THE FINANCIAL SERVICES ROUNDTABLE
Financing America's Economy

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Ms. Elizabeth Murphy
Secretary
Securities and Exchange Committee
100 F Street NE
Washington DC 20549-1090

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

Dear Ms. Murphy:

The Financial Services Roundtable[1] ("Roundtable") appreciates the opportunity to share its responses to the Securities Exchange Commission's ("Commission") investigation into the effectiveness of existing standards of care applicable to brokers, dealers, and investment advisers when providing personalized investment advice to retail investors. The Roundtable has long been supportive of the harmonization of the regulations for broker-dealers and investment advisers when providing personalized investment advice to retail customers. We also support strong consumer protections for retail investors.

These worthy goals can be achieved without subjecting broker-dealers and investment advisers to identical legislative and regulatory regimes that may not acknowledge the different services and products provided by these professionals. We believe the Commission can achieve regulatory harmonization and increased consumer-protections by harnessing the Commission's existing rulemaking powers with the new authority granted in section 913(f) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010) ("Dodd-Frank Act").

As reform efforts progress, it is important that the retail investors - who should benefit the most from regulatory reform - not suffer inadvertent harm. The avoidance of undesirable consequences requires a rulemaking procedure that balances the needs of the retail investor with the scope of services provided by broker-dealers and investment advisers. We hope the Commission will investigate exactly what information customers need in order to determine which services or products work best for them, and preserves their rights to make informed choices.

Combating Customer Confusion in the Financial Services Marketplace

The Commission's release asks whether retail investors understand that brokers, dealers, and investment advisers are subject to discrete standards of care, and whether the different standards of care

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $85.5 trillion in managed assets, $965 billion in revenue, and 2.3 million jobs.

creates confusion among customers. The Roundtable believes that some retail investors may not aware that broker-dealers and investment advisers are governed by alternative standards of care. However, we also believe the risk of confusion is less severe than imagined and that the focus should be on ensuring customers understand what services are contracted for, at what cost, and what potential conflicts may impact the relationship.

Understanding the Significance of Customer Confusion in terms of Customer Satisfaction

Customers may be confused about the precise legal duties that apply to broker-dealers, investment advisers and financial professionals with generic titles. However, a 2008 RAND Report found that retail customers generally understood that broker-dealers and investment advisers provided different services and products.[2] Moreover, any confusion over the legal duties and proper taxonomy of broker-dealers and investment advisers did not lower retail customers' satisfaction with their broker-dealer or investment adviser.[3] Most respondents and participants reported being very satisfied with their broker-dealer or investment adviser; these reports are incongruent with the claims that customers are overwhelmed or harmed by the existence of alternative standards of care. The findings indicate that the risk and actual effects of customer confusion are less severe than imagined, and that the focus should instead be on ensuring that customers understand three critical issues before engaging a financial professional. First, what services am I contracting for? Second, at what cost? And third, what conflicts of interest may impact what you recommend to me?

The answers to these three questions are at the core of any relationship with a trusted provider of services. Strengthening disclosure rules to provide this information in a clear and simple format may be more useful to customers than applying a uniform fiduciary standard on broker-dealers and investment advisers, because the information is very similar to the type of information customers seek whenever they contract for services, whether they are contracting with an auto mechanic, a babysitter, or a real estate agent.

However, if the SEC toughens disclosure requirements, we urge it to make these changes in the context of a wholesale review of *all* of the disclosure rules, instead of considering each proposed disclosure change piecemeal (*e.g.*, confirm disclosures for the 12b-1 proposals; point-of-sale disclosures; disclosure rules in the context of fiduciary duty rules, *etc.*). The promulgation or amendment of disclosure rules holistically (all at once) would increase the efficiency of the disclosure process and prevent the development of overlaps and gaps in disclosure rules. Wholesale promulgation of disclosure rules also would give regulators and consumers a bird's eye-view of industry practices; this would allow consumers to easily compare disclosure practices across the securities industry.

The Current Regulatory Oversight of Broker-Dealers and Investment Advisers

There is a misperception on the part of some observers that customers who receive personalized investment advice from broker-dealers may be more vulnerable to fraud or bad-actors because section 202(a)(11)(C) of the Investment Advisers Act (the "Act") excludes broker-dealers from the definition of "investment adviser," and the Act obligates investment advisers to act in the "best interest of the customer" when providing personalized investment advice to retail customers. The implication is that

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[2] RAND Corporation, RAND Institute for Civil Justice, Technical Report, *Investor & Industry Perspectives on Investment Advisers and Broker-Dealers (*hereinafter *RAND Report),* ¶ 118 (Jan 2008) (reporting that the roles of broker-dealers and investment advisers was generally confusing to survey respondents and focus group participants, although most respondents and focus-group participants understood the general differences between investment advisers and broker-dealers).

[3] *Id.*

the exclusion creates a higher-risk for customers of broker-dealers who provide incidental, personalized investment advice.

This premise belies the fact that broker-dealers (and associated persons of broker-dealers) do owe extensive duties to their retail clients under the existing regulatory framework, including the duty to make suitable recommendations, to comply with just and equitable principles of trade, and other FINRA rules governing the conduct of broker-dealers and their associated persons. Taken together, the duties of broker-dealers are very similar to the "best interests" standard articulated in the Investment Advisers Act. For example, investment advisers and broker dealers both must satisfy suitability obligations.[4] According to FINRA, "[s]uitability obligations constitute a material part of a fiduciary standard in the context of investment advice and recommendations."[5] FINRA also noted that "case law makes clear that, under FINRA's suitability rule, 'a broker's recommendations must be consistent with his customers' best interests.'"[6] The dual suitability requirements for investment advisers and broker-dealers need not be found in the same statute to be effective. Given this, imposing broad new requirements on broker-dealers to address what may be an immaterial distinction seems excessive because broker-dealers, regardless of their functions, are currently subject to a number of rules and regulations governing their conduct and standards when providing personalized investment advice to retail customers. For example, brokers and dealers must perform their duties in conformance with the following standards:

- *Duty of fair dealing.* The antifraud provisions of the Exchange Act and the "shingle theory"[7] requires broker-dealers to deal fairly with customers, execute orders promptly, disclose material information, charge prices reasonable to the market, and fully disclose any conflict of interest. SROs generally require broker-dealers to observe high standards of commercial honor and "just and equitable" principles of trade in conducting their business. The exchanges and the MSRB have similar rules.

- *Suitability Requirements and a duty of inquiry regarding customer objectives and financial circumstances.* The antifraud provisions and SRO rules, such as NASD Rule 2310, mandate that brokers and dealers owe their customers an obligation to limit their recommendations to suitable investments that are consistent with a customer's investment objectives. Suitability requires the broker-dealer to have an "adequate and reasonable basis" for the belief that an investment is suitable for a particular customer, and imposes an affirmative duty of inquiry on broker-dealers to obtain relevant and current information regarding a customer's financial situations. Over the years the NASD and FINRA have issued numerous regulatory notices to members (RN, NTM) outlining additional factors to be considered in recommending specific types of securities or in providing services to certain types of customers (e.g. FINRA Rule 2330 governing recommendations to purchase deferred variable annuities; NTMs 96-60,89-65 regarding low-priced securities; NTM 96-66 on government securities; NTM 03-71 on non-conventional investments; NTM 08-82 on cash alternatives; NTM 05-59 on structured products; NTM 94-16 on mutual funds; NTM 09-35 on municipal securities; NTM 09-73 on principal protected

[4] *See* SEC Rel. No 62718, ¶ 19 (August 13, 2010) (comparing the existing suitability requirements of broker-dealers and investment advisers).
[5] *Id.*
[6] *Id.*
[7] The shingle theory holds that when a broker hangs out its shingle to do business it impliedly represents that it will deal fairly with its customers and in accordance with industry standards. The theory had its origins in an early SEC administrative case. *In re Duker & Duker*, 6 SEC 386, 388 (1939). Most often the theory is applied to the concept of fair pricing and full disclosure.

notices; NTM 08-30 on illiquid investments; NTM 96-32 on speculative securities; NTM 09-31 on exchange traded funds; and NTM 04-30 on bonds and bond funds).

- *Duty of Best Execution.* The Exchange Act and SRO rules require broker-dealers to obtain the most favorable terms available under the circumstances for customer orders, regardless of whether the broker-dealer acts as an agent or principal in the transaction. FINRA requires members to use "reasonable diligence" to determine the best market for a security so the customer benefits from the most favorable price available.

- *Duty to Disclose and Confirm.* The antifraud provisions require broker-dealers to make certain disclosures at the time of the investment. This requirement was improved by the Dodd-Frank's provision that all disclosures be clear and simple. Rule 10b-10 and MSRB rule G-15 obligate broker-dealers to provide certain confirmation information at or before the completion of a transaction, including:

    - the date, time, identity, price, and number of shares involved;
    - Agency or principal status, and compensation. If acting as a principal, mark-up disclosure may also be required.
    - The source and amount of any third party remuneration it has received or will receive.
    - General disclosures (*e.g.,* if the broker-dealer is not a SIPC member) and transaction-specific, like the yield, in most transactions involving debt securities.

- *Disclosure of credit terms.* Prior to the extension of credit, under Rule 10b-16, brokers are obligated to disclose credit terms and provide account information.

- *Duty to Protect the Privacy of Consumer Financial Information.* Regulation S-P requires broker-dealers to guard customers' private information; restricts the use and sharing of customer information; and imposes administrative, technical and physical safeguards regarding the storage, use, and disposal of such information. Broker-dealers must also provide customers with clear and conspicuous notices of the broker-dealers privacy policies and practices, and provide customers an opportunity to opt-out of permissible information sharing.

The Oversight of the Regulation of Broker-Dealers and Investment Advisers

The primary differences between the standards governing broker-dealers and investment advisers that provide personalized investment advice to retail customers are the origin of the duties. Most of the broker-dealers' rules stem from the antifraud provisions in the Securities Exchange Act of 1934 ("Exchange Act") and the rules and regulations of various Self-Regulatory Organizations' ("SRO").[8] Investment advisers generally rely on the aptly-named Investment Advisers Act of 1940 for standards of care. The existence of different governing statutes for broker-dealers and investment advisers has evolved in response to the different functions and services provided by each industry sector. The Roundtable does not oppose harmonizing regulations, but we encourage the Commission to examine the alternate roles and services provided by broker-dealers and investment advisers so the final rules are appropriately tailored to meet the diverse needs of consumers in each industry.

The Registration and Licensing of Broker-Dealers and Investment Advisers

[8] Brokers and dealers are subject to the Exchange Act's antifraud provisions found in §§ 9(a), 10(b), 15(c)(1) and (2) of the Exchange Act and SEC Rules 10b-1 through 10b-18, 15c1-1 through 15c1-9, 15c2-1 through 15c2-11, and Regulation M.

Entities that are licensed as broker-dealers by the Securities and Exchange Commission must also be registered with the Financial Industry Regulatory Authority ("FINRA") and are entitled, by virtue of their licenses and registrations, to buy and sell securities for their clients' accounts. Within licensed broker-dealer firms there is a significant range of heterogeneity in the firms' operational activities and services. Below is a sample of common functions provided within a licensed broker-dealer firm:

i. *Limited Recommendations of "approved securities."* Registered representatives are licensed and associated with licensed broker-dealer firms and make recommendations to clients regarding the purchase or sale of securities, but are limited in their recommendations to those securities that appear on their associated broker-dealer's list of "approved securities."

ii. *Broker-Dealers Acting as Principal or Dealer.* Some firms may also act as principals or dealers trading securities for their own inventory. Other broker-dealers act in *both* capacities, for example, offering clients securities from the firm's own inventory, often at a lower cost than the price available in the open market.

iii. *Wholesalers and Distributors.* Wholesaling and distributing broker-dealers market and distribute their own proprietary products to other firms. Wholesale and distributor broker-dealers have limited, if any, contact with retail customers.

iv. *Introducing and Clearing Broker-Dealers.* "Introducing" broker-dealers hold no client funds or securities and instead contract with a "clearing" broker-dealer to handle the execution and settlement of orders that the introducing firm receives from its clients or its own trading desk to buy and sell securities. In these arrangements, the introducing broker-dealer has the relationship with the customer, but the clearing firm, not the introducing broker, receives payments and securities from the clients and handles record-keeping.

The Registration and Licensing of Investment Advisers

Investment advisers are registered with the Securities Exchange Commission and/or states in which they do business. Such persons are able to provide "investment advice" as that term is defined in Section 202(a)(11) of the Investment Advisers Act, and may:

> "…for compensation, engage in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or, for compensation and as part of a regular business, issue or promulgate analyses or reports concerning securities."

Investment advisers may *not* offer and sell securities, they can only advise on the suitability of investing in securities. The definition would otherwise include broker-dealers who make recommendations to purchase and sell securities, the SEC carved broker-dealers out of the definition of investment adviser in recognition of the fact that under the Securities Exchange Act of 1934, broker-dealers were already subject to copious regulations.

Notably, the Commission's exclusion of broker-dealers is not a blanket-exemption from the definition of investment adviser. The exclusion of broker-dealers and their representatives applies only if the personalized investment advice is *"solely incidental"* to the sale of securities, and then only if they

receive no special compensation for such advice. Section 202(a)(11)(C). To receive compensation for their investment advice (outside of the context of selling securities), a registered representative of a broker-dealer must be registered as an investment adviser or investment adviser representative. Thus, broker-dealers who provide personalized investment advice to retail customers on a regular basis are already registered with the SEC, and possibly with state regulators, as an investment adviser.

Conclusions

While the Roundtable is not opposed to heightened duties of care for certain broker-dealers or increased disclosures, we request that any changes in standards consider that a broker-dealer's conduct does not exist in an unregulated vacuum: broker-dealers are already heavily regulated by federal and state standards intended to protect consumers from fraud and misconduct. Unfortunately, creating a uniform fiduciary duty does nothing to protect investors from fraud unless there is a robust supervisory and regulatory structure capable of deterring, detecting, and prosecuting fraud. This will require strong and effective supervision within financial services firms and regular, periodic inspections by the SEC and other regulatory bodies.

Subjecting investment advisers or broker-dealers to a regulatory regime that was designed for *a different* sector of the financial industry could negatively influence the pricing or availability of services, which would harm consumers. This can be avoided and harmonization can be achieved without subjecting brokers, dealers, and investment advisers to identical and potentially duplicative regulatory regimes. We hope the Commission's efforts will consider the diverse duties and functions of broker-dealers and investment advisers, in addition to any similar duties performed by the parties. Where gaps or overlaps occur, the Dodd-Frank Act empowers the SEC to shape new guidelines and regulations for brokers, dealers, and investment advisers in an equitable manner that avoids duplicative burdens. We hope the SEC will take advantage of the flexible provisions provided in 913(f) to maximize consumer protection and minimize potentially harmful consequences, such as reduced access to services.

However, if a uniform fiduciary standard is adopted, we respectfully request that the uniform standard be tied to *the investment services provided,* as opposed to the label attached to the provider of those services. Further, any uniform standard should preempt state laws as a means to maximize a uniform standard of care, and minimize the possibility of customer confusion over applicable standards.

The Roundtable thanks the SEC for the opportunity to participate in the study on the obligations of brokers, dealers, and investment advisers. If you should have any questions or concerns about this or any other issue, please don't hesitate to contact myself, at Rich@fsround.org or the Roundtable's Senior Regulatory Counsel, Brad Ipema, at Brad.Ipema@fsround.org.

Very Sincerely Yours,

Richard M. Whiting