MEMORANDUM

To: SEC IA/BD Study Group

From: The Financial Services Institute

Re: Implementation of a Uniform Fiduciary Standard of Conduct

Date: February 7, 2012

Introduction

FSI supports the adoption of a clearly stated universal fiduciary standard of care, plainly articulated conduct rules, effective customer disclosures, and balanced regulatory supervision efforts. The fiduciary standard of care should be applicable to all financial services providers who offer personalized investment advice to retail customers. The new fiduciary standard of care must be carefully designed to promote access to advice, preserve investor choice, and enhance investor protection.

FSI strongly supported the inclusion of the Study in Section 913 of the Dodd-Frank Act because we believe it provides the SEC, the financial services industry, investor advocates, and others possessing great familiarity with the retail market for securities sales and investment advice the opportunity to provide meaningful input and shape important regulatory reforms. Expertise in these areas is essential to ensure that the final regulatory reforms support investor access to competent investment advice, preserve investor choice in service providers, and ensure effective regulatory supervision of all market participants. As a result, we appreciate the SEC IA/BD Study Group's willingness to meet with us to discuss our thoughts and concerns surrounding efforts to implement a uniform fiduciary standard of care.

It is Inappropriate to Overlay the Investment Advisers Act Standard on B/Ds

While FSI supports a uniform fiduciary standard of care applicable to all financial services providers who provide personalized investment advice to retail clients, we do not support applying the standard of care derived from the Investment Advisers Act of 1940 (Advisers Act), or other Advisers Act requirements, to broker-dealers and their registered representatives. Attempting to resolve the inconsistencies in the competing standards of care by transferring the standards and requirements developed over decades of case law for investment advisers to the broker-dealer world - a world that has its own history, business practices, cost structure and clientele - is fraught with difficulty.

Imposing the amorphous standard of care and other Adviser Act requirements on broker-dealers and registered representatives would subject these firms to tremendous uncertainty as to their compliance obligations. Generally speaking, the rules imposed on broker-dealers are direct and prescriptive in nature. The rules imposed on investment advisers are principles based and do not provide specific direction for compliance. The *Capital Gains* decision articulated the investment adviser fiduciary standard of care, but its specific application to investment adviser activities has been developed through fact specific case law over the course of several decades. That case law addresses the fiduciary standard only in very vague terms and simply could not be neatly imposed on the broker-dealer model.

Broker-dealer firms cannot control costs if they do not know what is expected of them. If the Advisers Act Standard were to be imposed directly, broker-dealers would likely result in substantial uncertainty as to the use of different fee structures (such as the use of commissions), as well as legal uncertainty regarding the recommendation and use of proprietary products. As a result, we would expect firms to react to the uncertainty created by the imposition of the Advisers Act standard to their business activities by limiting their services and advice to only those investors who offer significant profit potential, thereby reducing investor access to products and services. The ultimate result of imposing the principles based standard of the Advisers Act on broker-dealers would be to limit investor choice, product access, and affordable access to financial services for all investors.

Additionally, it is clear that it was not Congress' intent to apply the Advisers Act standard of care to the broker-dealer space. We believe that if Congress had intended to apply the standard of care and Adviser Act requirements on broker-dealers, it could have done so by simply eliminating the broker-dealer exception to the definition of investment adviser. Instead, we believe Congress intended to allow for a uniform fiduciary standard that could be applied appropriately given the differences between broker-dealers and investment advisers. This conclusion is supported by a May 31, 2011 letter from Ranking Member Barney Frank of the House Committee on Financial Services to Chairman Schapiro in which he states that "the requirement that the new standard be "no less stringent" than 206(1) and (2) was not intended to encourage the SEC to impose the ['40 Act] standard on broker dealers…" and that the "new standard contemplated by Congress is intended to recognize and appropriately adapt to the differences between broker-dealers and registered investment advisors."[1]

Instead of importing the existing investment adviser standard of care and other requirements into the broker-dealer regulatory framework, FSI supports the adoption of a clearly stated new uniform fiduciary standard of care. The new uniform fiduciary standard of care must be carefully designed to promote access to advice and preserve investor choice while enhancing investor protection.

A Proposed Framework for Rulemaking

FSI supports the proposed framework for Section 913 rulemaking articulated by SIFMA.[2] This framework includes the following components:

1. Enunciate the core principles of the uniform fiduciary standard of conduct – The uniform standard that should be applicable to both broker-dealers and investment advisers should be to act in the best interest of the customer when providing personalized investment advice, and must be no less stringent than the duties currently owed under the Advisers Act. Such a standard should also include a requirement that any material conflicts be disclosed and consented to by the customer, but should not be construed to require a continuing duty of care to the customer after providing personalized advice, unless otherwise agreed to by the parties. The SEC should then develop business model specific regulatory requirements that reflect these core principles while recognizing the unique history, business practices, cost structure and clientele of broker-dealers and investment advisers.
2. Articulate the scope of the obligations under the uniform fiduciary standard of conduct – The fiduciary obligations should apply once the customer signs the customer agreement and should be applicable only in the context of providing personalized investment advice. Preliminary

[1] Available at http://media.advisorone.com/advisorone/files/ckeditor/Barney%20Frank%20Letter.pdf.
[2] Letter from Ira D. Hammerman to Chairman Mary Schapiro, July 14, 2011, available at http://www.sifma.org/workarea/downloadasset.aspx?id=8589934675.

discussions regarding the nature of the agreement should not be covered by the standard and the broker-dealer's obligations should be explicitly set forth in the customer agreement. Finally, the uniform standard should not be construed to prohibit sale of proprietary products or compensation based on commissions.

3. Define "personalized investment advice" – The SEC should seek to precisely define what is and is not considered personalized investment advice. This definition should specify that things such as providing a customer with specific buy or sell recommendations or discretionary decisions regarding securities transactions are deemed to be providing personalized advice, while activities such as providing general research literature, engaging in investor education efforts or discussing non-specific investment strategies should be excluded from the definition.
4. Provide clear guidance regarding disclosure that would satisfy the uniform fiduciary standard of conduct – Imposition of a uniform standard must also include clear guidance regarding what type of disclosure would be deemed to be adequate. Guidance regarding disclosure requirements is essential for broker-dealers who have not previously been subject to a "best interest of the customer" standard. We provide additional recommendations regarding disclosure below.
5. Preserve principal transactions – Under the Dodd-Frank Act, Congress intended to maintain a broker-dealer's ability to engage in principal transactions under a uniform fiduciary standard of conduct. In applying a uniform standard to both broker-dealers and investment advisers, the SEC should seek to adopt rules that preserve this practice while providing investors the information needed to make informed decisions.

An approach that incorporates these elements is desirable because it would allow a flexible application of core principles to the distinct businesses run by broker-dealers and investment advisers. It would also provide firms the clarity necessary to quantify and control their costs. In this way, the SEC's rulemaking will protect investors and at the same time preserve investor choice and access.

Client Disclosures Must Be Focused on Being Effective, Not Comprehensive

FSI supports an effective broker-dealer disclosure regime. Investors can make better choices when they are properly informed of the differences between the advice and services being offered. In order to provide investors with the information they need, investors should receive concise, consolidated disclosure documents written in plain English. Investors should be involved in the development of such disclosures, and we urge the SEC to develop investor-tested templates (e.g., privacy policy templates) that would provide the industry with greater confidence that their client disclosures satisfy their compliance obligations and that would provide regulators with confidence that the disclosures will give investors the information they need to make appropriate decisions.

Additionally, we support a two-tiered approach to providing required disclosure. Such an approach would involve the following:

1. First Tier – The first tier disclosure would be limited to a short form disclosure document in the style of the mutual fund "summary prospectus" and would be provided in electronic form at the point of engagement, prior to the establishment of a brokerage account or no later than 10 days after a person becomes a client of a broker-dealer. The short-form disclosure would focus on the issues that are of greatest importance to investors, including:
   a. The standard of care owed by the broker-dealer to each client;
   b. The nature and scope of the business relationship between the parties, the services to be provided, and the duration of the engagement;

c. A general description of the nature and form of compensation to be received by the broker-dealer;
d. A general description of any material conflicts of interest that may exist between the broker-dealer and investor;
e. An explanation of the investor's obligation to provide the broker-dealer with information regarding the investor's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose;
f. An explanation of the investor's obligation to inform the broker-dealer of any changes in the investor's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose;
g. A phone number and/or e-mail address the investor can use to contact the broker-dealer regarding any concerns about the advice or service they have received; and
h. A description of the means by which a customer can obtain more detailed information regarding these issues, free of charge.

2. Second Tier – The second tier disclosure would provide investors with access to full details via the broker-dealer's website or brochures to be provided free of cost. Utilizing hyperlinks and other internet functionality, investors will be able to drill down in areas where they desire additional detail. The expanded disclosure would include:
   a. A detailed schedule of typical fees and service charges;
   b. The specific details of all arrangements in which the firm receives an economic benefit for providing a particular product, investment strategy or service to a customer; and
   c. Other information necessary to disclose material conflicts of interest.

In addition to this two-tiered approach, the SEC should also limit the volume of post-engagement disclosures. The amount and frequency of post-engagement should be limited in an effort to reduce the likelihood of information overload. Investors should also be provided with the opportunity to opt out of additional disclosures. However, investors may always reverse this decision by opting in to future disclosures or by visiting the broker-dealer's website to obtain the most up-to-date information.

Harmonization of Regulation Must Not be Lost in Effort to Finalize the Fiduciary Rule

FSI supports harmonization of broker-dealer and investment adviser regulation.The SEC Study recommended harmonization of broker-dealer and investment adviser regulations concerning the following areas: advertising, the use of finders and solicitors, supervision requirements, licensing and registration of firms and associated persons, continuing education and books and records. Such harmonization would alleviate investor confusion by providing investors assurances that no matter the type of professional advice and services they obtain, from either investment advisers or broker-dealers, each will be subject to the same standards and would provide the same protections. A study released by the RAND Corporation and commissioned by the SEC to study investor understanding regarding the differences between broker-dealers and investment advisers indicated that investors failed to understand differences between the standard of care applicable to each, and even expressed doubt that such a difference existed.[3] In order to eliminate this confusion and provide an underlying reality to investor belief that the same standards and protections are applicable across financial services providers, the SEC must seek to implement harmonization in the areas noted above.

Furthermore, in order to affect meaningful regulatory reform, the new standard of care and harmonization of regulation must be supported by effective regulatory supervision efforts. The existing gaps in regulatory supervision must be closed in order to make meaningful enhancements to investor protection. As a result, FSI supports a balanced, effective, and efficient program of regulatory supervision, examination, and enforcement for all financial service providers offering personalized investment advice to retail investors. Specifically, FSI supports the creation of an industry-informed, self-funded regulatory authority for registered investment advisers dedicated to effective supervision, timely examination, and vigorous enforcement. Emphasizing examination and supervision of investment advisers will benefit investors by contributing to the transparency, effectiveness, and efficiency of the financial services regulatory structure. Therefore, it is an essential part of any serious effort to enhance investor protection. FSI supports draft legislation sponsored by Representative Spencer Bachus, known as the Investment Adviser Oversight Act of 2011,[4] which would permit the SEC to authorize a self-regulatory organization (SRO) to oversee registered investment advisors.

We also support FINRA to fill the role of SRO for retail investment advisers. FINRA is best positioned to serve as the SRO for investment advisers. It has an existing comprehensive examination program with dedicated resources of more than 1,000 employees, with substantial experience operating an SRO whose structure is designed to ensure its governing body, committees, and staff act independently and in the public interest. Furthermore, it has extensive knowledge of the overlapping nature of the financial products and services offered by broker-dealers and investment advisers. Finally, it has successfully developed and operated the Investment Adviser Registration Depository (IARD), a key resource for any investment adviser regulator.

We urge the SEC not to lose focus on these important needs as it pushes forward on the fiduciary duty. The SEC should take advantage of the rule making process to harmonize all issues that require attention during this important process.

Coordination With Other Entities

Finally, we urge the SEC to reduce the risk of conflicting fiduciary standards by coordinating with other federal agencies in developing a uniform fiduciary standard. The Department of Labor (DOL) has recently withdrawn a proposed rule that would redefine of the term "fiduciary" and is planning to re-propose the rule at some point later this year. The DOL's attempt to redefine the term fiduciary has the potential to impose significant regulatory burdens on investment advisers and broker-dealers, as well as potentially creating conflicts with the fiduciary standard contemplated by the SEC.

This concern has been expressed by members of Congress as well. In a letter to SEC Chairman Mary Schapiro and Department of Labor Secretary Hilda Solis,[5] several members of Congress urged

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[3] See Technical Report: Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, the RAND Corporation, available at http://www.rand.org/pubs/technical_reports/TR556.html.
[4] Available at http://financialservices.house.gov/UploadedFiles/BACHUS_017_xml.pdf.
[5] Letter from Rep. Spencer Bachus (Chairman of the Committee on Financial Services), Rep. John Kline (Chairman of the Committee on Education and the Workforce), and Rep. Frank Lucas (Chairman of the Committee on Agriculture) to Hilda Solis, Secretary of the Department of Labor and Mary Schapiro, Chairman of the US Securities and Exchange Commission, March 15, 2011, available at http://www.sec.gov/comments/df-title-vii/swap/swap-72.pdf.

cooperation between the SEC and the DOL on developing a fiduciary standard, noting that "[w]hen multiple government agencies propose regulations related to the same subject matter without consultation and coordination, the resulting rules often conflict, causing market confusion and economic disruption."[6] Coordination between agencies is vital to preserving legal and regulatory certainty for investment advisers and broker-dealers and we urge the SEC to coordinate its efforts with the DOL.

Conclusion

We welcome the opportunity to provide our views on this issue. We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to harmonize the regulation of brokers, dealers and investment advisers.

About the Financial Services Institute

FSI is an advocacy organization for independent financial services firms and independent financial advisors. Established in January 2004, we have 125 broker-dealer members and over 35,000 financial advisor members. Our member firms have upwards of 180,000 financial advisors affiliated with them. Our mission is to create a more responsible regulatory environment for independent broker- dealers and their affiliated independent financial advisors through effective advocacy, education and public awareness. And our strategy includes involvement in FINRA governance, constructive engagement in the regulatory process and effective influence on the legislative process. For more information, please visit www.financialservices.org.

[6] Id.