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Invested in America

July 14, 2011

Via E-mail

Mary L. Schapiro, Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Framework for Rulemaking under Section 913 (Fiduciary Duty) of the Dodd-Frank Act; **File No. 4-604**

Dear Chairman Schapiro:

The Securities Industry and Financial Markets Association[1] ("**SIFMA**") appreciates the opportunity to submit the following comments for consideration by the Securities and Exchange Commission (the "**SEC**" or the "**Commission**") as it establishes, pursuant to its plenary authority under Sections 913(f) and (g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.

Throughout the legislative process and debate that preceded the enactment of the Dodd-Frank Act, SIFMA has supported the development of a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.[2]

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] *See, e.g., Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 2-3 (2009) (statement of John Taft, Head of U.S. Wealth Management, RBC Wealth Management on behalf of SIFMA), *available at* http://financialservices.house.gov/media/file/hearings/111/taft_testimony.pdf; *Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 21 (2009) (statement of Randolph C. Snook, Executive Vice President, SIFMA), *available at* http://financialservices.house.gov/media/file/hearings/111/snook.pdf.

The purpose of this letter is to offer a framework and principles for rulemaking under Section 913 of the Dodd-Frank Act to help inform the Commission's rulemaking process. We also seek to encourage further deliberation and dialogue about the optimal approach for implementing a uniform fiduciary standard of conduct in accordance with the Dodd-Frank Act that is designed to protect investors, preserve investor choice and access to cost-effective financial products and services, and adapt to the substantially different operating models of broker-dealers and investment advisers.

Consistent with these objectives, we also believe that appropriately robust and rigorous cost-benefit analyses are essential to inform and shape any SEC rulemakings, particularly those that call for the type of "sea change" reform envisioned by Section 913 of the Dodd-Frank Act. Thus, we remain supportive of the current cost-benefit and other empirical analyses that we understand the SEC is currently undertaking on this issue, as well as any other analyses that may help inform the optimal approach for implementing a uniform fiduciary standard of conduct. We also will support, as an industry, such studies or analyses by providing appropriate data, feedback, or other information that would result in the most accurate and meaningful findings and conclusions. Accordingly, we are eager to further engage and communicate with the SEC and others on this important issue.

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Executive Summary

SIFMA supports the establishment of a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.[3] The guiding principle that underpins this uniform standard is to act in the best interest of the customer. The standard should be articulated through comprehensive SEC rulemaking as a uniform standard of conduct that is "no less stringent than" the general fiduciary duty implied under the Investment Advisers Act of 1940 (the "**Advisers Act**").

The SEC's Study on Investment Advisers and Broker-Dealers (the "**Study**")[4] contains a number of thoughtful findings. It does not, however, specify that the contemplated uniform fiduciary standard of conduct for broker-dealers and investment advisers should be separate and distinct from the general fiduciary duty implied under Section 206 of the Advisers Act. Instead, the Study raised the serious concern among our member firms that the SEC may be contemplating an "overlay" on broker-dealers of the existing Advisers Act standard.[5] SIFMA strongly opposes imposing on broker-dealers the existing Advisers Act standard together with its associated case law, guidance, and other legal precedent.

Our members are also concerned that the SEC could take the unnecessarily narrow view that, because Section 913 of the Dodd-Frank Act requires that the uniform fiduciary standard be "no less stringent than" the general fiduciary duty implied under Section 206 of the Advisers Act, the SEC's latitude and ability to establish a separate, unique uniform fiduciary standard is limited. We believe no such limitation exists or was intended under the Dodd-Frank Act. The plain language of Section 913, together with the legislative history of the Dodd-Frank Act, makes clear that the "no less stringent" language does *not* require that the SEC impose the Advisers Act standard on broker-dealers.[6] As Congressman Barney Frank has indicated,

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[3] SIFMA's position is limited to retail customers, i.e., natural persons who use investment advice for personal, family or household purposes. SIFMA does not propose to modify the current Advisers Act standard applicable to the delivery of investment advice to the institutional clients of investment advisers, or the existing case law, guidance or other legal precedent developed under Section 206 of the Advisers Act.

[4] Commission Study on Investment Advisers and Broker-Dealers, as required by Section 913 (Jan. 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

[5] *Id.* at pp. 109 and 111.

[6] Letter from Congressman Barney Frank to Chairman Mary Schapiro at p. 1 (May 31, 2011) (the **"Frank Letter"**) ("'no less stringent' … was not intended to encourage the SEC to impose the … Advisers Act… standard on broker-dealers…").

> "If Congress intended the SEC to simply copy the [Advisers] Act and apply it to broker-dealers, it would have simply repealed the broker-dealer exemption – an approach Congress considered but rejected. The new standard contemplated by Congress is intended to recognize and appropriately adapt to the differences between broker-dealers and registered investment advisers."[7]

Investment advisers are generally engaged in the business of providing advice about securities for a fee, or managing assets on a discretionary basis. Broker-dealers engage in the former activity on occasion (advice about securities), but also provide a broad range of additional products and services. Broker-dealers provide, for example, initial and follow-on public offerings and other underwritten offerings, and market fixed-income and affiliated products, all of which contribute to the capital raising, liquidity, best execution, and portfolio balancing functions of our securities markets. Yet, these services, which are beneficial to both the economy and individual investors, often carry inherent (though generally accepted and well-managed) conflicts of interest. The general fiduciary duty implied under Section 206 of the Advisers Act, as developed through case law, guidance and other legal precedent, however, provides incompatible and insufficient guidance for broker-dealers on how to manage, disclose, or obtain consents to these conflicts.

In Section II, we explain in detail why a wholesale extension to broker-dealers of the case law, guidance and other legal precedent under Section 206 of the Advisers Act would entail a host of adverse consequences. Most importantly, it would *not* be in the best interest of retail customers, because it would negatively impact choice, product access and affordability of customer services. It would also be problematic for broker-dealers from a commercial, legal, compliance, and supervisory perspective, thereby undercutting the SEC's stated intent to take a "business model neutral" approach. The Dodd-Frank Act authorizes, the SEC Study supports, and investor protection warrants, taking a fresh approach by establishing, through SEC rulemaking under Section 913 of the Dodd-Frank Act, a uniform fiduciary standard of conduct for broker-dealers and investment advisers.

In Section III, we offer, for the first time, a proposed framework and principles to advance the development of a fiduciary standard of conduct through SEC rulemaking under Section 913 of the Dodd-Frank Act. Under our proposed framework, the general fiduciary duty implied under Section 206 of the Advisers Act, which derives from the traditional, generally understood and accepted common law,[8] would be newly articulated through SEC

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[7] *Id.*

[8] *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963) ("…Congress codified the common law 'remedially' [in the Advisers Act] … to prevent[] fraudulent securities transactions by fiduciaries"). *See also* Restatement of Agency (Third) (agency is the fiduciary relationship that arises when one person (the principal) manifests assent to another person (the agent) that the agent shall act on the principal's behalf and subject to the principal's control, and

rulemaking under Section 211 of the Advisers Act and Section 15 of the Securities Exchange Act of 1934 (the "**Exchange Act**").[9] The standard of conduct would apply equally to broker-dealers (through Section 15(k) of the Exchange Act) and investment advisers (through Section 211(g) of the Advisers Act) when providing personalized investment advice about securities to retail customers. The SEC would also issue rules and guidance to provide the detail, structure and guidance necessary to enable broker-dealers and investment advisers to apply the uniform fiduciary standard of conduct to their distinct operational models.[10]"

The uniform fiduciary standard of conduct would begin with the core principle mandated by the Dodd-Frank Act that all brokers, dealers and investment advisers, when providing personalized investment advice about securities to retail customers, shall "act in the best interest of the customer …."[11] The complete phrase reads "act in the best interest of the customer *without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice*" (emphasis added). The italicized language could be interpreted to require firms to operate a conflicts-free business (if read literally and not in conjunction with other Section 913 statutory language that permits disclosure of, and customer agreement to, material conflicts).[12] It also appears to conflict with other Section 913 statutory language that allows commission-based compensation, proprietary products, and a non-continuing fiduciary duty. Based upon our communications with the Commission and their staff, however, we agree with their view that such language should *not* represent an impediment to the SEC establishing a uniform fiduciary standard that is

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the agent manifests assent or otherwise consents so to act). *But see* Section II.B.2, explaining that existing case law regarding the fiduciary duty of investment advisers was developed in the context of a business model which is inapplicable to broker-dealers, and applying such case law in the broker-dealer context could have legal and regulatory consequences that would undermine the broker-dealer business model, with no corresponding benefit to retail customers.

[9] Thus, the uniform fiduciary standard of conduct would conclusively satisfy the Dodd-Frank Act's requirement that the standard be "no less stringent than" the standard implied under Section 206 of the Advisers Act.

[10] Our proposed approach is consistent with that historically followed in agency and trust contexts. The precise contours of the fiduciary obligation are molded to particular fiduciary fields or contexts. Thereafter, common sets of facts are addressed through implementing rules that apply the duties of loyalty and care to those circumstances. "The ... rules simplify application of the fiduciary obligation to cases that fall within their terms, reducing decision costs." *See* Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. Law Rev. 1039, 1044-45 (2011).

[11] Section 913(g) of the Dodd-Frank Act.

[12] *Id.* ("In accordance with [the rules promulgated under the uniform fiduciary standard of conduct], any material conflicts of interest shall be disclosed and may be consented to by the customer.")

sufficiently flexible, fairly balanced, business model neutral and, most importantly, investor protection focused. Accordingly, the principle of "acting in the best interest of the customer" would serve as the bedrock cornerstone of the SEC rules promulgated under Section 211 of the Advisers Act and Section 15 of the Exchange Act.

Existing case law, guidance, and other legal precedent developed under Section 206 of the Advisers Act would continue to apply to investment advisers. While there would be many parallels, this Section 206 precedent would *not* apply to broker-dealers, because: (i) broker-dealers provide a different range of products and services, and operate under an operational model distinct from that of investment advisers;[13] and (ii) Section 206 precedent does not now apply to broker-dealers. Section 206 precedent would therefore not apply in the future to broker-dealers under the uniform fiduciary standard of conduct established under Section 211 of the Advisers Act and Section 15 of the Exchange Act.[14]

Attached as **Appendix 1** is a one-page graphical representation to help visualize the framework we are now proposing. Our framework is built around the following five key components:

1. Enunciate the core principles of the uniform fiduciary standard of conduct.

2. Articulate the scope of obligations under the uniform fiduciary standard of conduct.

3. Define "personalized investment advice".

4. Provide clear guidance regarding disclosure that would satisfy the uniform fiduciary standard of conduct.

5. Preserve principal transactions.

[13] While broker-dealers and investment advisers may at times provide similar services, there are many substantive differences in the products, services, conflicts, and traditional compensation practices between the two well-established and highly regulated business models. *See, e.g.*, Letter to Elizabeth M. Murphy, SEC, from Ira D. Hammerman, SIFMA (Aug. 30, 2010), *available at* http://www.sec.gov/comments/4-606/4606-2553.pdf ("**SIFMA Section 913 Comment Letter**"); Frank Letter at p. 1.

[14] The express language of Dodd-Frank Act Section 913 appears to support this approach. Section 913 pegs the uniform fiduciary standard to Sections 206(1) and (2) of the Advisers Act, but not to Section 206(3), which restricts principal transactions, or to Section 206(4), which grants the SEC authority to issue rules under Section 206. Thus, it may fairly be said that Congress did not intend for Section 206 rules or other legal precedent to apply to broker-dealers under the uniform fiduciary standard of conduct.

Our proposal is intended to inform the Commission's rulemaking process and encourage further discussion about the optimal approach for implementing a uniform fiduciary standard of conduct. We believe the optimal approach is one that fully protects investors, preserves their choice of and access to financial products and services, and adapts to the substantially different business models of broker-dealers and investment advisers. We believe that our proposal, and call for a uniform fiduciary standard to be established through SEC rulemaking, fully satisfies these criteria and will benefit millions of retail investors for years to come. We are hopeful that the Commission will find this framework constructive and useful to the process going forward.

While not a focus of this letter, SIFMA also generally supports the Study's recommendation that the SEC consider harmonizing other areas of broker-dealer and investment adviser regulation, including advertising, the use of finders and solicitors, supervisory requirements, licensing and registration of firms and associated persons, and books and records, among others. We encourage further deliberation by the SEC regarding these discrete regulatory areas, and we hope to engage the staff in future dialogue on these topics.

I. Introduction

We welcome the Commission's efforts to develop a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. As we have previously stated, SIFMA's position is limited to retail customers, i.e., natural persons who use investment advice for personal, family or household purposes, and we do not propose to modify the current Advisers Act standard applicable to the delivery of investment advice to the institutional clients of investment advisers, or the existing case law, guidance or other legal precedent developed under Section 206 of the Advisers Act.

We believe the following key principles should guide the development of the standard:[15]

- The interests of retail customers should be put first. When providing personalized investment advice about securities to retail customers, broker-dealers and investment advisers should deal fairly with these customers, and, at a minimum, appropriately manage conflicts and provide retail customers with full disclosure that is simple and clear and allows retail customers to make an informed decision about a particular product or service.

- Investors should continue to have access to, and choice among, a wide range of products and services. The standard of conduct should allow broker-dealers to

[15] SIFMA Section 913 Comment Letter.

continue to offer products and services that are available today, such as providing retail customers liquidity as principal, proprietary products and advice regarding sophisticated investment strategies. The standard should allow retail customers to choose among various models for compensating their financial services provider.[16]

- The uniform fiduciary standard of conduct should be "business model neutral."

- The SEC should clearly define the standard of conduct and should provide guidance as to how it can be implemented by broker-dealers, tailored to their various business models.

- Where products and services involve material conflicts of interest, broker-dealers and investment advisers should be able to provide disclosures to customers in a pragmatic way to clearly and effectively communicate, and receive the customer's consent to, these conflicts of interest. Similarly, the SEC should provide guidance to clarify whether a customer's affirmative consent is required or not, and if so, at what point it should be obtained.[17]

The Dodd-Frank Act authorizes the Commission to adopt rules to provide that the standard of conduct for all broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers, is to act in the best interest of the customer. This standard of conduct shall be no less stringent than the fiduciary duty applicable to investment advisers under Sections 206(1) and (2) of the Advisers Act.

As explained in detail in Section II, while we embrace the adoption of a uniform fiduciary standard of conduct, we believe that a wholesale extension to broker-dealers of the general fiduciary duty implied under the Advisers Act is not in the best interests of investors and is problematic for the broker-dealer business model. Instead, we advocate for taking the sum and substance of the general fiduciary duty implied under the Advisers Act and articulating it through SEC rulemaking as the uniform fiduciary standard of conduct – a standard which would:

- apply only to, and be tailored for, those services and activities involving provision of personalized investment advice about securities to retail customers;

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[16] We note that the Dodd-Frank Act provides that the sale of only proprietary or other limited range of products, or the receipt of commission-based compensation, shall not, in and of themselves, violate the uniform fiduciary standard of conduct.

[17] *See* Section III.C.4.b.v. and vi.

- provide for reasonable approaches to managing conflicts;

- provide adequate flexibility to preserve and enhance client choice, product and service innovation, and capital formation; and

- otherwise provide the detail and guidance necessary to enable broker-dealers and investment advisers to apply the standard of conduct to their distinct operational models.

In Section III below, we offer a framework for the uniform fiduciary standard of conduct to inform the Commission's rulemaking process. We believe that this proposed standard of conduct, adapted to the substantially different operating models for broker-dealers and investment advisers, offers the best approach for protecting investors and preserving investor choice and access to cost-effective financial products and services.

II. The Need for a New Articulation of a Uniform Fiduciary Standard of Conduct

A. Overview

In January 2011, the SEC published its Study, which contained a number of thoughtful findings. It did not, however, specify that the contemplated uniform fiduciary standard of conduct for broker-dealers and investment advisers would be separate and distinct from the general fiduciary duty implied under Section 206 of the Advisers Act. Instead, the Study raised serious concern among our member firms that the SEC may be contemplating an "overlay" on broker-dealers of the existing Advisers Act standard, with its associated case law, SEC guidance and other legal precedent.[18]

The wholesale imposition of the Advisers Act fiduciary duty on broker-dealers would be commercially impracticable. In light of the distinct differences between the operating models of investment advisers and broker-dealers,[19] and in order to maintain broker-dealer products and services for investors, SIFMA believes the obligations of broker-dealers when providing personalized investment advice about securities to retail customers under the uniform fiduciary standard of conduct should *not* be governed by the existing rules, case law, guidance or other legal precedent under Section 206 of the Advisers Act.[20]

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[18] Study at pp. 109 and 111.

[19] *See* SIFMA Section 913 Comment Letter.

[20] As explained in the Executive Summary, existing Section 206 legal precedent and guidance would continue to apply to investment advisers.

SIFMA therefore supports a new articulation, through SEC rulemaking, of the general fiduciary duty implied under Section 206 of the Advisers Act as the uniform fiduciary standard of conduct. SIFMA likewise opposes any approach that would extend the existing rules, case law, guidance and other legal precedent under Section 206 of the Advisers Act standard wholesale to broker-dealers.[21]

B. The Adverse Implications of Imposing the Advisers Act on Broker-Dealers

The viability of a uniform standard is predicated upon a new articulation of the standard of conduct for investment advisers and broker-dealers, because wholesale extension of the Advisers Act standard to broker-dealers is unworkable and inconsistent with the purposes of Section 913 of the Dodd-Frank Act, investor protection, and the broker-dealer business model.

1. The Advisers Act was not designed to regulate broker-dealer activity. The Advisers Act was not intended or designed to apply to the incidental advice offered by broker-dealers,[22] and the interpretations that have been given under that Act have not taken into account broker-dealer roles.

In passing the Dodd-Frank Act, Congress could have simply eliminated the broker-dealer exception to the Advisers Act definition of "investment adviser" and applied to both broker-dealers and investment advisers the general fiduciary duty implied under the Advisers Act. Congress affirmatively elected *not* to do so.[23] Thus, Congress recognized that the uniform fiduciary standard should "appropriately adapt to the differences between broker-dealers and registered investment advisers."[24]

2. The case law regarding the fiduciary duty of investment advisers was developed in the context of a business model which is inapplicable to broker-dealers. There are very

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[21] *See, e.g.*, SIFMA Section 913 Comment Letter; and SIFMA comment letter on FINRA Regulatory Notice 10-54 (Dec. 2010), available at http://www.sifma.org/Issues/item.aspx?id=22482 ("**SIFMA RN 10-54 Comment Letter**").

[22] The definition of "investment adviser" in the Advisers Act specifically excludes "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." Section 202(a)(11) of the Advisers Act.

[23] *See* Restoring American Financial Stability Act of 2009, S. ___, 111th Cong. § 913 (discussion draft as proposed by Senator Dodd, Chairman, Senate Comm. on Banking, Hous., & Urban Affairs, Nov. 10, 2009), *available at* http://banking.senate.gov/public/_files/AYO09D44_xml.pdf. *See also* Frank Letter at p. 1.

[24] Frank Letter at p. 1.

few federal fiduciary cases brought against investment advisers. A primary reason is that customers cannot sue their advisers for breach of their fiduciary duty under Section 206 of the Advisers Act.[25] The few existing case law precedents apply to a different business model, and speak only in very general, high-level and vague terms about the fiduciary standard and what is required to satisfy it. Yet, if the fiduciary duty applicable to investment advisers is simply overlaid onto broker-dealers, these same precedents could easily be misinterpreted and misapplied – by courts and regulators alike – in any number of ways that would disadvantage and undermine the broker-dealer business model, and without a corresponding benefit to retail customers.[26]

3. <u>SEC staff statements regarding the fiduciary duty of investment advisers under the Advisers Act are not readily translatable to broker-dealers.</u> Over the years, the SEC staff has issued guidance regarding the fiduciary duty of investment advisers under Section 206 of the Advisers Act. These statements speak far more in terms of entirely avoiding conflicts, rather than appropriately managing them.[27] Accordingly, these statements

[25] *Transamerica Mortg. Advisors v. Lewis*, 444 U.S. 11 (1979). In *Transamerica*, the Court found that private plaintiffs can only sue their advisers under Section 215 of the Advisers Act, which provides that contracts made or performed in violation of the Act are void.

[26] In addition, the nationwide body of state case law on whether broker-dealers owe fiduciary duties and the scope of those duties also raises concerns, given that this body of law is so uneven and inconsistent – a point on which courts and commentators overwhelmingly agree. *See, e.g., Patsos v. First Albany Corp.*, 741 N.E.2d 841, 848-51 (Mass. 2001) ("Courts in other States have not been of single mind whether fiduciary duties inhere in every relationship between a stockbroker and his customer."); *Johnson v. John Hancock Funds*, 217 S.W.3d 414, 428 (Tenn. Ct. App. 2006) ("The courts have not been of a single mind whether fiduciary duties inhere in every relationship between a stock broker or investment advisor and his or her client"). *See also* discussion and cases cited in the following five scholarly works: (i) Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 Vill. L. Rev. 701 (2010) ("This sliver of securities law doctrine comprises a bewildering inconsistency of judicial decisions."); (ii) Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. Cin. L. Rev. 527 (2002) (describing division in state courts regarding fiduciary obligations of broker-dealers); (iii) Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 Iowa J. Corp. L. 65 (1997) ("Courts have often failed to do a careful analysis of the duty, resulting in erroneous, confusing or poorly explained opinions."); (iv) Gregory A. Hicks, *Defining the Scope of Broker and Dealer Duties – Some Problems in Adjudicating the Responsibilities of Securities and Commodities Professionals*, 39 DePaul L. Rev. 709 (1990) (noting the "uncertain significance of the fiduciary label often attached to these [brokers and dealers], and an accompanying uncertainty about the legal duties which the fiduciary label implies"); and (v) Carol R. Goforth, *Stockbrokers Duties to their Customers*, 33 St. Louis U. L.J. 407 (1989) (discussing inconsistent judicial approaches to whether and when fiduciary relationship arises between broker and customer).

[27] *See, e.g.*, Release No. IA-3060, File No. S7-10-00 ("An adviser must … seek to avoid conflicts with its client…."); Information for newly-registered investment advisers, available at

could be interpreted and applied in a manner more proscriptive than the "eliminate or disclose conflicts" approach recommended in the Study.[28] If such guidance were applied to broker-dealers under the uniform fiduciary standard of conduct, it would create legal and compliance uncertainty (described in greater detail below) that would in the worst case prevent, and in the best case disincentivize, broker-dealers from offering many of the beneficial products and services that they currently provide and that retail customers have come to value and rely upon.

4. The inability to gauge compliance with, or legal exposure under, the Advisers Act standard would undermine the broker-dealer business model. The Advisers Act standard does not provide necessary guidance regarding, for example, what disclosures will be adjudged complete and how and when consents must be obtained, when a broker-dealer provides advice involving principal trades, structured products, receipt of commissions and differential loads for different products. Nor does it provide necessary guidance regarding when the fiduciary duty begins and ends, or how it applies in the context of, for example, hybrid accounts or complex investment strategies, such as concentrated positions which may in many instances be at the customer's request.

Absent new rules and guidance – issued under Section 211 of the Advisers Act and Section 15 of the Exchange Act, as authorized by the Dodd-Frank Act – to enable broker-dealers to apply the fiduciary standard to their distinct operational models, broker-dealers cannot adequately supervise or gauge their compliance with the standard, nor can they manage litigation risks. Moreover, as noted above, customers cannot sue their advisers for breach of their fiduciary duty under Section 206 of the Advisers Act.[29] Thus, application of the Advisers Act standard to broker-dealers would subject broker-dealers to the unfair and unharmonized (and likely Congressionally unintended) consequence that retail customers could sue their broker-dealers, but not their investment advisers, for breach of the "uniform" fiduciary standard. Under circumstances where the business and legal risks are unmanageable, broker-dealers will withdraw from offering the affected products and services, which would disserve the interests of retail customers.

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http://sec.gov/divisions/investment/advoverview.htm ("You should not engage in any activity in conflict with the interest of any client…"); *In re Terence Michael Coxon*, Release ID-140 (Apr. 1, 1999) ("A fiduciary must therefore refrain from putting himself in a position of conflict of interest…"); *In re Monetta Financial Services, Inc.*, Release No. ID-162 (Mar. 27, 2000) (same); SEC No-Action Letter, National Deferred Compensation, Inc. (Aug. 31, 1987) ("An adviser may not fulfill its fiduciary obligations if it … imposes an additional fee on a client for choosing to change his investment").

[28] Study at p. vii.

[29] *Transamerica Mortg. Advisors v. Lewis*, 444 U.S. 11 (1979).

5. Empirical study shows that wholesale application of the Advisers Act duty to broker-dealers would negatively impact choice, product access, and affordability of customer services.[30]

a. **Choice**. Notwithstanding the Dodd-Frank Act provision stating that commission-based compensation alone would not violate the uniform fiduciary standard, undifferentiated application of existing Advisers Act case law, guidance and other precedents to broker-dealers could result in reduced access to brokerage accounts, given the potential conflicts that could arise from charging commissions. Commission-based brokerage accounts are overwhelmingly the preferred model for retail customers, with only 5% of households preferring the fee-based advisory platform. This is true across all wealth segments, but particularly for smaller investors with less than $250,000 in assets. For smaller investors, or those with more limited trading activity, a commission-based brokerage account is likely to be the more economical choice.

b. **Product access**. Undifferentiated application of existing Advisers Act case law, guidance and other precedents to broker-dealers could result in reduced access to products distributed primarily through broker-dealers. Given their inherent (though generally accepted and well-managed) conflicts, broker-dealers may not be able to continue to act as principal and sell proprietary products, including: sales of underwritten offerings (*e.g.*, IPOs); providing retail customers liquidity through market making and principal trading, including access to fixed-income products (*e.g.*, municipal and corporate bonds, which represent approximately 15% of assets held by retail customers); and sales of proprietary and affiliated products (notwithstanding the Dodd-Frank Act provision stating that such sales alone would not violate the uniform fiduciary standard).

c. **Affordability of advisory services**. Undifferentiated application of existing Advisers Act case law, guidance and other precedents to broker-dealers could result in reduced access of broker-dealer customers to investment options with fee structures adaptable to their needs, as well as the imposition of increased compliance, disclosure and surveillance costs, which would disproportionately impact small investors.

For these reasons, the Advisers Act standard is unworkable for broker-dealers. It would result in unfair treatment of broker-dealers vis-a-vis investment advisers, is inconsistent with the principles of investor protection (and likely Congressional intent), and would result in decreased access to products and services for retail customers. For a uniform

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[30] *See* SIFMA/Oliver Wyman study (Oct. 2010), available at http://www.sifma.org/Issues/item.aspx?id=21999. The SEC has also acknowledged the negative consequences of imposing the requirements of the Advisers Act, which include an adverse impact on retail investor choice of products and services, and how investors pay for those products and services. *See* Study at pp. 139-143.

standard of conduct to work without fundamentally disrupting the broker-dealer business model, it must employ a new articulation of the standard of conduct.

III. The Framework for Rulemaking

A. Overview

We offer below a framework for a newly articulated fiduciary standard of conduct to inform the Commission's rulemaking process. We believe that a standard guided by these principles, adapted to the substantially different operating models for broker-dealers and investment advisers, is the best approach for protecting investors and preserving investor choice and access to cost-effective financial products and services.

B. The Standard

The Commission's rulemaking under Section 913 shall "provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers… shall be to act in the best interest of the customer…." Material conflicts of interest should be disclosed and may be consented to by the customer. Section 913 also provides that the newly articulated standard must be no less stringent than Sections 206(1) and (2) of the Advisers Act, and is not constrained by the principal transactions restrictions of Section 206(3) of the Advisers Act.

As explained in the Executive Summary, under our proposed framework, the general fiduciary duty implied under Section 206, which derives from the traditional, generally understood and accepted common law, would be newly articulated as the uniform standard.[31] Under Section 211 of the Advisers Act and Section 15 of the Exchange Act (as authorized by the Dodd-Frank Act), the SEC would issue rules and guidance to provide the detail, structure and guidance necessary to enable broker-dealers to apply the fiduciary standard to their distinct operational model. In addition, while many parallels would occur, existing Section 206 investment adviser case law, guidance, and other legal precedent would continue to apply to investment advisers, but would *not* likewise apply wholesale to broker-dealers, in recognition that broker-

[31] In the Executive Summary, we noted that our proposed approach is consistent with that historically followed in agency and trust contexts. We also note that it is not unprecedented for a federal regulator to borrow and restate standards applicable to one group of financial services professionals in order to promote clarity and transparency in regulations applicable to a different set of financial services professionals. For example, the Department of Labor ("**DOL**"), rather than requiring bank collective funds to complete SEC Form N-1A, extracted the elements of certain calculations set forth in the Form and incorporated them into a DOL regulation. *See* 29 CFR Part 2550, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 75 Fed. Reg. 64910 at 64940 (October 20, 2010), available at http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24323.

dealers provide a different range of products and services, and operate under a distinct operational model.

C. Rulemaking Principles to Implement Dodd-Frank Act Section 913

Commission rulemaking to articulate the uniform standard of conduct must provide retail customers with tangible protections and affordable choices, while maintaining sufficient flexibility to accommodate distinct operational models for financial service providers. To facilitate the Commission's rulemaking under Section 913 of the Dodd-Frank Act, we recommend that the following key principles be addressed:[32]

1. Enunciate the core principles of the uniform fiduciary standard of conduct. SEC rulemaking should clearly enunciate the core principles that underpin the uniform standard applicable to all brokers, dealers, and investment advisers. First, the standard for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers, should be to act in the best interest of the customer.[33] Second, the standard should be no less stringent than the standard applicable to investment advisers under Sections 206(1) and (2) of the Advisers Act.[34] Third, material conflicts of interest should be disclosed and may be consented to by the customer.[35] Finally, consistent with Section 913, unless otherwise agreed with the customer, a broker or dealer or registered representative should not have a continuing duty of care to the customer after providing personalized investment advice about securities.[36]

2. Articulate the scope of obligations under the uniform fiduciary standard of conduct. SEC rulemaking should articulate the scope of a broker-dealer's obligations under the uniform standard of conduct. For example:

a. **Commencement of the standard of conduct**. The standard of conduct should commence when the customer agreement is signed by the customer (or, if earlier, upon the making of trades based on personalized investment advice about securities) and should apply only when providing personalized investment advice about securities to retail customers. Introductory discussions regarding the *nature of the relationship* would not be subject to the standard of conduct. Broker-dealers and investment advisers may discuss

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[32] It is critical that the Commission provide for a reasonable phase-in period for the new rules, to facilitate the transition for broker-dealers and thus for their retail customers.

[33] Derived from the explicit language of Section 913 of the Dodd-Frank Act.

[34] *Id.*

[35] *Id.*

[36] *Id.*

the different types of relationships available with a potential client without the standard of conduct applying to these discussions.

b. **Shape of the standard of conduct**. A broker-dealer's obligations to a retail customer under the standard of conduct should be specified in the customer agreement. The obligations may be crafted to reflect the specific agreement and objectives of the parties. For example, the customer agreement might specify that the broker-dealer's obligations do not extend beyond the particular sale, or might address the broker-dealer's obligations in the case of "hybrid" accounts; or the obligations may appropriately be limited to assets over which the broker-dealer has been given discretionary authority, specific recommendations about securities that are available through the broker-dealer, or such other limitations and disclosures to which the customer agrees.[37]

c. **Application of the standard of conduct to an account**. The uniform fiduciary standard of conduct should apply on an account-by-account basis, when providing personalized investment advice about securities, pursuant to the written customer agreement. Application on an account basis is consistent with they way firms currently enter into agreements with customers, and document customer relationships. Application on an account basis is also consistent with broker-dealers' records requirements to document investment objectives on an account basis.

d. **Inclusion of traditional product sales or compensation**. Traditional types of broker-dealer product sales or compensation arrangements should not be viewed to violate the standard of conduct. For example, the sale of proprietary-only, or other limited range of products, should not violate the standard, as applied to a broker or dealer, provided there is appropriate disclosure to and possibly consent by the customer, and the fiduciary ('best interest of the customer') standard is otherwise satisfied.[38] In addition, receipt of compensation based on commissions or other fees or standard forms of compensation including, without limitation, annual marketing or distribution fees on mutual funds, revenue sharing or shareholder accounting, should not violate the standard of conduct with appropriate customer disclosure.[39]

The SEC might consider "scenario planning" as part of the rulemaking process so that it can comprehensively examine, taking a bottom-up approach, the areas of particular concern to broker-dealers (e.g., advice involving principal trades, structured products,

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[37] There is, of course, a mandatory core to the fiduciary duty that cannot be overridden by agreement. For example, the principal cannot authorize the fiduciary to act in bad faith. The fiduciary must always act in good faith and deal fairly with and for the principal. *See* Sitkoff, 91 B.U. Law Rev. at 1046.

[38] *Id.*

[39] *Id.*

hybrid accounts, complex investment strategies, concentrated positions, and receipt of commissions and differential loads for different products). The SEC should provide the necessary rule-based guidance regarding when the fiduciary duty begins and ends and what disclosures and consents, if any, are necessary to satisfy the duty, and otherwise address how broker-dealers can satisfy the uniform fiduciary standard of conduct under these various scenarios.

3. <u>Define "personalized investment advice."</u> The standard of conduct applies only "when providing personalized investment advice about securities to retail customers." Thus, SEC rules should define with specificity which business activities fall within, and which remain outside, the scope of "personalized investment advice."[40]

A general definition might provide that "personalized investment advice" about securities means investment recommendations about securities that are provided to address the objectives or needs of a specific retail customer after taking into account the retail customer's specific circumstances.[41]

SEC rules should also provide specific guidance on personalized investment advice. For example, personalized investment advice about securities should include:[42]

- communications to a specific customer recommending that the customer purchase or sell one or more securities;

- communications about securities to one or more targeted customers encouraging the particular customers to purchase or sell a security;

- technology that analyzes a customer's financial or online activity and sends specific investment suggestions that the customer buy or sell a security;[43] and

[40] SEC rules should likewise adequately define the term "retail customer" to appropriately limit the scope of the new standard to, for example, natural persons that do not meet the "Qualified Institutional Buyer," or QIB, threshold.

[41] Derived from p. 125 of the Study.

[42] Derived from p. 124 of the Study.

[43] NASD Notice to Members 01-23, "Online Suitability" ("**NTM 01-23**"). NTM 01-23, however, also cites several examples of electronic applications that would fall outside the definition of "recommendation" and thus, in our view, should also fall outside the definition of personalized investment advice.

- discretionary decisions regarding securities bought, sold, or exchanged by the person or firm exercising investment discretion.

Personalized investment advice about securities should *not* include: [44]

- providing general research and strategy literature;
- discussing general investment and allocation strategies;
- seminar content that is not specific to a customer;
- general marketing and education materials that are not specific to a customer;
- financial planning tools and calculators that use customer information but do not recommend specific securities;
- broker-dealer investing web sites where retail customers use tools to analyze securities to make self-directed investment decisions;
- holding securities, including concentrated positions, or other complex or risky investment strategies, at the customers' request in a nondiscretionary account;
- taking and executing unsolicited customer orders;
- account and customer relationship maintenance (*e.g.*, periodic contact to remind customers to rebalance assets to match allocations previously established, absent efforts to recommend changes to the allocation percentages);
- needs analysis (*e.g.*, meetings to determine customers' current and any new investment objectives and financial needs);
- providing ancillary account features and services (*e.g.*, debit card, cash sweep, and margin lending);
- market making, absent efforts to recommend the traded securities;
- underwriting, absent efforts to recommend the underwritten security;

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[44] Derived generally from p. 126 of the Study, and Section 913 of the Dodd-Frank Act.

- referring customers to affiliated or third-party providers of financial or financial related services; or

- use of social media to convey investment strategies to a broad audience.

4. Provide clear guidance regarding disclosure that would satisfy the uniform fiduciary standard of conduct. Adequate disclosure guidance should be in place on or before the date the Section 913 standard of conduct becomes operative. Otherwise, broker-dealers cannot reasonably be expected to comply with or manage liability risks under the uniform fiduciary standard.

Establishment of clear guidelines regarding what disclosure is adequate and reasonable is particularly pressing for broker-dealers, whose activities involve conflicts that have not previously been subject to a "customer best interest" standard of conduct. Without clear guidelines, broker-dealers face the unquantifiable risk of courts and arbitrators second-guessing the adequacy of their disclosure of these conflicts on a post-hoc basis, and ultimately holding them liable as guarantors of their products or services based on inadequate disclosure or consent. This, in turn, creates the very real risk that broker-dealers would withdraw from offering many products and services, many of which are helpful to investors who wish to develop portfolios tailored to their needs and tolerance for risk.

a. ***Prospective guidance on disclosure should incorporate the following principles***:[45]

i. ***Clear disclosure***. Section 913 of the Dodd-Frank Act requires "simple and clear disclosures to investors…."[46] Retail customers will benefit from disclosure that is concise, direct, and in plain English.

ii. ***A layered approach***. Detail can overwhelm key facts. A layered approach to disclosure should be used to provide retail customers with the clearest, most relevant information at the time it is most important to their decision making, and therefore most likely to be read, with greater detail simultaneously made available to the customer if desired. For example, broker-dealers and investment advisers could provide printed materials applicable to all retail customers at the time of account opening, with more detailed disclosures that are relevant to particular transactions available on the internet.

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[45] These principles were also set forth in the SIFMA RN 10-54 Comment Letter.

[46] Section 913(g) of the Dodd-Frank Act.

iii. ***Web-based disclosure***.[47] Web-based disclosure is an effective manner to make immediate information available to many customers at a time that is most relevant to their investment decisions. It is also well adapted to providing layered disclosure that provides supplemental information to customers at the level of detail they desire.[48] Web-based information is also always available, while paper disclosures are easily discarded and easily forgotten. Of course, paper disclosures should be provided to customers that lack effective Internet access or that otherwise so request.

b. ***<u>Specific disclosure guidance would address the following areas</u>***:

i. ***Prospective customers***. Web-based disclosures should accompany web-based marketing materials for prospective customers that have had direct contact with a broker-dealer.

ii. ***Account opening***. Disclosures should include:

- the type of relationships available from the broker-dealer or investment adviser, and the scope of the standard of conduct that would apply to those relationships;
- the services that would be provided as part of the relationships, and information about applicable fees;
- material potential conflicts of interest that apply to these relationships, including conflicts arising from compensation

[47] SIFMA has been a consistent advocate of the benefits of web-based disclosure for over five years. *See*, *e.g.*, Letter from George R. Kramer, Vice President and Acting General Counsel, Securities Industry Association, to, Jonathan G. Katz, Secretary, SEC (April 12, 2004) (comments on proposed point of sale disclosure requirements for transactions in certain mutual funds), *available at* http://www.sec.gov/rules/proposed/s70604/sia041204.pdf; Letter from Elizabeth Varley, SIFMA, to Department of Labor (July 24, 2007) (comments on request for information regarding fee and expense disclosures to participants in individual account plans), *available at* http://www.sifma.org/issues/item.aspx?id=232; Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to, Kim Allen, International Organization of Securities Commissions (Oct 2, 2008), *available at* http://www.sifma.org/issues/item.aspx?id=355 (comments on IOSCO's point of sale disclosure issues paper).

[48] For example, where the customer has the ability to effectively access documents furnished in electronic form, a "notice and access" delivery option should be available, whereby the firm posts material on its internet website and sends a notice to the customer that the materials are available online. The SEC successfully followed this approach in the E-proxy rules. See http://www.sec.gov/rules/final/2010/33-9108.pdf.

arrangements, proprietary products, underwritten new issues, types of principal transactions,[49] and customer consents thereto;

- the availability of many products under other fee structures and from other providers;
- disclosure and consents regarding any aggressive or sophisticated investment strategy, including concentrated positions; and
- disclosures of the background of the firm and of its associated persons, building upon existing systems, such as FINRA's BrokerCheck database.

iii. ***Point-of-sale***. If applicable, in appropriate circumstances, disclosures might include: the nature of the product; the nature of the fees involved; and the specific conflicts of interest applicable to that product. The regime should be sufficiently flexible to allow for verbal disclosures with further details made available via confirmation or online information.

iv. ***Disclosure updates***. Updates, if necessary or appropriate, should be permitted through an annual notification that provides a website address where specific changes to a firm's disclosure are highlighted.

v. ***Consents, generally***. Guidance should be provided to clarify when a customer's affirmative consent is required and when it is not.[50] When it is required, the rules should facilitate obtaining customer consent, including, in appropriate circumstances, through global consents granted at account opening. In general, the consent regime should focus particular attention on ensuring that it can be practically implemented and readily integrated into the current broker-dealer operational model.[51]

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[49] In omitting any reference to Section 206(3) of the Advisers Act in the legislative language of Section 913 of the Dodd-Frank Act, the Congressional intent was to preserve for broker-dealers the ability to engage in principal transactions under the uniform standard of conduct. Accordingly, SEC rules should affirmatively provide this relief for broker-dealers. See further discussion on principal transactions in Section III.C.5. *infra*.

[50] Section 913 of the Dodd-Frank Act does not appear to contemplate consent in every instance. *See* Section 913(g)(1) ("…conflicts of interest shall be disclosed and may be consented to by the customer.").

[51] For example, as our industry has long argued, the Advisers Act framework for consent to principal transactions would be unworkable for broker-dealers. See further discussion on principal transactions in Section III.C.5. *infra*.

vi. ***Consents from existing customers***.[52] Guidance should be given that would allow customers with accounts established prior to the effective date of the uniform fiduciary standard to consent to disclosures of conflicts by continuing to accept or use account services after receiving written disclosures.

Because customers often do not provide affirmative responses even to repeated requests from broker-dealers, requiring written consent to conflicts from existing retail customers would risk an interruption of services for these customers until the new account arrangements were in place.

For existing retail customers, consent by continuing to accept or use account services after disclosure should be permitted due to the impracticability of obtaining signatures from all existing retail customers.

5. Preserve principal transactions. In omitting any reference to Section 206(3) of the Advisers Act in the legislative language of Section 913 of the Dodd-Frank Act, Congress intended to preserve for broker-dealers the ability to engage in principal transactions under the uniform fiduciary standard of conduct. Accordingly, new SEC rules should affirmatively provide this relief for broker-dealers. One possible formulation is as follows:

A broker-dealer may, acting as principal for his own account, sell any security to or purchase any security from a customer, or acting as broker for a person other than such customer, effect any sale or purchase of any security for the account of such customer, if (A) such broker or dealer is not acting as an investment adviser in relation to such transactions; or (B) the customer has consented in writing prospectively authorizing the broker or dealer to act in any such capacity after receiving disclosure of material conflicts of interest that the broker or dealer may have and the compensation or ranges of compensation the broker or dealer may receive in such transactions.[53]

IV. Conclusion

SIFMA supports the Commission as it undertakes to address various, interrelated investor protection concerns. We urge the Commission to newly articulate a uniform fiduciary standard of conduct, rather than attempting to apply Section 206 legal precedent to the broker-dealer business model with significant negative effects for investor protection and choice. By adhering to the principles outlined above, and the additional principles noted in our prior comment letters, the Commission can develop a regulatory structure for the uniform fiduciary standard of conduct that ensures that investors are protected and are able to access the financial services they want and need to achieve their investment goals.

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[52] This point was also made in the SIFMA Section 913 Comment Letter.

[53] Modeled after the language of Section 206(3) of the Advisers Act.

We hope we can continue to serve as a constructive and insightful voice of the securities industry during the course of what we expect will be a significant undertaking and multi-step process.

Sincerely yours,

Ira D. Hammerman
Senior Managing Director
and General Counsel

cc: Luis A. Aguilar, Commissioner
Kathleen L. Casey, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
Robert W. Cook, Director, Division of Trading and Markets
Eileen P. Rominger, Director, Division of Investment Management
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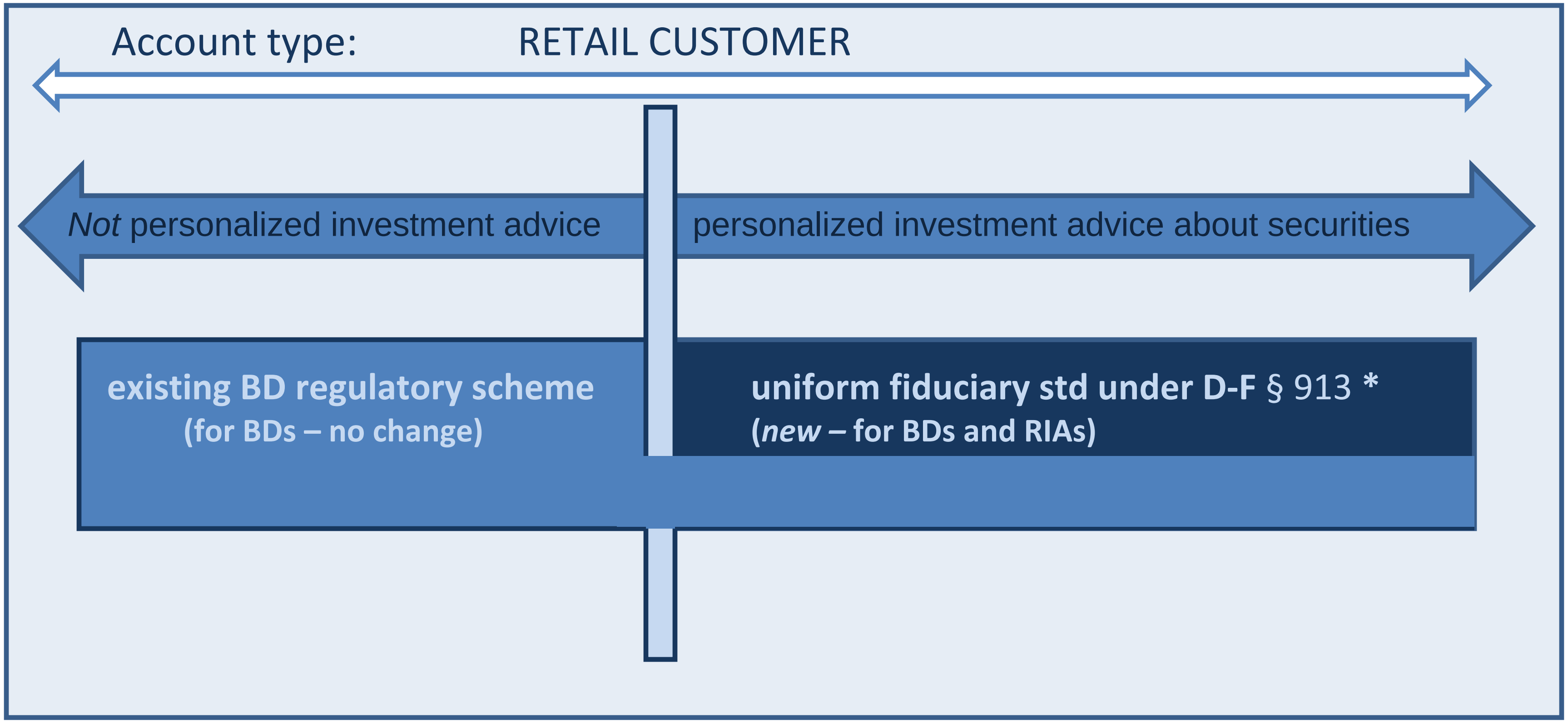
<u>Appendix 1</u>: Framework for Implementing D-F § 913



* The SEC would issue rules & guidance under § 211 of the Advisers Act and § 15 of the Exchange Act to provide the detail & guidance necessary to enable BDs and RIAs to apply the uniform fiduciary standard to their distinct operational models.

The rules would also articulate the general fiduciary duty implied under § 206 of the Advisers Act as the uniform fiduciary standard of conduct to apply equally to BDs and RIAs when providing personalized investment advice about securities to retail customers.

Existing case law & guidance under § 206 would continue to apply to RIAs, but not to BDs, because § 206 does not now, and would not under the uniform fiduciary standard, apply to BDs.