamentally important, in developing the standard of conduct, for investors to have the same access to and choice among financial products, services and providers. As we have stated in our comment letter, imposition of the existing standard of care under the Advisers Act upon brokers, dealers and their associated persons thereof may result in the following deleterious consequences:

- relinquishment of brokerage licenses;
- inability to offer certain services and products (unless exemptions were created), including, without limitation, cash sweep services, discount and unsolicited brokerage services, underwriting, proprietary product sales, certain incentive based compensation

arrangements, incidental advice in connection with non-discretionary, commission-based trading, and principal trading.

- to the extent brokerage licenses are relinquished the existing, extensive regulation provided under the Exchange Act would not apply to the services provided to investors.

Question 10.

[Comment on] the potential impact of eliminating the broker and dealer exclusion from the definition of "investment adviser" under section 202(a)(11)(C) of the Investment Advisers Act of 1940, in terms of –

(A) The impact and potential benefits and harm to retail customers that could result from such a change, including any potential impact on access to personalized investment advice and recommendations about securities to retail customers or the availability of such advice and recommendations;

(B) The number of additional entities and individuals that would be required to register under, or become subject to, the Investment Advisers Act of 1940, and the additional requirements to which brokers, dealers, and persons associated with brokers and dealers would become subject, including

(i) Any potential additional associated person licensing, registration, and examination requirements; and

(ii) The additional costs, if any, to the additional entities and individuals; and

(C) The impact on Commission and State resources to –

(i) Conduct examinations of registered investment advisers and the representatives of registered investment advisers, including the impact on the examination cycle; and

(ii) Enforce the standard of care and other applicable requirements imposed under the Investment Advisers Act of 1940.

Eliminating the broker-dealer exclusion from the definition of "investment adviser" under the Advisers Act would have unintended and disruptive consequences. The regulatory regime under the Advisers Act is generally less rigorous. For example, investment advisers are not required to be subject to inspection and regulation by a self-regulatory organization. Elimination of the exclusion would therefore induce broker-dealers to give up their Exchange Act registrations. This would require significant reallocation of regulatory resources. It also could limit consumer choices, as discount brokerage services and incidental brokerage transactions as noted in response to question 9.

There is also a concern as to the cost of asset management services for small accounts with fewer assets and no need for ongoing management services.

<u>Question 11.</u>

[Comment on] the varying level of services provided by brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers to retail customers and the varying scope and terms of retail customer relationships of brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers with such retail customers.

We refer the Commission to the letters submitted by dually licensed financial advisers of LPL Financial for comment on the varying level of services provided by brokers, dealers, investment advisers, and associated persons thereof.

<u>Question 12.</u>

[Comment on] the potential impact upon retail customers that could result from potential changes in the regulatory requirements or legal standards of care affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers relating to their obligations to retail customers regarding the provision of investment advice, including any potential impact on –

- ***(A) protection from fraud;***
- ***(B) access to personalized investment advice, and recommendations about securities to retail customers; or***
- ***(C) the availability of such advice and recommendations.***

There are parallel antifraud provisions in the Advisors Act and Exchange Act which should continue in full force without impact by the establishment of an uniform standard of conduct. As noted in response to questions 9 and 10, attention needs to be paid to preservation of basic brokerage services and products such as incidental advice in connection with a solicited brokerage order. Where personalized investment advice to a retail customer is not being offered, the existing regulatory regime under the Exchange Act and FINRA rules and regulations should remain in force.

<u>Question 13.</u>

[Comment on] the potential additional costs and expenses to –

- ***(A) retail customers regarding, and the potential impact on the profitability of, their investment decisions; and***
- ***(B) brokers, dealers, and investment advisers resulting from potential changes in the regulatory requirements or legal standards affecting brokers, dealers, investment advisers, persons associated with brokers or dealers, and person associated with investment advisers relating to their obligations, including duty of care, to retail customers.***

We have not done an analysis of costs and expenses.

Question 14.

[Comment on] any other considerations commenters would like to comment on to assist the Commission in determining whether to conduct a rulemaking, following the study, to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers.

We have no further comment but remain available and interested in discussing our letter and memoranda with the Commission.

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Date September 29, 2009

To Chairman Mary L. Schapiro
Commissioner Kathleen L. Casey
Commissioner Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes

From LPL Financial Corporation*

Re **The Standard of Conduct for Broker-Dealers and Investment Advisers Providing Personalized Investment Advice**

I. Introduction

Historically, broker-dealers and investment advisers provided different financial services and fees to investors, and their activities were governed by a statutory regime developed during the late 1930s. Although broker-dealers always have provided advice to many of their customers, they traditionally sold securities for a commission on each transaction and were regulated by the Securities Exchange Act of 1934 ("Exchange Act"). Investment advisers traditionally provided investment advice for a fee based on the assets under management and were regulated under the Investment Advisers Act of 1940 ("Advisers Act"). The Exchange Act and the Advisers Act impose different duties and requirements on registrants.

Since 1940, the boundaries between broker-dealers and investment advisers have blurred, but the two separate regulatory regimes have remained. For example, after 1975 broker-dealers were no longer constrained to charging fixed commissions and they began offering services for other forms of compensation, such as charging fixed fees and fees based on assets in the client's account. They also began to provide more investment advice, which they could do without registering as investment advisers if the advice was "solely incidental" to their brokerage services and they received no "special compensation" for the advice. Many firms also began to provide both brokerage and advisory services as dual registrants subject to both the Exchange Act and the Advisers Act.

Although the services that broker-dealers and investment advisers provide to their clients continue to converge, the two different statutory regimes governing the activities of these financial intermediaries have not changed significantly. As discussed in numerous

* LPL Financial Corporation ("LPL") was formed in 1989 through the merger of two small brokerage firms, and currently is one of the nation's leading diversified financial services companies and the largest independent broker/dealer. LPL has extensive experience with the regulatory regimes that govern registered investment advisers and broker-dealers because LPL is dually registered and provides advisory and brokerage services to our clients.

studies and reports, the different requirements have created customer confusion about the differences between the roles of investment advisers and broker-dealers and their related duties to customers. The current regulatory structure also has resulted in overlapping regulations that impose different requirements for similar activities.[1] The Ponzi scheme that Bernard Madoff operated without detection through a dually registered firm subject to oversight by both the SEC and the Financial Industry Regulatory Authority ("FINRA") highlighted the current gaps in regulation and enforcement that have arisen, in part, from the bifurcated statutory and regulatory scheme.

We agree that the statutes and rules that govern investment advisers and broker-dealers should be harmonized more generally, however we believe that a critical first step is harmonizing the standard of conduct applicable to investment advisers and broker-dealers providing the same services to their clients. This memorandum focuses on the need for and factors relevant to developing a universal standard of conduct for brokers, dealers, and investment advisers. As discussed below, we believe that a universal standard is an important gating issue and will be the basis for broader harmonization efforts.

II. Harmonization of the Appropriate Standard is Necessary

The Department of the Treasury, the SEC Chairman, and several SEC Commissioners, among others, have suggested that issues related to customer confusion, and regulatory overlay and gaps should be addressed by harmonizing the regulation of broker-dealers and investment advisers, including, most notably, the standard of conduct required of each intermediary.[2] The Department of the Treasury has proposed legislation that would authorize the SEC to require any brokers, dealers, and investment advisers that provide investment advice about securities to retail customers or clients to be subject to the same

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[1] For example, the Rand Institute for Civil Justice, a division of the RAND Corporation, published a report for the SEC after conducting a study of the financial services industry. The Report noted that the regulation of investment advisers and broker-dealers is not consistent and that investors do not understand differences between broker-dealers and investment advisers, their services or regulations that apply to them. Angela A. Hung et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (RAND Corp. ed., 2008) ("RAND Report"). The Department of the Treasury also proposed changes for the U.S. financial regulatory system, noting the convergence of services broker-dealers and investment advisers provide, and commenting that the separate regulatory regimes currently regulating financial services by function are outdated and inadequate. Department of the Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation 71 (Jun. 17, 2009) ("Financial Regulatory Reform"); Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure 13, 106, 123-126 (Mar. 2008).

[2] *See, e.g.*, Mary L. Schapiro, Chairman, SEC, Address before the New York Financial Writers' Association Annual Awards Dinner (Jun. 18, 2009); Financial Regulatory Reform, *supra* note 1, at 71-72; Elisse B. Walter, Commissioner, SEC, Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?, Address before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 5, 2009); Rachelle Younglai, Reuters, "Rules for Financial Pros Need Work: SEC Member" (Jan. 14, 2009) (interview with SEC Commissioner Kathleen L. Casey); Blueprint for a Modernized Financial Regulatory Structure, *supra* note 1, at 13, 106, 125-126. Commissioner Aguilar has called for a fiduciary standard for broker-dealers that provide investment advice. Louis A. Aguilar, Commissioner, SEC, SEC's Oversight of the Adviser Industry Bolsters Investor Protection, Address before the Investment Advisers Association Annual Conference (May 7, 2009); Luis A. Aguilar, Commissioner, SEC, The Globalization of Investment Advisers – How Will Regulators Respond?, Address before the International Institute for the Regulation and Inspection of Investment Advisers (Jun. 23, 2009).

standard, which would require them to act solely in the interests of the customer or client without regard to the firm's financial or other interests.[3] The legislation also would authorize the SEC to require straightforward disclosure to investors regarding the terms of their relationships with investment professionals, and to examine and, where appropriate, promulgate rules prohibiting certain conflicts of interest and compensation schemes and sales practices that are contrary to the public interest and interests of investors.[4] Chairman Schapiro has indicated her support for the proposed legislation.[5]

As discussed in more detail in Section V below, we believe a universal standard of conduct should apply to all firms that provide personalized investment advice concerning securities to retail clients, should be based on principles derived from the common law of agency, and should recognize that the specific obligations owed to retail investors necessarily depend on the nature of the relationship between the financial service provider and each investor. We support the Treasury's approach of authorizing the Commission to promulgate rules to define the standard and believe that it is critical that application of the standard should be tailored to the specific services offered to investors. We also believe that the various roles and duties undertaken by firms, conflicts of interest and firm compensation practices should be clearly and plainly disclosed to investors. The proposed universal standard will necessitate that the Commission provide additional flexibility to firms as to the manner in which they may address potential and actual conflicts of interest. Finally, it will be critical that the Commission recognize the different types of financial services currently offered to investors when considering

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[3] Investor Protection Act of 2009, Sec. 913. *See also* Financial Regulatory Reform, *supra* note 1 ("Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers").

[4] Investor Protection Act of 2009, Sec. 913.

[5] *See, e.g.,* Mary L. Schapiro, Chairman, SEC, Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Testimony on behalf of the SEC before the H. Comm. on Financial Services (July 22, 2009) (supports proposed legislation's standard and believes "all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients and be subject to equivalent regulation"); Mary L. Schapiro, Chairman, SEC, Address before the New York Financial Writers' Association Annual Awards Dinner, *supra* note 2 ("all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients" which would require the financial service provider to put its clients' interests first, avoid conflicts of interest, and provide full and fair disclosure about and obtain informed consent to any conflicts that cannot be avoided). Other SEC Commissioners also have indicated their support for a uniform standard. *See* Luis A. Aguilar, Commissioner, SEC, The Globalization of Investment Advisers – How Will Regulators Respond?, *supra* note 2 ("As broker-dealers increasingly provide advisory services to their clients, I believe that the higher standards and fiduciary duties of advisers should also be applied to these broker-dealers."); Elisse B. Walter, Commissioner, SEC, Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?, *supra* note 2 ("every financial professional should be subject to a uniform standard of conduct…requir[ing] all financial professionals to act as fiduciaries at all times," but acknowledging that "what a fiduciary duty requires depends on the scope of the engagement"). *See also* Mary L. Schapiro, Chairman, SEC, SEC Oversight: Current State and Agenda, Testimony on behalf of SEC before the Subcomm. on Capital Markets, Insurance and Government-Sponsored Enterprises of the H. Comm. on Financial Services (Jul. 14, 2009); Louis A. Aguilar, Commissioner, SEC, SEC's Oversight of the Adviser Industry Bolsters Investor Protection, *supra* note 2.

standards of care more generally if investors are to be able to have flexibility to select those services that best suit their needs.

We begin our analysis of the universal standard by reviewing fiduciary duties under common law and the current standards of conduct that apply to registered investment advisers and broker-dealers. We then describe the new standard that we recommend.

III. Common Law Origins of Fiduciary Duty

Although there is no single body of general "fiduciary law" under common law, general principles of fiduciary duty that are relevant to investment advisers and broker-dealers are largely derived from the law of agency and the law of trusts.[6] Differences exist between the scope of the fiduciary duty required of agents and trustees, and the need for the fiduciaries to obtain consent for certain types of transactions. These differences demonstrate the inadequacy of simply calling an intermediary a "fiduciary" and emphasize the necessity of clear standards of conduct for broker-dealers and investment advisers to follow when providing specific services. They also illustrate different approaches the Commission could take to further define the universal standard of conduct.

A. Fiduciary Duties in Agency Law

Agency is a fiduciary relationship that arises when an agent consents to act on behalf of the principal, and the principal has the right to control the agent's acts.[7] The general fiduciary duty of an agent is to act loyally for the principal's benefit in all matters connected with the agency relationship.[8] When acting on the principal's behalf, the agent must use care[9] and reasonable efforts to provide information.[10] The principal may agree to define the scope of the agent's duties differently by consenting to a specific act before or after the conduct occurs.[11]

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[6] Anderson, Bagnall, and Smythe, Investment Advisers: Law and Compliance § 9.02[1].

[7] Restatement (Third) of Agency § 1.01 (2006).

[8] *Id.* at § 8.01.

[9] *Id.* at § 8.08. When acting on behalf of the principal, the agent must act with the care, competence, and diligence that are normally exercised by agents in similar circumstances. *Id.*

[10] *Id.* at § 8.11. When an agent knows or has reason to know that the principal would wish to have facts that are subject to the agent's duty to the principal, an agent has a duty to use reasonable efforts to provide the principal with the facts that the agent knows, has reason to know, or should know. *Id.*

[11] *Id.* at § 8.06 cmt. b.

1. Scope of Duty of Loyalty

An agent's duties to the principal vary depending on the parties' agreement.[12] Instead of creating a blanket prohibition on conduct that may create a conflict between the agent's personal interest and the principal's interest, the Restatement (Third) of Agency establishes four areas where the agent must act loyally to the principal. First, the agent has a duty not to materially benefit from transactions conducted on the principal's behalf or from the use of the agent's position.[13] Second, an agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship.[14] Third, the agent must refrain from competing with the principal and from assisting or taking action on behalf of the principal's competitors.[15] Unless the agent has agreed otherwise, the agent has the right to compete with the principal once the agency relationship has terminated.[16] Furthermore, the agent has no duty to disclose that the agent plans to compete with the principal after the termination of relationship, even though the information would be useful to the principal.[17] Finally, the agent has a duty not to use the principal's property or confidential information for its own purposes or for the purposes of a third party.[18]

2. Waiver of Duty of Loyalty

If the agent's conduct would violate any of the four duties of loyalty, the agent must obtain consent from the principal.[19] An agent may obtain consent from the principal for a breach of loyalty before or after the conduct has taken place.[20] When obtaining consent

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12 *Id.* at § 8.01 cmt. c.

13 *Id.* at § 8.02. This applies even if the agent's interest seems consistent with the interest of the principal, and no demonstrable harm was done to the principal. *Id.* at cmt. b. This provision is similar to a trustee's duty to refrain from personal transactions that would give rise to a future conflict of interest. Restatement (Third) of Trusts § 78 cmt. e (2007).

14 Restatement (Third) of Agency § 8.03 (2006). "An agent is deemed to act as or for an adverse party when the agent has a substantial economic interest in the party with whom the principal deals" or when the transaction is between the principal and a closely-related associate of the agent. *Id.* at cmt. c. If the agent has contracted with the principal to allow the agent to self-deal, then the agent is subject to a contract-law duty of good faith and fair dealing. *Id.* at cmt. b.

15 *Id.* at § 8.04.

16 *Id.* at cmt. c. A trustee is prohibited from personally acquiring or establishing a business that competes with the business aspects of the trust because it would create a conflict between the trustee's fiduciary duty and the trustee's personal interests. Restatement (Third) of Trusts § 78 cmt. e (2007).

17 Restatement (Third) of Agency § 8.04 cmt. c (2006).

18 *Id.* at § 8.05. This applies even if the agent's use of the principal's property is beneficial to the property. *Id.* at cmt. b.

19 *Id.* at § 8.06.

20 *Id.* at cmt. b.

from the principal, the agent must act in good faith.[21] The agent must disclose all material facts that the agent knows, or has reason to know, would reasonably affect the principal's judgment.[22] Additionally, the agent must deal fairly with the principal.[23] Since the principal cannot broadly release an agent of its fiduciary duties, the principal's consent must concern a specific act that is reasonably expected to occur in the ordinary course of the agency relationship.[24]

When an agent acts for more than one principal in a transaction, the agent must satisfy other requirements to obtain consent. The agent also must disclose to each principal that the agent works for the other principal(s), and all facts that the agent knows, or has reason to know, would reasonably affect the principal's judgment.[25] If the agent's duty of confidentiality to one principal prevents the agent from disclosing material facts to another principal, then the agent must withdraw as an agent to the latter principal.[26]

An agent may rely on customs normally associated with the type of agency relationship for implicit consent to violate the fiduciary duty of loyalty. For example, if it is customary, an agent may receive a material benefit from a third party for conducting business on behalf of the principal[27] or engage in competition with the principal.[28]

B. Fiduciary Duties in Trust Law

Under trust law, the trustee serves as a fiduciary to all beneficiaries of the trust.[29] As a fiduciary, the trustee must exercise prudence when making investment decisions,[30] undivided loyalty when serving the interest of the beneficiaries,[31] and impartiality when balancing competing interests or claims of the beneficiaries.[32] As the duty of loyalty is

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21 *Id.* at § 8.06(1)(a)(i).

22 *Id.* at § 8.06(1)(a)(ii). This applies unless the principal has manifested that such facts are already known, or that the principal does not wish to know them. *Id.*

23 *Id.* § 8.06(1)(a)(iii).

24 *Id.* at § 8.06(1)(b).

25 *Id.* at § 8.06(2)(b). The agent does not have to make such disclosures if the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them. *Id.* at § 8.06(2)(b)(ii).

26 *Id.* at § 8.06 cmt. (d)(2); *see also id.* at § 8.03 cmt. b.

27 *Id.* at § 8.06 cmt. c.

28 *Id.* at cmt. e. However, if the customs are not known to the principal, then the agent is not relieved of the duty. *Id.* at § 8.03 cmt. b.

29 Restatement (Third) of Trusts § 78 cmt. a (2007).

30 *Id.* at § 77.

31 *Id.* at § 78.

32 *Id.* at § 79.

the "cardinal" principle of all fiduciary relationships, the scope, conflict, and waiver of conflict should be considered under the duty of loyalty. The loyalty required of a trustee is more rigorous than required of other fiduciaries, and the rationale for this is threefold. First, rather than monitoring a trustee's fiduciary behavior and uncovering abuses, it is preferable to remove a trustee's temptations to serve their personal interests.[33] Second, a trustee can easily conceal misconduct in its administration of the trust. This makes the beneficiaries' efforts to prevent improprieties ineffective and inefficient.[34] Third, beneficiaries are often unable to dispose of their interest or easily vote out fiduciaries.[35]

1. <u>Scope of Duty of Loyalty</u>

A trustee serves as a fiduciary in all matters involving the administration of the trust.[36] Under the duty of loyalty, the trustee is broadly required to perform all matters solely in the interests of the beneficiaries.[37] This broad duty of loyalty is further emphasized by Section 78(2) of the Restatement (Third) of Trusts, which provides that "the trustee is *strictly prohibited* from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests."[38] Self-dealing is broadly defined and prohibited, even if a trustee acted in good faith and provided adequate consideration to the beneficiaries.[39] Self-dealing occurs when a trustee personally engages in a transaction with the trust.[40] Trustees also are strictly prohibited from receiving outside compensation for acts performed as a trustee, and from conducting transactions, as a fiduciary or personally, with closely-related or associated third persons[41] that may give rise to a future conflict of interest.[42]

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[33] *Id.* at § 78 cmt. b.

[34] *Id.*

[35] *Id.*

[36] *Id.* at cmt. a.

[37] *Id.* at § 78(1).

[38] *Id.* at § 78(2) (emphasis added).

[39] *Id.* at cmt. d. Under this standard, known as the "no-further-inquiry rule," if the trustee personally conducts a transaction with the trust, it is immaterial if the property has a market value, whether the trustee profits from the transaction, and whether the sale is at a private or public auction. *Id.*

[40] *Id.* For example, a trustee is prohibited from purchasing property held in the trust, selling the trustee's property to the trust, borrowing money from or lending money to the trust, or conducting any transaction where the trustee has a personal financial interest. Similarly, a corporate trustee is prohibited from entering into a transaction on behalf of the trust with one of its departments or with a subsidiary corporation or affiliate. *Id.*

[41] Closely-related or associated third parties include family members of the trustee, personal agents of the trustee, or any party that could improperly influence the decisions of the trustee. If the third party is a personal agent of the trustee, a conflict of interests is presumed. *Id.* at cmt. e.

[42] *Id.* at cmts. d(1)-e. The latter restriction broadens the scope of the trustee's fiduciary duty because it applies to personal transactions that do not involve the property of the trust and requires the trustee to avoid transactions that may give rise to future conflicts. For example, this duty prevents a corporate trustee from engaging in a transaction on behalf of the trust with one of its officers or directors. *Id.*

Further, if the trustee already owns an interest in a business, the trustee cannot purchase an interest in the business for the trust if the combined interest is substantial enough to create a future conflict of interest.[43]

2. Waiver of Duty of Loyalty

With limited exceptions,[44] a trustee is strictly prohibited from engaging in a transaction that would create a conflict between the trustee's fiduciary duties and trustee's personal interests, unless the trustee receives authorization from the proper court, express or implied authorization from the terms of the trust, or the consent all of the beneficiaries.[45] If the trustee is relieved from the strict prohibition against conduct involving divided loyalty, the trustee remains under a duty to act prudently,[46] fairly, in good faith, and in the interest of the beneficiaries.[47]

When the trustee obtains the consent of the beneficiaries to engage in conduct that involves or may create a conflict of interest, the trustee must be able to show that the dealings were fair and impartial, done in good faith, and that all material facts that the trustee knew or should have known in connection with the matter were communicated to the beneficiaries.[48] Notably, the trustee is required to make full disclosure of material

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[43] *Id.* at cmt. e.

[44] The limited common law exceptions allow the trustee to 1) receive reasonable compensation, 2) perform special services, such as legal counsel to the trust, that the trustee has the skill and facilities to perform, 3) advance funds to the estate for proper expenses or deposit the funds in a regulated financial-services institution operated or affiliated with the trustee, and 4) deal with other trusts for which the trustee is a fiduciary. *Id.* at cmts. c(4)-c(7).

[45] *Id.* at cmt. c(1)-c(3). Obtaining the consent of all beneficiaries is often a difficult task. *See id.* at § 65. If a trustee commits a breach of the duty of loyalty, it is only liable to the beneficiaries who did not consent to the conduct. *Id.* § 78 cmt. c(3).

[46] Section 77 provides that:

(1) The trustee has a duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust.

(2) The duty of prudence requires the exercise of reasonable care, skill, and caution.

(3) If the trustee possesses, or procured appointment by purporting to possess, special facilities or greater skill than that of a person of ordinary prudence, the trustee has a duty to use such facilities or skill.

Id. at § 77.

[47] *Id.* at §78 cmt. c(2).

[48] *Id.* at § 78(3).

facts to the beneficiaries in all transactions.[49] Even with disclosure and consent, the trustee must not violate the duty of prudence, impartiality, or any provision of the trust.[50]

In short, the duty of loyalty required for a trustee is different than the duty required of agents, and an agent and principal may agree to define the scope of the agent's duties differently from the general fiduciary duty applicable to agents. The duties of trustees and agents may be waived through consent after disclosure of all material facts if the dealings are fair and in good faith, but an agent may obtain consent after the conduct has taken place.

IV. Current Regulatory Standards Regarding the Provision of Investment Advice Are Similar

We believe that much of the current debate over the appropriate standard overstates the differences in the legal standards applicable to investment advisers, on the one hand, and broker-dealers providing investment advice to retail customers, on the other. In truth, neither the Advisers Act nor the Exchange Act expressly provide that investment advisers or broker-dealers are fiduciaries. Although it is true that the Supreme Court has found that investment advisers are fiduciaries, the Court also has held that broker-dealers providing investment advice are fiduciaries in some circumstances.[51]

Moreover, as Justice Cardozo famously wrote:

> But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[52]

The remainder of this section will show that the current legal standards governing the provision of investment advice are based largely on the same principles, discuss and compare the existing standards of care for investment advisers and broker-dealers, and show that the specific implications of being a fiduciary depend largely on the exact contours of the obligations assumed by the financial service provider. The different implications of the current duties applicable to investment advisers and broker-dealers

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[49] *Id.* This includes personal transactions that fall outside of the scope of the trustee's fiduciary relationship with the beneficiaries but involve a broader confidentiality requirement that is similar to the basic loyalty concept in some other fiduciary relationships. *Id.* at § 2 cmt. b(1). A confidential relationship is presumed to exist between the trustee and the beneficiaries, unless the beneficiary's interest in the trust is remote and interactions with the trustee as a fiduciary are insignificant. *Id.* at § 78 cmt. g.

[50] *Id.* at cmt. g.

[51] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (finding that investment advisers have fiduciary duty to clients); SEC v. Zandford, 535 U.S. 813, 823 (2002) (sale of customer's securities and unauthorized use of proceeds for broker's own benefit constituted fraud and breach of fiduciary duty where customer trusted broker to make discretionary transactions in customer's best interest).

[52] SEC v. Chenery Corp., 318 U.S. 80, 84-85 (1943).

providing similar services further emphasizes the importance of clearly defining a universal standard of care and its application.

A. Standards Applicable to Investment Advisers

Although the Investment Advisers Act of 1940 has no express fiduciary duty provision, it does have a general antifraud provision, Section 206.[53] The Supreme Court has held that the antifraud provision imposes fiduciary duties on investment advisers.[54]

Under Section 206, the SEC and its staff have found that an investment adviser has an obligation to disclose to its clients all material facts about the adviser relationship. In this regard, the Supreme Court said that the congressional intent in enacting the Advisers Act was "to eliminate, or at least to expose, all conflicts of interest which might incline and investment adviser — consciously or unconsciously — to render advice which was not disinterested."[55] Information is material if there is a substantial likelihood that a reasonable client would attach importance to it.

The SEC and staff also have found that an investment adviser has a duty to act only in the best interests of its clients, which requires that the investment adviser place the interests of its clients above its own interests when a conflict may be present.[56] In some instances,

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[53] Section 206, in relevant part, provides:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

Two provisions of the Investment Company Act of 1940 provide for fiduciary obligations for investment advisers, but only in very limited ways. Section 36(a) authorizes the SEC to bring an injunctive action in U.S. District Court against investment advisers, investment company directors and officers, and others based on a "breach of fiduciary duty involving personal misconduct" as to any registered investment company. Section 36(b) provides for a cause of action in favor of the SEC and registered investment company shareholders for a breach of fiduciary duty as to compensation from more payments paid by a registered investment company to its investment adviser.

[54] *Capital Gains*, *supra* note 51. The case involved an investment adviser that published an investment advisory report. The adviser effected its own transactions in securities before recommending that subscribers effect the same transactions. It should be noted that it was not necessary to hold that the adviser was a fiduciary to find a violation of Section 206; the Court could have found that the adviser's recommendations were misleading, because the adviser did not disclose that it effected its own transactions before making the recommendations.

[55] *Id.* at 191-92.

[56] *E.g.*, Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2107 (Feb. 5, 2003) (explaining that the Advisers Act "imposes a broad fiduciary duty on advisers, requiring them to act in the best interest of their clients"); Proxy Voting by Investment Advisers, Advisers Act Release No. 2106 (Jan. 31, 2003) (providing that an "adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own") ("Proxy Voting Release").

the SEC has said that the investment adviser must disclose the existence of any conflict and obtain the client's consent to the relevant arrangement.[57] In other instances, it appears to be enough for the adviser to have made general disclosure about the conflict in its Form ADV disclosures to its clients.[58]

Finally, the SEC and its staff at times have suggested that an adviser has a duty to treat each client fairly.[59] This duty requires the adviser ensure that it does not benefit one client to the disadvantage of another.

From these general principles, over the decades of administration of the Advisers Act, the SEC and its staff have articulated many required practices, based on the status of investment advisers as fiduciaries. For example, the SEC has closely regulated the allocation of orders for new issue securities or other limited supply investment opportunities by registered investment advisers.[60] In another example of the reach of the fiduciary duty theory, the SEC has said that investment advisers have an affirmative obligation to vote proxies on securities held by their clients, even though the Advisers Act is silent on the subject.[61] Importantly, the SEC has recognized that although advisers have a general fiduciary duty to vote proxies, an adviser and its clients may by contract provide that the adviser will have no such duty.[62] The SEC also has said that investment

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[57] *E.g.*, Proxy Voting Release, *supra* note 56 (indicating that when implemented, "an adviser's policy of disclosing the conflict to clients and obtaining their consents ... fulfills the adviser's fiduciary obligations under the Advisers Act").

[58] For example, in TD Waterhouse Investor Services, Advisers Act Release No. 2299 (Sept. 21, 2004), the SEC found an adviser liable under Section 206(2) for not disclosing the compensation it received as encouragement to direct brokerage a particular broker-dealer. As noted in the settlement order, the adviser should have disclosed this information to its clients in its Form ADV.

[59] For example, the SEC staff has indicated that an adviser's fiduciary duty requires it to ensure that all clients are treated fairly when trades are aggregated and allocated. *See, e.g.*, Pretzel & Stouffer, SEC No-Action Letter, 1995 SEC No-Act LEXIS 911 (Dec. 1, 1995); SMC Capital, Inc., SEC No-Action Letter, 1995 SEC No-Act. LEXIS 695 (Sept. 5, 1995).

[60] The SEC brought an enforcement action against an investment adviser and its principal for allocating new IPOs disproportionately to accounts paying performance-based fees. Mckenzie Walker Inv. Mgmt. Inc., Advisers Act Release No. 1571 (July 16, 1996). According to the SEC order, the adviser violated Section 206(2) by not disclosing to its clients, current or prospective, its practice of generally favoring its performance-based fee clients in the allocation of profitable equity trades and new issue securities and specifically favoring certain performance-based fee clients over other clients. In another case, the SEC brought an enforcement action against an adviser and its principals for, among other things, allocating short-term trading opportunities in new issue securities disproportionately to a limited group of accounts and not disclosing this practice to all of its clients. Account Mgmt. Corp., Advisers Act Release No. 1529 (Sept. 29, 1995).

[61] Proxy Voting Release, *supra* note 56. In one instance, the SEC found that an investment adviser violated its fiduciary duty under the Advisers Act when it voted proxies on securities held by clients when an affiliate was acting as investment banker and financial adviser to one of the persons participating in the proxy contest. The SEC stated that the adviser could not simply refrain from voting proxies, because it would not be fulfilling its fiduciary responsibilities to its clients. Deutsche Asset Mgmt., Inc., Advisers Act Release No. 2160 (Aug. 19, 2003).

[62] Proxy Voting Release at n.10.

advisers must address conflicts of interest in developing policies and procedures for proxy voting.[63]

Additionally, the SEC has used the fiduciary duty theory to impose other responsibilities on investment advisers, such as a duty to provide only suitable investment advice[64] and a duty to provide full and fair disclosure to clients when recommending affiliated service providers.[65]

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[63] The exact contours of the requirements to address conflicts of interest and proxy voting remain unclear. The SEC did not specify what would be a material conflict of interest, or what, as a practical matter, is required to address a conflict. In describing what may be a material conflict, the SEC stated:

> An adviser may have a number of conflicts that can affect how it votes proxies. For example, an adviser (or its affiliate) may manage a pension plan, administer employee benefit plans, or provide brokerage, underwriting, insurance, or banking services to a company whose management is soliciting proxies. Failure to vote in favor of management may harm the adviser's relationship with the company. The adviser may also have business or personal relationships with participants in proxy contests, corporate directors or candidates for directorships. For example, an executive of the adviser may have a spouse or other close relative who serves as a director or executive of the company.

In describing what may be required to address a conflict of interest, the SEC stated:

> Clearly, an adviser's policy of disclosing the conflict to clients in obtaining their consent before voting satisfies the requirements of the rule, and when implemented, fulfills the adviser's fiduciary obligations under the Advisers Act.
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> * * *
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> Advisers today use various means of ensuring that proxy votes are voted in their clients' best interests and not affected by the advisers' conflicts of interest. An adviser that votes securities based on a pre-determined voting policy could demonstrate that its vote was not a product of a conflict of interest if the application of the policy to matters presented to shareholders involve little discretion on the part of the adviser. Similarly, an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party. An adviser could also suggest that the client engage another party to determine how the proxy should be voted, which would relieve the adviser of the responsibility to vote proxies. Other policies and procedures are also available; their effectiveness (and the effectiveness of any policies and procedures) will turn on how well they insulate the decision on how to vote client proxies from the conflict.

[64] *See, e.g.*, David A. King, Advisers Act Release No. 1391 (Nov. 9, 1993) (adviser advised clients to invest in unregistered mortgage pool). It should be noted that the SEC once proposed to make the duty to provide suitable investment advice express. Suitability of Investment Advice Provided by Advisers, Advisers Act Release No. 1406 (Mar. 16, 1994). The SEC never took final action on the rule, however.

[65] Smith Barney Fund Mgmt., Inc., Advisers Act Release No. 2390 (May 31, 2005).

The duty to seek best execution when placing client transactions also arises from an adviser's status as a fiduciary.[66] The SEC has acknowledged, however, that this duty may be altered by agreement between the client and the adviser, if the adviser makes appropriate disclosures to the client regarding the implications of the agreement.[67]

In certain circumstances, the exact contours of being a fiduciary necessarily vary depending on the nature of the advisory relationship. The SEC and its staff have agreed that an investment adviser may treat different clients, or classes of clients, differently, depending on the nature of the adviser relationship and on whether the adviser has made adequate disclosure regarding the different treatment.[68] The SEC staff also has agreed that under appropriate circumstances an investment adviser may decline to vote proxies,[69] and it seems apparent that an adviser that does not provide discretionary investment advice and does not have control over its clients' assets has no obligation to vote proxies. The SEC also has recognized that an adviser who acts in a limited role and provides only very limited advice does not have the same obligations to its clients as those advisers who act in a broader capacity.[70]

B. Standards Applicable to Broker-Dealers

The Exchange Act includes antifraud provisions that are substantially similar to Section 206 under the Advisers Act.[71] However, courts and regulatory authorities have not found that these provisions necessarily impose a fiduciary duty on broker-dealers. Instead, the nature of a broker-dealer's duty to a customer depends on its relationship with and services it provides to the customer.

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[66] Arleen W. Hughes, Advisers Act Release No. 4073 (Feb. 20, 1948), *aff'd sub nom.*, Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) (a fiduciary's duty of loyalty entails the "duty to obtain or dispose of property for his principal at the best price discoverable in the exercise of reasonable diligence").

[67] United Missouri Bank of Kansas City, SEC No-Action Letter (May 11, 1990).

[68] For example, in the context of trade allocations, the SEC has held advisers liable for fraud where the adviser failed to disclose that only certain clients would receive access to limited opportunities. *See, e.g., In re* Monetta Fin. Servs., Inc., Init. Dec. Release No. 162 (Mar. 27, 2000).

[69] Proxy Voting Release, *supra* note 56, at II.A.2.a.

[70] For example, under certain conditions, an investment adviser who only provides impersonal advice need not deliver to clients the information required by Part II of Form ADV. 17 C.F.R. § 275.204-3(c).

[71] Exchange Act Rule 10b-5 prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security. Section 15(c)(1), as clarified by the rules thereunder, prohibits a broker-dealer from using a manipulative, deceptive, or other fraudulent device or contrivance (including, but not limited to, knowingly making untrue statements of material fact or omitting to state a material fact necessary to make a statement not misleading) in connection with effecting a transaction in, or inducing or attempting to induce the purchase or sale of any security otherwise than on a national securities exchange of which it is a member. Broker-dealers also are subject to requirements under the Securities Act of 1933, which prohibits fraud or deceit in connection with the offer or sale of securities, and FINRA rule requirements that prohibit members from effecting any transaction in or inducing the purchase or sale of any security by manipulative, deceptive or other fraudulent device or contrivance. Securities Act of 1933, Section 17(a); FINRA Rule 2020.

All broker-dealers are subject to rules requiring fair dealing and just and equitable principles of trade, standards that are quite similar to the concept of fiduciary duty established under the Advisers Act.[72] The Exchange Act and FINRA rules require specific practices to ensure that broker-dealers comply with these general standards. The Exchange Act establishes, among other things, customer protection, net capital, and recordkeeping requirements for broker-dealers, and requires broker-dealers to give transaction-specific disclosures at or before the completion of a transaction.[73] FINRA imposes numerous conduct rules, some of which require members to (1) buy or sell at a price that is fair, meaning that the price must be reasonably related to the current market price for the security; [74] (2) limit markups so they generally do not exceed 5% of the prevailing market price;[75] (3) provide "best execution" to customers;[76] (4) have reasonable grounds for believing a recommendation to a customer is suitable for that customer as to his or her portfolio, financial situation, and needs;[77] and (5) ensure that communications with the public are based on principles of fair dealing and good faith, are fair and balanced, and provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service.[78] The specific requirements may differ depending on whether the customer is a retail customer or institution.[79]

When broker-dealers provide brokerage services to clients without providing any investment advice, they are subject to these duties and requirements, and are not held to a

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[72] Section 15A(b)(6) of the Exchange Act requires the rules of any self-regulatory organization for broker-dealers to be "designed to prevent fraudulent and manipulative acts and practices, [and] to promote just and equitable principles of trade…" Accordingly, FINRA Rule 2010 requires, "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

[73] Exchange Act Rules 15c3-3, 15c3-1,17a-3, and 10b-10.

[74] NASD Rule 2440; NASD IM-2440-1.

[75] NASD IM-2440-1. This policy is a guide, and FINRA considers several factors to determine whether a markup is excessive.

[76] NASD Rule 2320(a). "Best execution" means using reasonable diligence to ascertain the best market for the security and buying or selling in such market so the resultant price to the customer is as favorable as possible under prevailing market conditions. *Id.*

[77] NASD Rule 2310.

[78] NASD Rule 2210(d)(1)(A).

[79] For example, to determine whether a security is suitable for a non-institutional customer, a broker-dealer must use "reasonable efforts" to determine the customer's financial status, tax status, investment objectives, and such other information the broker-dealer considered to be reasonable in making the recommendation. NASD Rule 2310(b). Whether a recommendation is suitable for an institutional customer depends on the customer's ability to evaluate investment risk and the extent to which the customer exercises independent judgment to evaluate the recommendation. NASD IM-2310-3.

higher fiduciary standard.[80] When broker-dealers also provide investment advice, they may be subject to a fiduciary standard, depending on the nature of their relationship with their customers.[81] Courts evaluate the totality of the circumstances to determine the nature of a broker-dealer's relationship with a customer, including: (1) the customer's degree of sophistication, business acumen and intelligence; (2) the course of conduct between the parties, including the extent to which the customer followed the broker's advice, whether the broker trades without the customer's consent, the frequency of communication between the broker and customer, and the degree of trust and confidence reposed in the broker; and (3) the broker-dealer's past activities as an investment adviser.[82] The mere act of providing advice to the client does not automatically transform a brokerage relationship into a fiduciary relationship.[83]

Non-discretionary brokerage accounts give rise to the duty of reasonable care that arises out of the agency relationship between the broker-dealer and customer, and broker-dealers that provide services to such accounts principally are subject to the requirements that apply to all registered broker-dealers.[84] In particular, broker-dealers providing non-discretionary brokerage services have a duty to: (1) recommend a security only after determining the security's nature, price, and financial prognosis and the customer's particular needs and goals (suitability); (2) effect the customer's orders promptly in a manner best suited to serve the customer's interests (best execution); (3) refrain from self-dealing and charging excessive markups; (4) disclose the transaction's risks and any personal interest the broker may have in a particular recommended security; (5) accurately disclose all material facts; and (6) transact business only after receiving the

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[80] *See, e.g.*, Levitin v. PaineWebber, Inc., 159 F.3d 698, 707 (2d Cir. 1998) ("Under New York law, '[a] broker does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities.'" (citations omitted)), *cert. denied*, 525 U.S. 1144 (1999); *Hughes, supra* note 66. However, some courts have held that broker-dealers always owe a degree of fiduciary duty to customers. *See* Davis v. Merrill Lynch, 906 F.2d 1206, 1215-17 (8th Cir. 1990); Jaksich v. Thompson McKinnon Secs., 582 F. Supp. 485, 502 (S.D.N.Y. 1984).

[81] *See, e.g.*, Romano v. Merrill Lynch, 834 F.2d 523, 530 (5th Cir. 1987); McGinn v. Merrill Lynch, 736 F.2d 1254, 1258 (8th Cir. 1984); Roth v. Roth, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978); Stevens v. Abbott, Proctor & Paine, 288 F.Supp. 836, 846 (E.D. Va. 1968).

[82] *See, e.g.*, Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 516-518 (Colo. 1986); Lieb v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981).

[83] *See* De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1307 (2d Cir. 2002), 306 F.3d at 1307 (stating "giving advice on particular occasions does not alter the character of the relationship by triggering an ongoing duty to give advice in the future (or between transactions)").

[84] *See De Kwiatkowski, supra* note 83, at 1305-06; Independent Order of Foresters v. Donald, Lufkin and Jenrette, Inc., 157 F.3d 933, 940-941 (2d Cir. 1998); Hill v. Bache Halsey Stuart Shields, 790 F.2d 817 (10th Cir. 1986); *Hughes, supra* note 66. *See also* Press v. Chemical Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999); Bissell v. Merrill Lynch & Co., 937 F. Supp. 237, 246 (S.D.N.Y. 1996); Paine, Webber, *supra* note 82, at 516. However, if a broker-dealer gains control over a non-discretionary account, courts have held that broker-dealers owe the same fiduciary duties owed to discretionary account clients as if the account had been discretionary "from the moment of its creation." *Lieb, supra* note 82, at 954; and *Paine, Webber, supra* note 82, at 516.

customer's prior authorization.[85] Many courts have recognized that a broker-dealer's duties are defined by the duration of the transaction and a broker-dealer's duties cease once the transaction is complete.[86]

However, courts and the SEC have found that broker-dealers have a fiduciary duty to a customer when they act in a position of trust and confidence, such as exercising discretionary authority to purchase or sell securities for a customer's account (often subject to certain restrictions), or providing services to a client who has impaired faculties or is so lacking in sophistication that the broker is deemed to have de facto control of the account.[87] In these circumstances, a broker-dealer has a duty to (1) manage the account consistently with the customer's needs and objectives, as stated in the account authorization documents or as apparent from the customer's investment and trading history; (2) keep informed regarding market changes that affect the customer's interest and act to protect those interests; (3) keep the customer informed about each completed transaction; and (4) explain the practical impact and potential risks of the broker-dealer's services.[88] The broker-dealer also is required to disclose to customers material facts and the broker-dealer's adverse interests.[89]

In short, although it is true that investment advisers are fiduciaries and have many obligations as a result, broker-dealers are held to substantially similar standards in several instances, either by courts or by requirements imposed by self-regulatory organizations. Certain standards that apply to investment advisers and broker-dealers may vary based on the circumstances of their relationship with a particular customer or client, and broker-dealers are held to a different standard of conduct when they provide numerous other services that do not involve advice or a position of trust and confidence.

V. A New Approach: Universal Standard of Conduct for Broker-Dealers and Investment Advisers

Investors unquestionably would benefit from greater clarity regarding the duties owed to them by broker-dealers and investment advisers, as well as from a broader harmonization of the regulatory structures governing these intermediaries. As the RAND Report found,

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[85] *De Kwiatkowski, supra* note 83, at 1302. *See also Independent Order of Foresters, supra* note 84, at 941; Conway v. Icahn & Co., 16 F.3d 504, 510 (2d Cir. 1994); *Lieb*, note 82, at 953; Caravan Mobile Home Sales, Inc. v. Lehman Bros. Khun Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985); Robinson v. Merrill Lynch Pierce, Fenner & Smith, Inc., 337 F. Supp. 107, 111-12 (N.D. Ala. 1971), *aff'd* 452 F.2d 417 (5th Cir. 1972).

[86] *See, e.g., De Kwiatkowski, supra* note 83, at 1302-03; *Lieb, supra* note 82, at 953; *Robinson, supra* note 85, at 112. For example, after the transaction the broker-dealer does not have a duty to monitor information that may affect a customer's portfolio, keep the customer informed of developments that may affect the customer's investments, or offer any other on-going advice. *Robinson, supra* note 85, at 112.

[87] *See, e.g., Zandford, supra* note 51, at 823; Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228, 231 (D.C. Cir. 1949).

[88] *Lieb, supra* note 82, at 953. *See also* Patsos v. First Albany Corp., 741 N.E.2d 841, 850 (Mass. 2001).

[89] *Hughes, supra* note 66, at 971.

investors "do not have a clear understanding of the boundaries between investment advisers and broker-dealers."[90] We agree that this situation is not desirable.

LPL believes there are three fundamental principles that should be paramount to the Commission when assessing how best to clarify the conduct owed by intermediaries to their customers: adopting a uniform standard for broker-dealers and investment advisers providing personalized investment advice to retail investors, based on fiduciary duty principles under the law of agency; significantly enhancing the disclosure provided to investors by broker-dealers and investment advisers; and, just as importantly, ensuring the continued ability of investors to make informed decisions as to the financial services that best suit their needs. While the first two principles, appropriately, have been widely discussed in recent months, the ability of investors to retain control over their portfolios and how they are managed has received less attention. This issue also should be of critical importance to the Commission as it determines how to enhance investor protection.

A. Investment Advisers and Broker-Dealers Should Act in the Best Interests of their Customers When Providing Advice to Retail Investors

LPL wholeheartedly agrees with Chairman's Schapiro's statement that "When investors receive similar services from similar financial service providers, it is critical that the service providers be subject to the same standard of conduct and equivalent regulatory requirements, regardless of the label attached to the providers."[91] In particular, we support the view that investment advisers and broker-dealers should be subject to the same standard when providing investment advice to retail investors. As a result, and not surprisingly, we favor the Administration's proposal to require intermediaries to act solely in the interests of a retail customer without regard to the firm's financial or other interests.

Although the proposed standard would go a long way toward reconciling the duties of investment advisers and broker-dealers providing advice to retail customers, the Investor Protection Act of 2009 leaves much to Commission rulemaking. For example, the proposed legislation does not define the contours of the requirement "to act solely in the interest of the customer or client," does not address the standard's applicability to different services, and authorizes the Commission to promulgate rules regarding conflicts of interest.

We agree with the Treasury that the Commission is best suited to determine the contours and application of the standard. The Commission's mandate includes protecting investors, maintaining fair markets, and facilitating capital formation. The Commission

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[90] RAND Report, *supra* note 1, at 87.

[91] Mary L. Schapiro, Chairman, SEC, Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, *supra* note 5.

also understands the complexities of the services provided by broker-dealers and investment advisers through its extensive experience overseeing these industries. As the Commission defines, implements, and applies the universal standard, we recommend that the Commission adopt the following principles to ensure that the requirements are clear and that the current variety of investor choices is preserved.

1. Definition of Standard Based on General Law of Agency

We believe that the universal standard should be based on the fiduciary principles under the law of agency. The relationship between a broker-dealer or investment adviser and its client more closely resembles the relationship between an agent and principal than the relationship between a trustee and trust beneficiaries. As discussed more fully in Section III.B, the relationship between a trustee and its beneficiaries necessitates a more rigorous duty of loyalty for a trustee than required of other fiduciaries. A trustee can more easily conceal misconduct in its administration of the trust, and beneficiaries are often unable to dispose of their interest or easily vote out the trustee; therefore, it is preferable to remove a trustee's temptations to serve its personal interests. In contrast, when a financial services firm provides personalized investment advice to an individual, the individual retains more control over the relationship than trust beneficiaries. The individual enters into a contract directly with the firm, receives periodic account statements to monitor the account and firm's activities, and has the ability to terminate the relationship. In instances involving non-discretionary accounts, it ultimately is the investor's decision whether to implement the advice of the investment adviser or broker-dealer. This relationship is more like the relationship between an agent and principal, where an agent consents to act on behalf of the principal and the principal has the right to control the agent's acts,[92] so the additional protections provided under trust law are not necessary.

Accordingly, we recommend that the Commission define the scope of the proposed standard "to act solely in the interest of the customer or client" to require firms to act loyally for the client's benefit in all matters connected with the relationship, using the same care, competence, and diligence that a prudent person would exercise in similar circumstances.[93] The Commission should permit the parties to agree to define the scope of the duties of a broker-dealer or investment adviser in an agreement at the beginning of the relationship, and to consent to specific arrangements before or after the conduct occurs, as appropriate. A broker-dealer or investment adviser would have a duty not to engage in the following without the client's consent (1) materially benefitting from transactions conducted on its behalf or from the use of its position,[94] (2) dealing with the client as or on behalf of an adverse party in a transaction connected with the

[92] *See, e.g.,* Restatement (Third) of Agency § 8.01, cmt. b (2006).

[93] The proposed standard would follow the law of agency. See Section III.A, *supra.*

[94] This would apply even if the intermediary's interest seems consistent with the client's interest and no demonstrable harm was done to the client. This provision is similar to a trustee's duty to refrain from personal transactions that would give rise to a future conflict of interest. Restatement (Third) of Trusts § 78 cmt. e (2007).

relationship,[95] (3) competing with the client or assisting or taking action on behalf of the client's competitors before the relationship between the client and firm is terminated; and (4) using the client's property or confidential information for its own purposes or for the purposes of a third party.[96] When obtaining consent from the client, the intermediary would be required to act in good faith, and disclose all material facts that the intermediary knows, or has reason to know, would reasonably affect the client's judgment.[97] Additionally, the intermediary would have to deal fairly with the client.

2. Application of Duty

The proposed legislation also does not explain how the standard would be applied to the varying types of advice that broker-dealers and investment advisers provide to retail customers, including discretionary or non-discretionary advice, and personal or impersonal advisory services.[98] Investment advisers also may provide continuous and regular supervisory or management services to clients, which may include clients for whom the adviser provides discretionary or non-discretionary advice.[99]

The application of the current legal standards for broker-dealers and investment advisers are not sufficient to define how the universal standard should be applied. Although the specific implications of being a fiduciary under the current legal standards depend largely on the exact contours of the obligations assumed by the financial service provider, the standards and their application for similar services may be different depending on whether the firm is a registered broker-dealer or investment adviser. For example, an

[95] An intermediary would be deemed to act as or for an adverse party when the intermediary has a substantial economic interest in the party with whom the principal deals or when the transaction is between the client and a closely-related associate of the intermediary. If the intermediary contracts with the client to allow the intermediary to self-deal, then the intermediary would be subject to a contract-law duty of good faith and fair dealing.

[96] This would apply even if the intermediary's use of the client's property is beneficial to the property.

[97] This would apply unless the client indicates that such facts are already known, or that the client does not wish to know them.

[98] A contract for impersonal advisory services refers to any contract relating solely to the provision of investment advisory services (i) by means of oral or written statements that do not purport to meet the objectives or needs of specific individuals or accounts, (ii) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security, or (iii) any combination of such services. 17 C.F.R. § 275.204-3(g)(1). For example, impersonal investment advisory services include the publication of market newsletters.

[99] An investment adviser provides continuous and regular supervisory or management services to clients with discretionary accounts when they exercise ongoing supervision or management as to the account. Even if an adviser does not have discretion as to an account, the adviser may exercise continuous and regular supervisory and management services to the account if it has ongoing responsibility to make recommendations based on the client's needs, as to specific securities or other investments the account may purchase or sell and, if the recommendations are accepted by the client, the adviser is responsible for arranging or effecting the purchase or sale. Form ADV: Instructions for Part 1A, Item 5(b)(3), General Criteria, 6. Advisers also may provide continuous and regular supervisory or management services if they allocate assets among other managers and have the ability to hire and fire managers and reallocate assets among them. Form ADV: Instructions for Part 1A, Item 5(b)(3), Examples, 7.

investment adviser currently has a fiduciary duty to a client receiving non-discretionary or impersonal advice,[100] while a broker-dealer has an arguably lower duty of reasonable care for providing the same services.[101]

a) *Application of Standard to Personalized Investment Advice*

We believe that the Commission should adopt a new model for applying the uniform standard to investment advisers and broker-dealers. The standard should only apply in those instances where a retail investor has a reasonable expectation that a broker-dealer or investment adviser would be acting in his or her best interests. This would exclude instances where a firm provides impersonal advice to retail investors, such as services provided (i) by oral or written statements that do not purport to meet the objectives or needs of specific individuals or accounts, or (ii) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security.[102] The standard also would exclude traditional brokerage services, such as market making, underwriting, trade executions, and exercising limited time and price discretion.

The universal standard would apply to the provision of all personalized investment advice, including discretionary advice, non-discretionary advice and financial planning. But the application of the standard would differ for each. In a discretionary account, a broker-dealer or investment adviser is responsible not just for generating advice but also is charged with making and implementing investment decisions and monitoring the client's account. A firm providing discretionary advice would be subject to a fiduciary duty while providing all of these services.

In contrast, intermediaries providing non-discretionary advice, including financial planning, focus solely on providing investment advice to a customer, and do not make ultimate decisions of whether to make an investment. Broker-dealers may or may not be asked to execute trades to implement the non-discretionary advice after it is given. Nor are persons providing non-discretionary advice generally responsible for monitoring the

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[100] Although an investment adviser who only provides impersonal advice need not deliver to clients the information required by Part II of Form ADV under certain conditions, the adviser still owes a fiduciary duty to such clients. *See* 17 C.F.R. § 275.204-3(c).

[101] *See supra* notes 84-86, and related text.

[102] *See* 17 C.F.R. § 275.204-3(g)(1). For example, impersonal advisory services would include the publication of market newsletters and research reports. We recognize that *Capital Gains* involved impersonal investment advice provided in an investment advisory report. But we believe this decision is premised on the adviser's provision of misleading disclosures, and not on whether impersonal investment advice requires a fiduciary duty. *Capital Gains*, *supra* note 51.

day-to-day activities of a non-discretionary account.[103] Thus, while we agree that intermediaries providing advice to non-discretionary retail investors should be required to act in the best interests of such investors when doing so, the Commission should clearly delineate by rule the parameters of this duty. For example, intermediaries providing non-discretionary investment advice should not have an obligation to monitor the information that may affect the client's portfolio, monitor the investments in the client's account, keep the client informed of developments that may affect the client's investments, or offer any other on-going advice.[104] Intermediaries providing a financial plan should be able to limit the scope of their services to the creation and delivery of the plan by the terms of their agreement with the client.[105]

Finally, the Commission should clarify that an intermediary that provides both brokerage and investment advisory services owes the universal standard of care only with respect to those accounts for which it provides personalized investment advice to retail customers and clients.[106] This position would be consistent with the Commission's long-standing view that a broker-dealer may distinguish its brokerage customers and advisory clients.[107]

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[103] Financial planning represents another illustration of the varying services that are provided to retail investors by broker-dealers and investment advisers. Financial planners frequently provide non-discretionary advice and, due to the nature of the service offered, some planners may regularly monitor a client's account. Others agree in advance with their customers that the scope of their engagement ends with the presentation of recommendations designed to achieve the client's long-term goals. *See, e.g.*, RAND Report, *supra* note 1, at 14-15 (financial planner generally offers advice about financial plan to client without handling client accounts or executing transactions, but "it is widely acknowledged that financial planners typically offer a range of services, which need not correspond with this description"), *citing* "Staff Study, Financial Planners," *Federal Securities Law Reporter*, ¶¶ 84,220–, at ¶89,011 (Mar. 16, 1988).

[104] *See, e.g., Robinson, supra* note 85, at 112 (after transaction, broker-dealer does not have duty to monitor information that may affect customer's portfolio, keep customer informed of developments that may affect customer's investments, or offer other on-going advice).

[105] *See* Letter from Robert E. Plaze, Associate Director, SEC Division of Investment Management to Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association (Dec. 16, 2005). We recognize that this letter was terminated after the Court of Appeals for the District of Columbia Circuit vacated Rule 202(a)(11)-1 in Financial Planning Association v. SEC, 482 F.3d 481 (D.C. Cir. 2007). However, we think the Commission should maintain the staff's positions that (1) the parties may agree to terminate an advisory relationship with the delivery of a financial plan, and (2) the extent to which the intermediary would thereby limit the scope of its fiduciary obligations to the client would turn on whether the intermediary provides full disclosure about the change in the relationship and the obligations that the intermediary assumes. Many courts have recognized that a broker-dealer's duties are defined by the duration of the transaction and the duties cease once the transaction is complete. *See, e.g., De Kwiatkowski, supra* note 83, at 1302-03; *Lieb, supra* note 82, at 953; *Robinson, supra* note 85, at 112.

[106] The Commission adopted a similar position in Rule 202(a)(11)-1(c), which was vacated in Financial Planning Association, and re-proposed the position in September 2007. 17 C.F.R § 202(a)(11)-1(c); Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, Advisers Act Release No. 2652 (Sep. 24, 2007); Financial Planning Association, *supra* note 105.

[107] *See* Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, *supra* note 106, *citing* Certain Broker-Dealers Deemed Not to be Investment Advisers, Advisers Act Release No. 2376 (Apr. 12, 2005); Final Extension of Temporary Rules, Advisers Act Release No. 626 (Apr. 27, 1978).

b) *Standard of Care for Institutional Clients*

The proposed legislation also authorizes the SEC to apply the standard to "such other customers or clients as the Commission may by rule provide," in addition to retail customers and clients.[108] A number of exemptive and safe harbor provisions under the federal securities laws are based, in part, on the degree of sophistication of investors.[109] Such provisions are supported by the view that sophisticated clients, such as institutions of a particular size, do not need the same level of protection afforded to retail clients because, among other things, they: (1) have a high degree of financial sophistication, (2) are able to appreciate and bear the risks associated with transactions and services that do not have all of the protections afforded to other investors, (3) can fend for themselves in negotiating agreement provisions, and (4) are able to evaluate on their own behalf fees, transactions with affiliates, investment risk, and other matters relevant to the services.[110] These exceptions also promote competition among financial services providers and more flexibility for investors.[111] Similarly, we believe that the Commission should not require the same universal standard of care for investment services provided to institutional clients, but instead should allow institutional clients to set the applicable standard of care by contract. We believe an appropriate standard for identifying such institutions can be based on the standard for determining when a company is deemed a "qualified purchaser" for purposes of Section 3(c)(7) of the Investment Company Act.[112]

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[108] Investor Protection Act of 2009, Sec. 913.

[109] 15 U.S.C. § 77d(6) (registration exemption for offer and sale to "accredited investors"); 17 C.F.R. § 230.144A (exemption for offer and sale to "qualified institutional buyers"); 15 U.S.C. § 80(a)-3(c)(7) (exemption from registration as investment company for issuer owned by "qualified purchasers"); 17 C.F.R. § 205-3 (exemption from performance compensation prohibition for "qualified clients").

[110] *See, e.g.,* S. Rep. No. 293, 104th Cong., 2d Sess. at 10 (1996); 138 Cong. Rec. at S4822 (daily ed. Apr. 2, 1992) (Mem. of S.E.C. in Supp. of the Small Business Incentive Act of 1992); Private Investment Companies, Investment Company Act Release No. 22405 (Dec. 18, 1996); Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Advisers Act Release No. 996 (Nov. 14, 1985); Conditional Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Advisers Act Release No. 961 (Mar. 15, 1985).

[111] *See, e.g.,* Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, *supra* note 110.

[112] The term "qualified purchaser" includes (A) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (B) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (C) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments. 15 U.S.C. § 80a-2(a)(51)(A).

c) *Application of Principal Trading Requirements*

Another issue which the Commission will have to resolve in connection with any universal standard of conduct that requires broker-dealers and investment advisers to act solely in the interests of the retail customer without regard to the firm's financial or other interests relates to principal trading. Specifically, legislation and any related rulemaking applying the same standard of conduct to broker-dealers and investment advisers providing investment advice will squarely present the question whether the proscriptive provisions of Section 206(3) of the Advisers Act also should be part of the duties attendant upon all intermediaries subject to the new standard?

The Commission and its staff have long considered the appropriate treatment of principal trading by investment advisers[113] and, with a notable exception within the last few years for principal trades for non-discretionary accounts, it largely has maintained the disclosure and trade-by-trade consent requirements of Section 206(3).[114] Strong arguments have been made over the years as to why more flexibility in this area is warranted, particularly as to certain fixed income securities transactions, and how the current notice and consent requirements sometimes work against the best interest of investors.[115] We believe that the extension of Section 206(3) type duties to broker-dealers providing investment advice to retail investors (without regard to whether such firms receive a fee or transaction-based compensation) only will exacerbate concerns in this area. As noted, the determination that one is a fiduciary only begins the analysis of his or her obligations. Although disclosure and consent are necessary to address conflicts of interest under fiduciary principles, these relationships should not require the trade-by-trade notice and consent requirements dictated by the Advisers Act for principal trades.[116]

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[113] *See generally* SEC Division of Investment Management, SEC Roundtable on Investment Adviser Regulatory Issues (May 23, 2000) (discussing principal trading and other conflicts of interest), available at http://www.sec.gov/divisions/investment/roundtable/iadvrndt.htm; Method for Compliance with Section 206(3) of the Investment Advisers Act of 1940 with Respect to Certain Transactions, Advisers Act Release No. 557 (Dec. 2, 1976) (describing proposed methods for complying with Section 206(3)); Paul F. Roye, Director, SEC Division of Investment Management, Regulatory Initiatives for the Investment Management Industry, Speech Before the Glasser Legal Works, Fourth Annual Institute on Investment Management Regulation (Nov. 9, 2000) (acknowledging market developments that minimized the need for principal trading restrictions in certain instances), available at http://www.sec.gov/news/speech/spch422.htm.

[114] Advisers Act Rule 206(3)-3T provides limited, temporary relief from the transaction by transaction written notice and consent requirements under Section 206(3) of the Advisers Act for principal trades executed with clients on a non-discretionary basis. 17 C.F.R. § 275.206(3)-3T.

[115] *See* Letter to Robert E. Plaze, Associate Director, SEC Division of Investment Management, from Lee B. Spencer, Jr., Chairman, Securities Industry Association Federal Regulation Committee (Feb. 26, 1998) (citing enhancements in market transparency and disclosure, and adverse consequences of Section 206(3) on advisory clients in request for principal trading relief), *available at* http://www.sifma.org/regulatory/exemption_archives/principal_transactions.pdf.

[116] Interestingly, Section 206(3) does not, by its terms, require trade-by-trade consent to principal trading by investment advisers with their clients. Rather, this requirement was made explicit by the SEC staff. *See* Opinion of Director of Trading and Exchange Division, Relating to Section 206 of the Investment Advisers Act of 1940, Section 17(a) of the Securities Act of 1933, and Section 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, Advisers Act Release No. 40 (Feb. 5, 1945).

Therefore, we urge the Commission to allow intermediaries to obtain customer consent to principal transactions at the time of account opening.

B. Investors Deserve Enhanced Disclosures About their Financial Services Professionals

To help them make prudent decisions regarding their investments and the management of their portfolios, investors also need more extensive, but plainly worded disclosures about their financial service providers. Of course, investment advisers have long been required to provide prospective clients copies of Form ADV, which contains information about the business of the adviser, and to offer such disclosures to existing clients on an annual basis.[117] Broker-dealers, in turn, are required to provide a variety of transaction specific-information to clients in confirmations, reports and account statements, and pursuant to SEC and FINRA rules.[118] There is, however, a need for standardized disclosure by both broker-dealers and investment advisers regarding the nature of a firm's relationships with its clients, actual and potential conflicts of interest and compensation arrangements. Such disclosure would be useful not only for retail investors receiving investment advice, but for all investors receiving services from broker-dealers and investment advisers.

First, broker-dealers and investment advisers should describe the various services that they offer to investors and their duties and obligations to an investor in each instance. The disclosures should point out any material differences in the obligations of the broker-dealer or investment adviser to an investor based on the type of services selected by the investor.

Financial service providers also should disclose conflicts of interest associated with various aspects of their businesses. Such conflicts should relate to the recommendation of securities purchased from or sold to an investor on a proprietary basis. They also should involve transactions with affiliates of the financial service provider. Does a firm have arrangements with third parties that present conflicts of interest, such as the receipt of revenue sharing, account servicing or other fees? Does the firm's compensation structure create any conflicts of interest for registered representatives of the firm? Firms also should be required to disclose how they manage any conflicts inherent in their business.

Investors also would benefit from a better understanding of how their financial service providers are compensated. The RAND Report showed that many investors lack even the most basic understanding of how their broker-dealers and investment advisers are paid.[119] Asset-based, transaction, and other fees earned by a broker-dealer or investment adviser for varying services should be clearly and plainly described. Similarly, investors should

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[117] 17 C.F.R.§ 275.204(3).

[118] *See, e.g.*, Exchange Act Rules 10b-10, 605, 606; NASD Rules 2230, 2240, 2250, 2340.

[119] RAND Report, *supra* note 1, at xix, 95-97.

be made aware of factors that incentivize a firm's registered representatives to recommend a particular security. Are there differences in compensation payouts to registered representatives based on the type of product sold? All of this information would better equip investors to make sound investment decisions.

C. Investors Must Retain Access to a Variety Financial Services Providers, as well as the Ability to Select Among Services in their Best Interests

The RAND Report is not without irony. The Report notes that investors are confused about what it means to be a broker-dealer versus an investment adviser, do not understand the obligations of these professionals to their clients, and in many instances do not appreciate with any depth how such professionals are compensated.[120] However, the study also concludes, somewhat quizzically, that investors generally *are* satisfied with the financial services they personally receive from their financial advisers.[121] We believe this demonstrates the significant value that investors put on the availability of alternatives as to financial services and providers.

Simply put, there is no one-size-fits-all approach to establishing a standard of conduct for broker-dealers and investment advisers generally. Instead, investors seek the type and amount of financial advisory help that they desire and based on their particular needs. Investment advisory services generally entail greater costs than brokerage services, not surprising given the broader duties that typically have been associated with an investment advisory relationship.[122] Some clients are more than willing to assume these excess costs in exchange for the broader services provided by an investment adviser. Other clients are content managing their own portfolios and are interested in execution-only services from their service provider.[123] When considering the appropriate standard for broker-dealers and investment advisers providing varying types of services, the Commission must be mindful to draw meaningful and clear distinctions between different services and corresponding duties offered by broker-dealers and investment advisers so as to preserve the flexibility in selecting among financial services providers that investors value. We think the standard and application parameters discussed above meet these goals.

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[120] *See, e.g., id.* at xix, 87, 95, 117-118.

[121] *Id.* at 87, 99, 118.

[122] Investors report paying higher annual fees on average for investment advisory services than brokerage services. *Id.* at 95. However, the median advisory fees were smaller than the median brokerage fees, and the industry noted lower minimum annual fees for advisory services. *Id.* at 73, 95.

[123] The RAND Study found investors were about equally likely to seek services from a broker or an investment adviser. The compensation structures, disclosure requirements, and legal duties made investment advisers appealing, but account minimums, industry certification, and costs made brokers appealing. *Id.* at 118.

VI. Conclusion

LPL appreciates the opportunity to express its support for a universal standard of conduct for investment advisers and broker-dealers that provide personal investment advice to retail investors. We believe that such a standard will yield significant benefits to investors and firms alike and, along with greater disclosure by firms to investors about their services, conflicts and compensation, is a gating issue for broader financial services reform. We look forward to working with the Commission to advance this important issue.

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Date October 29, 2009

To Chairman Mary L. Schapiro
Commissioner Kathleen L. Casey
Commissioner Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes

From LPL Financial Corporation

Re **Harmonization of Regulations Applicable to Broker-Dealers and Investment Advisers**

I. Introduction

A. Federally registered broker-dealers and investment advisers currently operate under two distinct regulatory schemes that impose different duties and requirements. The Securities Exchange Act of 1934[1] ("Exchange Act") provides the foundation for the regulation of broker-dealers and the Investment Advisers Act of 1940[2] ("Advisers Act") provides the foundation for the regulation of investment advisers.

1. This has led to confusion for investors (largely retail investors) and difficulties for entities that are dually registered as broker-dealers and investment advisers in ensuring full compliance with regulatory obligations.[3]

2. This also has resulted in overlapping regulations that impose different

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[1] 15 U.S.C. § 78a *et seq.* (2006).

[2] 15 U.S.C. § 80b-1 *et seq.* (2006).

[3] For example, the Rand Institute for Civil Justice, a division of the RAND Corporation, published a report for the SEC that noted the regulation of investment advisers and broker-dealers is not consistent and investors do not understand differences between broker-dealers and investment advisers, their services or regulations that apply to them. Angela A. Hung et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (RAND Corp. ed., 2008), *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf ("RAND Report").

requirements for similar activities.[4]

B. This outline discusses the different duties and requirements that the current regulatory schemes impose on broker-dealers and investment advisers, includes our specific recommendations for harmonizing certain requirements in connection with adopting a uniform fiduciary standard of care, and identifies changes that will require Congressional action or rulemaking by the SEC and FINRA.

C. The initiative to create a fiduciary standard of care for persons providing personalized investment advice to retail customers presents the opportunity to review comprehensively broker-dealer and investment adviser regulation, to select the best practices to govern persons under the fiduciary standard of care, and to harmonize key regulations pertaining to all broker-dealers and investment advisers.

D. Several draft bills are being considered that include a uniform fiduciary standard of care for broker-dealers and investment advisers.[5] Although these bills authorize the SEC to adopt certain uniform requirements for firms subject to the uniform standard of care, they do not address the need to reconcile, where appropriate, additional regulatory requirements that are different for federally registered broker-dealers and investment advisers providing similar services.[6]

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[4] The Department of the Treasury noted the convergence of services broker-dealers and investment advisers provide, and commented that the separate regulatory regimes currently regulating financial services by function are outdated and inadequate. Department of the Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation 71 (Jun. 17, 2009), *available at* http://financialstability.gov/docs/regs/finalreport_web.pdf; Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure 13, 106, 123-26 (Mar. 2008) *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf.

[5] The Department of the Treasury released a draft bill and Congressman Paul E. Kanjorski introduced a bill that would authorize the SEC to require any brokers, dealers, and investment advisers that provide investment advice about securities to retail customers to be subject to the same standard, which would require them to act in the interests of the customer or client without regard to the firm's financial or other interests. *See* Investor Protection Act of 2009, Sec. 913, *available at* http://www.treas.gov/press/releases/docs/tg_218IX.pdf ("Treasury Draft"); Investor Protection Act of 2009, H.R. 3817, 111th Cong. 1st Sess. § 103 (2009) ("Kanjorski Bill"). The Kanjorski Bill also defines the term "retail customer" as an individual or his or her legal representative who receives and uses personalized investment advice primarily for personal, family or household purposes. Investor Protection Act of 2009, H.R. 3817, 111th Cong. 1st Sess. § 103 (2009).

[6] The Treasury Draft and Kanjorski Bill would authorize the SEC to require straightforward disclosure to investors regarding the terms of their relationships with investment professionals, and to examine and, where appropriate, promulgate rules prohibiting certain conflicts of interest and compensation schemes and sales practices that are contrary to the public interest and interests of investors. *See* Investor Protection Act of 2009, Sec. 913, *available at* http://www.treas.gov/press/releases/docs/tg_218IX.pdf; Investor Protection Act of 2009, H.R. 3817, 111th Cong. 1st Sess. § 103 (2009). The Kanjorski Bill also would require the SEC to issue regulations to ensure that the enforcement options and remedies applicable to broker-dealers subject to the uniform standard are harmonized with the enforcement options and remedies under the Advisers Act. Investor Protection Act of 2009, H.R. 3817, 111th Cong. 1st Sess. § 103 (2009).

E. LPL Financial Corporation ("LPL")[7] supports the adoption of a uniform fiduciary standard of care for broker-dealers and investment advisers providing advice to retail customers. However, adopting a uniform fiduciary standard of care alone is an incomplete and inadequate solution unless the regulations applicable to broker-dealers and investment advisers are harmonized as well. LPL believes that firms providing similar services should not be required to follow different statutory regimes.

1. For example, if a broker-dealer simply were subject to the proposed uniform standard of care, absent other statutory changes, the firm still would be required to (i) maintain licensing for the broker-dealer's agents; (ii) ensure registered personnel pass qualification exams and undergo computer-based continuing education programs continuing; (iii) maintain minimum amounts of net capital; (iv) purchase a fidelity bond from an insurance company; and (v) provide annual audited financial statements. Yet an investment adviser subject to the same fiduciary standard of care would not be subject to any of these important investor protection requirements, even when providing advice similar to that provided by the broker-dealer.[8]

2. As described below, the majority of these requirements are imposed by statute or regulations promulgated pursuant to statutory authority. In most instances, the SEC does not have the legislative authority to change these requirements without Congressional action.

F. LPL recommends that Congress include in the Investor Protection Act of 2009 amendments to the Exchange Act and Advisers Act to harmonize key regulations applicable to all federally registered broker-dealers and investment advisers, and to require firms to comply with the uniform fiduciary standard of care. Congress also should direct the establishment of a common self-regulatory organization (SRO) for broker-dealers and investment advisers.[9] LPL, as a dual registrant, believes FINRA is well-equipped to serve as the SRO for both broker-dealers and investment advisers.

1. Harmonization efforts should recognize that sophisticated clients, such as institutional investors of a particular size, do not need the same level of protection afforded to retail clients, and any harmonized requirements

[7] LPL was formed in 1989 through the merger of two brokerage firms, and currently is one of the nation's leading diversified financial services companies and the largest independent broker-dealer. Our clients consist largely, but not entirely, of retail investors. LPL has extensive experience with the regulatory regimes that govern registered investment advisers and broker-dealers because LPL is dually registered and provides advisory and brokerage services to our clients.

[8] *See* 17 C.F.R. §§ 240.15c3-1, 17a-5; NASD Rule 1000 Series, Rule 3020.

[9] Unless otherwise noted, all recommendations are limited to federally registered broker-dealers and investment advisers.

should be developed with this important distinction in mind.[10] LPL believes an appropriate standard for identifying institutions that do not need the same types of protections as retail investors should be based on the standard for determining when a company is deemed a "qualified purchaser" under the Investment Company Act.[11]

2. Harmonized regulations for federally registered broker-dealers and investment advisers subject to the Exchange Act and Advisers Act should not alter the requirements under the Employee Retirement Income Security Act (ERISA), Investment Company Act of 1940, and other applicable laws and regulations.

3. The SEC should amend existing rules and adopt new rules under the amended statutes to further implement harmonization, and the common SRO should promulgate rules applicable to all of its member firms.

II. Regulatory Requirements

A. Regulators

1. Federally registered broker-dealers currently are subject to:

    a) Regulation by the SEC and an SRO (the Financial Industry Regulatory Authority, or FINRA), including regulations regarding a broker-dealer's financial operations, trading activities, and general conduct with customers and the public. FINRA rules also impose comprehensive supervision obligations on firms with respect to the activities of their employees;[12]

    b) Near annual examinations by FINRA and near annual examinations by the SEC; [13] and

[10] A number of exemptive and safe harbor provisions under the federal securities laws are based, in part, on the degree of sophistication of investors, and are supported by the view that they do not need the same level of protection. *See, e.g.*, 15 U.S.C. § 77d(6) (registration exemption for offer and sale to "accredited investors"); 17 C.F.R. § 230.144A (exemption for offer and sale to "qualified institutional buyers"); 15 U.S.C. § 80(a)-3(c)(7) (exemption from registration as investment company for issuer owned by "qualified purchasers"); 17 C.F.R. § 275.205-3 (exemption from performance compensation prohibition for "qualified clients").

[11] *See* 15 U.S.C. § 80a-2(a)(51)(A).

[12] *See, e.g.*, 15 U.S.C. §§ 78o, 78o-3, and 78s; FINRA Manual (generally).

[13] 15 U.S.C. §§ 78q(b), 78u(a); FINRA Rule 8210. *See also* Lori Richards, Director, SEC Office of Compliance Inspections and Examinations, Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals, Remarks at the National Meeting of the National Society of Compliance Professionals (Oct. 21, 2008) (indicating SEC examination program provides for "routine examinations of large broker-dealer firms to evaluate their internal controls; [and] 'oversight' examinations of broker-dealers to evaluate the SROs' regulatory programs"), *available at* http://www.sec.gov/news/speech/2008/spch102108lar.htm.

c) Periodic examinations by state regulators.[14]

2. Federally registered investment advisers are not regulated by an SRO and instead are subject to:

   a) Regulation by the SEC regarding their fiduciary duty to clients and their advisory activities;[15]

   b) Examinations by the SEC, usually only once every two to five years (there is no self-regulatory organization for investment advisers);[16] and

   c) Limited state regulation (states have the authority to investigate federally registered advisers only for suspected fraud or deceit).[17]

3. These requirements are based on statutory provisions in the Exchange Act and Advisers Act.

4. Recommendations:

   a) LPL recommends that Congress amend applicable statutes to establish a common SRO to examine and provide additional regulation of federally registered broker-dealers and investment advisers.

   b) As a dual registrant, LPL believes that FINRA is uniquely qualified to serve as the common SRO and should conduct all regulatory examinations.[18] Authorizing FINRA as the common SRO would leverage resources to enable more frequent examinations and enhanced supervision of advisory activities.[19]

   c) LPL recommends that at a minimum, FINRA should be designated as the SRO with the authority to conduct the regulatory examinations of dual registrants. FINRA has an established examination program and already examines these registrants in their capacity as broker-dealers. Congress could include a sunset

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[14] *See, e.g.,* N.Y. General Business Law § 352 (2009) (authorizing examinations by the New York Attorney General's office for the prevention of fraud).

[15] *See* 15 U.S.C. § 80b-1 *et seq.*; 17 C.F.R. § 275 *et seq.*

[16] 15 U.S.C. §§ 80b-4(a), 80b-9. *See also* SEC Examinations and the Risk Assessment Process, Presentation at the 2007 CCOutreach Regional Seminars (noting high-risk advisers are placed on three-year exam cycle), *available at* http://www.sec.gov/info/cco/examprocess2007.pdf.

[17] *See* 15 U.S.C. § 80b-18a (outlining limitations on state regulation of investment advisers).

[18] Alternatively, if a separate SRO for registered investment advisers is created, FINRA should serve as the SRO and conduct all regulatory examinations for broker-dealers and firms that are dually registered as broker-dealers and investment advisers.

[19] Richard G. Ketchum, Chairman and CEO, FINRA, Testimony before the H. Comm. on Financial Services (Oct. 6, 2009).

provision to monitor this extension of FINRA's authority and consider whether it is appropriate and should be continued.

B. Application/Registration Process

1. Broker-dealer registration applicants are required to (i) file Form BD with the SEC; (ii) provide additional information to FINRA as part of the FINRA membership process; (iii) submit to a pre-membership interview with FINRA; (iv) sign a FINRA Membership Agreement; and (v) obtain state licenses.[20]

2. Federally registered investment adviser registration applicants are required to (i) file Form ADV Part 1 with the SEC, which must be reviewed by a SEC staff member before registration is effective; (ii) deliver Form ADV Part II to clients; (iii) retain a copy of Form ADV Part II in their files; and (iv) fulfill state notice filing requirements.[21]

3. Recommendations:

    a) LPL believes that federally registered investment advisers should be required to become FINRA members. When investment advisers join FINRA, they should provide more detailed information about their operations to FINRA and submit to a pre-membership interview with FINRA.

    b) LPL suggests that the registration forms for broker-dealers and investment advisers be harmonized by the SEC to the extent possible, including the requirement that customers and clients receiving similar services receive a common disclosure document (see below).

C. Compliance / Supervision

1. Broker-dealers are required to establish and maintain processes to supervise the activities of registered representatives, registered principals and associated persons that are reasonably designed to achieve compliance with the federal securities laws.

    a) Broker-dealers must comply with specific requirements related to the examinations, recordkeeping, and supervision of offices of supervisory jurisdiction and other branch offices.[22]

    b) Supervisory systems must include comprehensive written procedures, internal inspections, annual compliance meetings, and

[20] NASD Rules 1010-1019. *See also* 15 U.S.C. §§ 78o(b), 78o-3(i); 17 C.F.R. § 240.15b1-1.

[21] 17 C.F.R. § 275.203-1; *see also* Form ADV, SEC 1707 (01-08).

[22] NASD Rules 3010, 3012.

the designation of principals to oversee registered representatives and to review transactions and correspondence.[23]

c) Broker-dealers also must identify one or more Chief Compliance Officers and a firm's CEO must provide an annual certification regarding the firm's compliance program.[24]

2. Investment advisers are not subject to any requirements specifically related to branch offices. Investment advisers are required to:

a) Adopt, implement, and annually review written compliance policies and procedures;[25]

b) Obtain written acknowledgement from certain employees indicating receipt of the adviser's Code of Ethics;[26] and

c) Designate a Chief Compliance Officer (but neither the CEO nor the CCO is required to sign a certification regarding the firm's compliance program).[27]

3. Recommendations:

a) LPL recommends that rules adopted by FINRA require investment advisers to comply with supervisory requirements similar to those applicable to broker-dealers, including in particular the rigorous internal inspection and annual certification requirements.

b) LPL believes that FINRA also should require investment advisers to comply with requirements similar to those applicable to the supervision of a broker-dealer's branch offices.

D. Licensing Standards, Proficiency Testing and Continuing Education

1. Broker-dealer registered personnel must pass qualification exams, file Form U-4 with FINRA, and undergo computer-based continuing education programs within two years of registering and every three years thereafter (regulatory element). Broker-dealers are required to have a written training plan for each year and hold annual compliance meetings for each registered representative and registered principal (firm element).[28]

2. Investment adviser representatives are not subject to federal licensing,

[23] 15 U.S.C. § 78o(b)(4)(E); NASD Rule 3010.

[24] FINRA Rule 3130.

[25] 17 C.F.R. § 275.206(4)-7(a)-(b).

[26] 17 C.F.R. § 275.204A-1(a)(5).

[27] 17 C.F.R. § 275.206(4)-7(c).

[28] *See generally*, NASD Rule 1000 Series.

continuing education or training requirements. State licensing standards and proficiency testing may apply for investment adviser representatives in certain locations, generally only if the representative provides personal investment advice, regularly communicates with or solicits the adviser's individual retail clients, and has a place of business in that state. Where investment adviser representative licensing applies, states generally require the submission of Form U-4 and the successful completion of applicable qualification exam(s).

3. Recommendations:

   a) LPL recommends that FINRA require investment adviser representatives to register with FINRA, pass qualification exams and file Forms U-4, unless providing services solely to institutional clients.

   b) LPL believes FINRA also should require continuing education for all investment adviser representatives, including both firm and regulatory elements.

E. Fee Structure

1. Currently broker-dealers charging asset-based fees or flat fees that also provide even limited investment advice may be deemed investment advisers.[29]

2. One of the draft bills being considered would amend the Exchange Act to provide that receiving compensation based on commissions shall not, in and of itself, violate the uniform fiduciary standard of care applied to a broker or dealer.[30]

3. Recommendations:

   a) LPL recommends that the Investor Protection Act clarify that broker-dealers and investment advisers are allowed to charge any type of fee, including transaction-based and asset-based fees.

   b) LPL believes that broker-dealers and investment advisers providing personalized investment advice to retail investors should be required to comply with the uniform standard of care regardless of the fee charged. The specific requirements of the standard should be based on the services provided, not the type of fee charged.

F. Financial Monitoring / Audited Financial Statements

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[29] *See, e.g.*, 15 U.S.C. § 80b-2(a)(11)(C).

[30] Investor Protection Act of 2009, H.R. 3817, 111th Cong. 1st Sess. § 103 (2009).

1. Depending on their activities, broker-dealers are required to submit monthly or quarterly financial filings relating to their capital position to the SEC and FINRA (*e.g.*, FOCUS Reports), and their financial statements also must be audited annually by an independent public accountant.[31]

2. Currently, investment advisers are not required to submit monthly or quarterly financial filings to the SEC. An adviser is required to undergo an annual surprise audit of client funds and securities by an independent public accountant only if it is deemed to have custody of client funds or securities and sends quarterly account statements to each client.[32]

3. Recommendation: LPL supports extending to investment advisers the statutory requirements to file periodic financial reports and provide annual audited financial statements.

III. Investor Protections

A. Fidelity Bond and Minimum Capital Requirements

1. Broker-dealers are required to purchase a fidelity bond from an insurance company, providing a source of compensation for clients who are victims of fraud or embezzlement by broker-dealer personnel.[33] Brokerage firms also are required to maintain minimum amounts of net capital.[34]

2. Investment advisers do not have these requirements under the Advisers Act. (State and ERISA requirements may impose bonding or minimum net capital requirements.)

3. Recommendation: LPL recommends that Congress extend the statutory requirements to require investment advisers to purchase a fidelity bond and maintain minimum net capital.

B. Custody

1. Broker-dealers generally (i) must maintain possession and control of client assets; (ii) must deposit customer cash or specified securities in a reserve account; and (iii) are subject to limits on the amount they borrow against securities that are not required to be in their possession to prevent the use of client assets as collateral to leverage their own business.[35]

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[31] 17 C.F.R. § 240.17a-5.

[32] 17 C.F.R. § 275.206(4)-2(a)(3)(ii).

[33] NASD Rule 3020.

[34] 17 C.F.R. § 240.15c3-1.

[35] 17 C.F.R. § 240.15c3-3.

2. Investment advisers that have custody of client assets must meet certain requirements, including: (i) maintaining client assets with a qualified custodian; (ii) notifying clients when an account is opened on their behalf; and (iii) if account statements are not sent to the client by the custodian, sending quarterly account statements and submitting to an annual surprise audit.[36]

3. Recommendations:

   a) The SEC is currently considering comments on proposed amendments to the rule concerning custody of client assets by investment advisers.[37]

      (1) LPL supports extending certain requirements, such as audited financial statements, minimum capital requirements, and fidelity bonds so that they also apply to investment advisers under the proposed amendments.

      (2) However, LPL also recommends several changes to the SEC's proposed amendments. In particular, we believe that dual registrants should be exempt from the proposed requirement that an adviser with custody undergo a surprise annual audit and produce internal control reports. LPL also believes that a surprise audit is not appropriate or necessary when an adviser is deemed to have custody solely because they have the authority to direct a custodian to withdraw fees.[38]

   b) If the SEC pursues a new harmonized approach to custody, LPL recommends following the regulations currently applicable to broker-dealers. While LPL believes that requiring a surprise audit for firms subject to the uniform standard of care is unnecessary, if pursued, it should not apply to fiduciaries that are deemed to have custody solely because they have the authority to direct a custodian to withdraw fees. LPL recommends that any additional requirements under these circumstances should be targeted to the verification of the fee calculations and fee instructions instead of a comprehensive verification of all applicable accounts and account balances.

C. Suitability

[36] 17 C.F.R. § 275.206(4)-2.

[37] Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Rel. No. 2876, 74 Fed. Reg. 25,354 (May 20, 2009).

[38] *See* Comment Letter of LPL Financial (Jul. 28, 2009), *available at* http://www.sec.gov/comments/s7-09-09/s70909-821.pdf.

1. Broker-dealers must have grounds for believing a recommendation is suitable, based on the customer's financial status, tax status, investment objectives, and other reasonable information. Broker-dealers also are required to seek "best execution" for client trades, generally viewed as the best execution available under the circumstances for an order. There are a variety of factors relevant to a broker-dealer's best execution obligation, including price, speed of execution, type of security sought, etc.[39]

2. Investment advisers must provide suitable advice in line with customer objectives and needs, and must seek best execution. An adviser's fiduciary standard arguably imposes a higher duty of care than a broker-dealer's suitability obligation.[40] In seeking best execution of customer orders, investment advisers are to consider the total cost or proceeds to the client as a result of an execution given the goods and services provided.

3. Recommendations:

    a) LPL believes that all recommendations by a broker-dealer or investment adviser should be suitable, based on information about the client's goals and objectives. LPL also believes that broker-dealers and investment advisers should be subject to the uniform standard of care if they provide personalized investment advice to retail customers.

    b) LPL recommends that any obligation to monitor continually and make recommendations with respect to an account be determined based on the contract between the firm and client.

D. Principal Trades

1. Broker-dealers must disclose whether they have purchased or sold a security as principal or agent in trade confirmations sent to customers prior to the settlement of the trade. Broker-dealers also must disclose whether they receive payment for order flow or other remuneration in connection with a customer's transaction.[41]

2. Investment advisers are prohibited from engaging in principal trades with their clients absent prior written, transaction-specific disclosure and client

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[39] NASD Rules 2310, 2320.

[40] *See* 15 U.S.C. § 80b-6(1) and (2). The suitability obligation has been largely articulated in enforcement actions. *See, e.g., In re* George Sein Lin, Investment Advisers Act Release No. 1174, 43 SEC Docket 1840-437 (Jun. 19, 1989) (invested client assets in unsuitable uncovered options using margin accounts). It should be noted that the SEC once proposed to make the duty to provide suitable investment advice express. Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Rel. No. 1406, 56 SEC-Docket 724-395 (Mar. 16, 1994). The SEC never took final action on the rule, however.

[41] 17 C.F.R. § 240.10b-10.

consent.[42]

3. Temporary Rule 206(3)-3T provides limited relief from the transaction-specific written notice requirement for principal trading by an investment adviser that is dually registered as a broker-dealer. Under the rule, a non-discretionary advisory client with a brokerage account subject to the Exchange Act and the rules thereunder is permitted to authorize an adviser in writing to engage in principal trades prospectively provided the adviser has provided certain conflict of interest disclosures to the client. A non-discretionary adviser that has obtained such consent must then obtain the oral or written consent of the client before each principal trade. Clients must then receive written confirmation of each transaction containing additional disclosure, as well as periodic summaries of all principal transactions made in reliance on the rule. This temporary rule is scheduled to expire on Dec. 31, 2009.[43]

4. Recommendations:

   a) Although disclosure and consent are necessary to address conflicts of interest under fiduciary principles, strong arguments have been made over the years as to why more flexibility in this area is warranted, particularly as to certain fixed income securities transactions, and how the current notice and consent requirements sometimes work against the best interest of investors.[44] Therefore, LPL recommends the SEC allow intermediaries to obtain customer consent to principal transactions at the time of account opening.

   b) If the SEC determines that it is essential to maintain trade-by-trade notice and consent requirements, LPL recommends the following modifications to that requirement.

      (1) In the short-term, we believe the SEC should adopt a final rule by December 31, 2009 that provides the same relief as the interim rule.

      (2) In the long-term as part of the harmonization process, we believe principal trades in discretionary accounts should be subject to trade-by-trade consent requirements similar to Advisers Act Section 206(3) and principal trades in non-discretionary accounts should be provided relief similar to Rule 206(3)-3T for all investment advisers and for broker-dealers subject to the uniform standard of care. Broker-

[42] 15 U.S.C. § 80b-6(3).

[43] 17 C.F.R. § 275.206(3)-3T.

[44] *See* Letter to Robert E. Plaze, Associate Director, SEC Division of Investment Management, from Lee B. Spencer, Jr., Chairman, Securities Industry Association Federal Regulation Committee (Feb. 26, 1998) (citing enhancements in market transparency and disclosure, and adverse consequences of Section 206(3) on advisory clients in request for principal trading relief), *available at* http://www.sifma.org/regulatory/exemption_archives/principal_transactions.pdf.

dealers that are not subject to the uniform standard of care should continue to be subject to the current requirements applicable to principal trades by broker-dealers.

(3) In addition, we recommend the SEC adopt an additional rule requiring riskless principal transactions in discretionary accounts to meet requirements similar to Rule 206(3)-2 (agency cross transactions). These types of principal transactions do not pose the same risks of abuse as other principal trades for which Section 206(3) should continue to apply.

E. Pre-Dispute Arbitration Clauses

1. Broker-dealers are permitted to include pre-dispute arbitration clauses in brokerage customer agreements, and standard brokerage agreements include such language.[45]

2. More than twenty years ago, there was some ambiguity whether the Advisers Act prohibited the use of pre-dispute arbitration clauses in investment advisory contracts.[46] However, the U.S. Supreme Court has held that arbitration agreements generally are enforceable under the Federal Arbitration Act[47] and several courts have found arbitration clauses between investment advisers and their customers to be enforceable.[48]

3. The draft bills being considered would permit the SEC to prohibit or impose conditions or limitations on the use of arbitration clauses in agreements that broker-dealers, municipal securities dealers, and investment advisers enter into with customers, if the SEC finds that such prohibition, conditions or limitations are in the public interest and for the protection of investors.[49]

4. Recommendations: With FINRA in place as the SRO for both investment

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[45] FINRA Rule 12200.

[46] The staff has indicated that an arbitration clause cannot constitute a waiver of investor rights under the Advisers Act – including the choice of forum in which to resolve disputes. *McEldowney Fin. Serv.*, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,373 (Oct. 17, 1986).

[47] Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987).

[48] *See* Piper Funds, Inc. v. Piper Capital Mgmt., Inc., 71 F.3d 298 (8th Cir. 1995) (investor's and fund manager's agreement to arbitrate all claims, including securities law claims was enforceable); Pritzker v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 7 F.3d 1110 (3rd Cir. 1993) (agreement to arbitrate required arbitration of ERISA claims for breach of fiduciary and statutory duties); Newcome v. Esrey, 862 F.2d 1099 (4th Cir. 1988) (investor's action against investment adviser and brokerage firm under section 10(b) of the Exchange Act was subject to arbitration clause); Fabian Fin. Serv. v. Kurt H. Volk, Inc. Profit Sharing Plan, 768 F. Supp. 728 (C.D. Cal. 1991) (arbitration clause in agreement between registered investment adviser and pension plan was valid).

[49] Investor Protection Act of 2009, H.R. 3817, 111th Cong. 1st Sess. § 201 (2009). *See also* Investor Protection Act of 2009, Sec. 921, *available at* http://www.treas.gov/press/releases/docs/tg_218IX.pdf.

advisers and broker-dealers, LPL recommends that Congress extend the current FINRA arbitration procedures to cover both broker-dealers and investment advisers.

F. Anti-Money Laundering

1. Broker-dealers are subject to PATRIOT Act and FINRA anti-money laundering regulations, which require comprehensive anti-money laundering compliance programs.[50]

2. Investment advisers are not expressly subject to the PATRIOT Act anti-money laundering regulations (though advisers may be responsible for anti-money laundering procedures by contract with a broker-dealer or investment company).[51]

3. Recommendation: LPL suggests that investment advisers be subject to anti-money laundering requirements.

IV. Disclosure Requirements

A. Disclosure documents

1. Brokerage firms are required to provide: (i) basic information about the firm on Form BD; (ii) transaction-specific disclosures on confirmations at or before completion of a transaction; (iii) specific information about trading activities in account statements at least quarterly; (iv) firm financial statements; and (v) depending on their activities, execution quality data or information with respect to their customer order routing activities.[52]

2. Investment advisers are required to provide: (i) basic information about the firm, its business, and disciplinary history on Form ADV, which is filed with the SEC and updated annually; and (ii) more detailed disclosures regarding advisory fees, conflicts of interest, and background of key personnel in Form ADV Part II or a brochure containing the same information, which must be provided to customers before or at the time of contract and offered to be delivered annually.[53] If an investment adviser is

[50] 31 U.S.C. §§ 5312(a)(2)(G), 5318(h); 31 C.F.R. § 103.120; 17 C.F.R. § 240.17a-8; NASD Rule 3011 (SEC recently approved FINRA Rule 3310 to replace NASD Rule 3011 eff. Jan. 1, 2010).

[51] The Dept. of the Treasury withdrew a proposed rule applying Patriot Act AML requirements to investment advisers in 2008. Financial Crimes Enforcement Network; Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers, 73 Fed. Reg. 65568 (Nov. 4, 2008).

[52] 15 U.S.C. § 78o(b); 17 C.F.R. §§ 240.10b-10, 15b1-1, 17a-5(c), 605 and 606; NASD Rule 2340; see also Form BD, *available at* http://www.sec.gov/about/forms/formbd.pdf.

[53] 17 C.F.R. §§ 275.203-1, 204-3; *see also* Form ADV, *available at http://www.sec.gov/about/forms/formadv.pdf.*

deemed to have custody of client assets, it is required to provide the client with quarterly account statements or have a reasonable basis for believing that the qualified custodian is providing such account statements to the client.[54]

3. Recommendations:

   a) LPL recommends that the Investor Protection Act direct the SEC to require investment advisers and broker-dealers to provide retail investors with a uniform plain English disclosure brochure at account opening explaining the various services offered to clients, the nature of a firm's relationships with its clients, material conflicts of interest, the capacity in which the firm is acting when providing each service offered (adviser vs. broker-dealer), fees, and material relationships. LPL also recommends that the SEC require the delivery of a short-form disclosure document and make a longer form available upon request. These disclosure documents would be required in lieu of providing a Form ADV Part II brochure to retail clients receiving investment advice.

   b) Such disclosure also may be useful not only for retail investors receiving investment advice, but for all investors receiving services from broker-dealers and investment advisers. We recommend that the SEC consider whether the disclosure document should be provided to all clients of investment advisers and broker-dealers not subject to the uniform standard of care.

   c) All investment advisers would still be required to file Form ADV Part 1 and all broker-dealers would still be required to file Form BD to provide basic data about the firm to the public and regulators.

   d) LPL believes the SEC also should continue to require transaction-specific disclosures at or before the completion of the transaction by broker-dealers and on quarterly account statements from the firm at which the account is located.

B. Advertising

1. Broker-dealers are prohibited from making false, exaggerated, unwarranted or misleading statements in any communications with the public. Additional prohibitions and disclosure requirements apply to advertisements and other public communications, and other requirements apply to institutional sales material and correspondence. A registered principal must approve advertisements and sales literature, and some types of communications (*e.g.*, mutual fund advertisements) must be filed with

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[54] 17 C.F.R. § 275.206(4)-2(a)(3).

FINRA.[55]

2. Investment advisers' advertisements are subject to the general antifraud provisions and, among other things, may not include testimonials, refer to past specific recommendations that were or would have been profitable, or overstate performance information.[56] There are no applicable approval or filing requirements.

3. Recommendations:

   a) LPL recommends that FINRA and the SEC establish advertising and sales literature standards that are applied according to the types of services provided.

   b) LPL believes that accounts subject to the fiduciary standard of care and all advisory accounts should be subject to the existing Advisers Act antifraud standards as well as the existing, parallel FINRA rules.

      (1) This would entail harmonizing different requirements currently contained in the advertising rules under the Advisers Act and FINRA rules.

      (2) For example, broker-dealers providing personalized investment advice to individuals should be prohibited from including testimonials, overstating performance, and using "Advisor" or "Financial Advisor" or similar term or language that implies a fiduciary relationship or other relationship of trust or confidence when the relationship is not fiduciary, which would entail amending the current FINRA rules.

      (3) A registered principal of investment advisers should be required to approve advertisements and sales literature, and certain communications (*e.g.*, mutual fund advertisements) should have to be filed with FINRA, which would entail new rules applicable to investment advisers.

   c) LPL recommends that brokerage accounts that are not subject to the uniform standard of care continue to be subject to the existing standards and FINRA rules currently applicable to broker-dealers.

C. Record Retention

1. Broker-dealers must maintain records related to transactions, customer accounts, personnel, assets and liabilities, customer complaints,

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[55] NASD Rules 2210, 2211.

[56] 17 C.F.R. § 275.206(4)-1.

advertisements, and communications with customers. Broker-dealers also are subject to the "business as such" standard – which means they have to keep any other records related to their business as broker-dealers. In addition, all electronic records must be maintained in WORM (write once, read many) format. Generally, records must be preserved for three or six years, the first two years in an easily accessible place.[57]

2. Investment advisers must maintain business records such as: business accounting records, order memoranda, advertisements, certain written communications with customers, contracts, the code of ethics, performance records, and compliance policies and procedures. Among other things, investment advisers are not required to keep all records related to their business as investment advisers and are not required to keep electronic records in WORM format. Generally, records must be preserved for five years from the end of the fiscal year, the first two years in an easily accessible place.[58]

3. Recommendations:

    a) LPL recommends that the SEC amend the recordkeeping rules under the Exchange Act and Advisers Act to include the same recordkeeping requirements for investment advisers and broker-dealers.

    b) Records should be maintained for the same time periods, the same types of records should be kept, and the same requirements should apply for maintaining electronic records, including requiring documents to be maintained in WORM format.

    c) LPL also recommends that the SEC eliminate the requirement that broker-dealers keep any other records related to their business as broker-dealers because this standard is difficult to interpret and implement.

V. Summary of recommendations

A. The current regulatory schemes under which federally registered broker-dealers and investment advisers currently operate impose different duties and requirements.

B. To address the resulting confusion for investors, difficulties for dually-registered financial services firms in ensuring full compliance, and overlapping regulations that impose different requirements for similar activities, we recommend harmonizing the different regulatory requirements for federally registered broker-dealers and investment advisers in connection with adopting the uniform fiduciary

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[57] 15 U.S.C. § 78q; 17 C.F.R. §§ 240.17a-3 and 17a-4.

[58] 15 U.S.C. § 80b-4; 17 C.F.R. § 275.204-2.

standard of care.

C. Harmonizing these requirements will require Congressional action and rulemaking by the SEC and FINRA.