FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS
AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

April 16, 2012

Jennifer B. McHugh
Senior Advisor to the Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

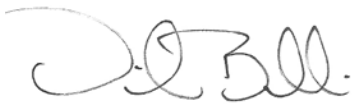
RE: FSI Position Memorandum Concerning Harmonization of Broker-Dealer and Investment Adviser Regulation

Dear Ms. McHugh:

In following up on our meeting with the SEC's IA/BD Study Group, we would like to provide you with FSI's position memorandum regarding areas of broker-dealer and investment adviser regulation where we believe harmonization can and should occur. We have produced this memorandum in response to your request during our meeting that we provide the Study Group with specific areas where regulation of broker-dealers and investment advisers would benefit from greater harmonization. Please distribute it to the members of your group and any other individuals you feel should receive it on our behalf.

We will be pursuing meetings with the Commissioners themselves in order to further our dialogue with the SEC regarding this issue. We would like to thank you and the entire Study Group staff for meeting with us and look forward to working with you going forward. Should you have any questions, please contact me at 202 803-6061.

Respectfully submitted,



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MEMORANDUM

To: SEC IA/BD Study Group

From: Financial Services Institute

Re: Harmonization of Broker-Dealer/Investment Adviser Regulation

Date: April 16, 2012

Introduction

A study released by the RAND Corporation and commissioned by the SEC to evaluate investor understanding regarding the differences between broker-dealers and investment advisers indicated that investors failed to understand differences between the legal standard of care applicable to each, and even expressed doubt that such a difference existed.[1] This lack of understanding was also confirmed by the SEC's Section 913 Study, which concluded that "retail customers do not understand and are confused by the roles played by investment advisers and broker-dealers, and more importantly, the standards of care applicable to investment advisers and broker-dealers when providing personalized investment advice and recommendations about securities."[2] The Financial Services Institute (FSI) supports harmonization of broker-dealer and investment adviser regulation as the vehicle through which investor understanding can be enhanced and confusion decreased.

Harmonization of regulation would have the salutary effect of enhancing investor understanding by providing investors with assurances that no matter what type of professional advice and services they obtain, from either investment advisers or broker-dealers, each will be subject to the same regulatory standards and investors will benefit from the same protections. We expressed these concerns when meeting recently with the SEC's IA/BD Study Group (Study Group). At the conclusion of this meeting, FSI was asked to provide the Study Group with a list of areas where the regulations applied to broker-dealers and investment advisers could be harmonized in order to eliminate regulatory gaps and enhance investor protections. In the sections that follow, we outline areas of regulation where harmonization can and should occur, and provide a brief description of the primary differences between the requirements faced by broker-dealers and investment advisers.

Finally, although not discussed in detail within this memorandum, FSI believes that to achieve meaningful regulatory reform harmonization of regulation must be supported by effective regulatory supervision efforts. The existing gaps in regulatory supervision must be closed. As a result, FSI supports a balanced,

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[1] 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.
[2] Study on Investment Advisers and Broker-Dealers, at 101, available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

effective, and efficient program of regulatory supervision, examination, and enforcement for all financial service providers offering personalized investment advice to retail investors and believes that creation of a self-regulatory organization (SRO) that has examination oversight for both broker-dealers and investment advisers is crucial to accomplishing this goal.

Advertising

The SEC's Study on Investment Advisers and Broker-Dealers mandated under Section 913 of the Dodd-Frank Act notes that the regulation of advertising is particularly important due to its potential impact on retail investors.[3] We agree. As it currently stands, advertising conducted by broker-dealers is regulated under the Securities Exchange Act of 1934 ('34 Act) and FINRA rules, while investment adviser advertising is regulated under the Investment Advisers Act of 1940 (Advisers Act). The result is a significant gap in regulation.

Registered representatives associated with broker-dealers are required to have their advertisements reviewed and approved by the broker-dealer prior to use. Additionally, some forms of advertising must be submitted to FINRA (for a cost) for review either shortly after initial use or prior to use depending on the content. Investment advisers, on the other hand, have no requirement to submit advertisements for review, and instead are subject to prohibitions on the use of testimonials; past specific recommendations; charts, graphs, and formulas; and free services unless they are entirely free. Both broker-dealers and investment advisers are prohibited generally from using misleading communications.

While broker-dealers are permitted to use a wider array of advertising materials, the regulations governing broker-dealer advertisements are far more detailed and rules-based. Investment adviser regulation is principles-based, with most of the guidance coming in the form of interpretive guidance, no-action letters, and enforcement cases. It is our belief that investor protection would be enhanced by adopting detailed advertising rules for investment advisers that mirror FINRA requirements. In addition, should Congress pass legislation authorizing the creation of an SRO for retail investment advisers, we would support the adoption of advertising filing requirements like those in place for broker-dealers. Advertising regulation should not provide an advantage to any business model. We believe the current system of regulation provides clear advantages to investment advisers. A review of existing NASD Conduct Rule 2210 and the Advisers Act would easily identify areas of overlap that would be appropriate for all communication types, such as ensuring communications are not misleading to the public. The pre-filing requirement required of FINRA should be reassessed as part of this harmonization to determine if this requirement can be restructured to be less burdensome, while still meeting the spirit of proper oversight for broker-dealers and the addition of investment advisers.

[3] Id at 130.

Supervision

Generally speaking, broker-dealers and investment advisers are subject to similar regulatory burdens regarding supervision. Broker-dealers are required to establish and maintain a system to supervise the activities of registered representatives.[4] Additionally, under FINRA rules, broker-dealers are required to establish a supervisory system that provides for a direct supervisor for each registered representative[5], and conduct examinations of the broker-dealer's branch offices.[6] Investment advisers, on the other hand, are required to have written policies and procedures designed to prevent violations of the Advisers Act.[7] Investment advisers must also review the effectiveness of such policies and procedures on at least an annual basis.[8] The primary difference between the two is that broker-dealers are subject to far more technical and detailed requirements while investment advisers are subject to requirements that are more general in nature.

A single set of universally applicable supervision requirements will facilitate compliance for both broker-dealers and investment advisers. Such a standard should generally require investment advisers to be subject to supervision obligations that mirror those currently applicable to broker-dealers. Also, such requirements should be designed to take into consideration the size and complexity of the business of the registered entity when determining whether a broker-dealer or investment adviser is in compliance with its supervision requirements. Attention should be given to eliminating potential conflicts of interest in the investment advisory supervisory structure by requiring distinct segregation of duties and roles similar to the existing standards for broker-dealers (i.e. see NASD Rule 3012). Another significant area related to the supervision of investment advisers is that FinCEN and the SEC still have yet to mandate Anti-Money Laundering requirements for these entities, which seems completely unacceptable given their access to customer funds and the standing commitment the US regulatory regime has to preventing terrorist financing and money laundering.

Books and Records

While some differences in the business models of broker-dealers and investment advisers lead to differences in the maintenance of books and records, other differences that exist are not based on such business distinctions. The rules for broker-dealers require far more in terms of record retention. Broker-dealers are required to keep a record of all communications that they send or receive, as well as any written agreements relating to the broker-dealer's business.[9] Additionally, broker-dealers are required to enter each transaction into a blotter (including information regarding redemption requests, transfers and exchanges, premium payments, policy loan requests, policy loan repayments, withdrawal requests,

[4] '34 Act Sections 15(b)(4)(E) and (b)(6)(A).
[5] FINRA Rule 3010.
[6] FINRA Rule 3010(c).
[7] Advisers Act Rule 206(4)-7.
[8] Id.
[9] '34 Act Rules 17a-4(b)(4) and (b)(7).

surrender requests, and death benefit payments; all receipts and disbursements of cash; and other debits and credits)[10] and must also maintain an account record containing specific client information which must be made available to new clients within 30 days of opening the account, and to all clients at least once every three years.[11] Investment advisers, by contrast, are required to retain only specified documents and records set forth in Advisers Act Rule 204-2, resulting in the absence of potentially important documents regarding business operations.

Furthermore, the time frames required for broker-dealers and investment advisers to keep the required books and records differs. Broker-dealers are required to keep records of original entry (blotters), customer account records, financial records, and cash records for six years and order tickets, guarantees and power of attorney, communications, net capital computations and related records, written agreements, advertising records, bills, and training, supervision and continuing education files for three years.[12] Investment advisers are required to keep records of original entry (journals), customer account records, financial records, communications, net capital computations and related records, bills, written agreements, advertising, and powers of attorney for five years.[13]

In order to provide greater protection for investors and to promote greater transparency for examination and compliance requirements, we urge the SEC to harmonize the record retention requirement for broker-dealers and investment advisers as well as the record retention periods. Harmonization should involve a more specific description of the investment adviser books and records that must be maintained along with consistent retention schedules.

Remedies

Broker-dealers generally are required to resolve disputes with customers and employees of the broker-dealer under binding arbitration agreements through FINRA's Dispute Resolution Department.[14] Investment advisers can resolve disputes in a variety of forums. These forums include arbitration, as well as county, state and federal court systems. However, advisory clients have very limited private rights of action under the Advisers Act. Furthermore, the lack of a specialized arbitration forum for clients of investment advisers presents a fairness gap to investors. Such a forum provides several benefits over the judicial system, including lower costs and greater accessibility than litigation.

Greater harmonization of remedies would provide investors with increased protections while also eliminating the need for investors to navigate the differences among potential remedies when seeking investment advice or services. In addition,

[10] '34 Act Rule 17a-3(a)(1).
[11] '34 Act Rule 17a-3(a)(17)(i)(A).
[12] '34 Act Rules 17a- 3 and 17a-4.
[13] See Section 204 and Rule 204-2 of the Advisers Act.
[14] See Code of Arbitration Procedure for Customer Disputes, Rule 12200 and Code of Arbitration Procedure for Industry Disputes Rule 13200.

it would provide regulators with an efficient means of tracking customer complaint data and trends.

Licensing and Continuing Education

Broker-dealers firms must satisfy FINRA requirements before they can operate as a broker-dealer. These requirements involve a rigorous process that begins with submission of a membership application that must include a discussion of the firm's business plan, as well as a description of the nature and source of the firm's capital, and disclosure regarding supervisory systems that will be in place. After submission of the membership application and any supporting documentation, FINRA conducts a thorough review to determine whether the firm has the operational and financial capacity to function as a broker-dealer.[15] To date, investment advisers face no such registration review process, thereby increasing the potential for inadequately capitalized and structured entities attempting to offer services to the investing public.

In addition to the broker-dealer firm application and review process, registered representatives of a broker-dealer must take and pass licensing examinations in order to be able to sell and/or supervise securities products.[16] As is the case with firm licensing, investment advisers have no examination requirement comparable to that of broker-dealers, again potentially subjecting the investing public to individuals that are not properly qualified to address their needs and objectives.

Finally, registered representatives of broker-dealers are subject to continuing education requirements. This includes both a regulatory and a firm element requirement. Each registered representative must, on the occurrence of their second registration anniversary date and every three years thereafter, complete the regulatory element of their continuing education requirements.[17] Additionally, each firm is required to maintain an annual continuing education program for its registered representatives designed to maintain skills, knowledge and professionalism.[18] Investment Advisers and associated persons are not subject to such a requirement.

A uniform system of licensing for both firms and associated persons, including substantive review of the content of the license application, along with examination and continuing education requirements applicable to both investment advisers and broker-dealers would provide investors with assurances that the source of financial advice and services the investor selects has the capacity to operate such a business, demonstrated basic competencies and is continually improving upon the skills and knowledge necessary to provide up-to-date advice.

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[15] See NASD Rule 1010.
[16] See generally, http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/RegisteredReps/Qualifications/p011051.
[17] NASD Conduct Rule 1120(a).
[18] NASD Conduct Rule 1120(b)(2)(A).

Custody

Both broker-dealers and investment advisers are subject to rules regarding custody of client funds and securities. Rule 15c3-3 of the '34 Act requires that a broker-dealer in custody of client funds either deploy those funds "in safe areas of the broker-dealer's business related to servicing its customers" or, if not deployed in such areas, deposit the funds in a reserve bank account to prevent commingling of customer and firm funds. The rule is designed to protect investor funds in the event of a broker-dealer liquidation.

Furthermore, FINRA Rule 4360 requires firms to maintain fidelity bonds to insure against certain losses and the potential effect of such losses on firm capital. Furthermore, broker-dealers are required to pay assessments to the Securities Investor Protection Corporation (SIPC) which offers investors protection in the event that a brokerage firm fails, leaving clients without money or securities. Investment advisers are not required to maintain fidelity bonds or pay assessments to SIPC or another similar fund. Yet, investment advisers present as much risk for loss to investors as broker-dealers do, with one such example being Bernie Madoff. Though he perpetrated his fraudulent Ponzi scheme through his registered investment adviser business, it is the broker-dealer industry that has suffered a significant burden of the fraud he committed through the imposition of astronomically higher SIPC assessments.

In contrast to the requirements faced by broker-dealers, if an investment adviser has custody of client assets, it is required to implement controls designed to protect client assets from being lost, misused, misappropriated or subject to the investment adviser's financial reserves.[19] However, investment advisers are not subject to specific fidelity bond, net capital or other requirements. Thus, while both broker-dealers and investment advisers are subject to custody rules, broker-dealers are subject to requirements that are more technical, detailed and costly. Investor protection can be greatly enhanced by raising the standards for investment adviser firms.

Principal Transactions

Principal trading is core to the business of many broker-dealers. This occurs where a brokerage firm buys securities on the secondary market with the strategy of holding those securities in hope of an increase in price, which is then realized as the securities are resold to investors. There is no prohibition on broker-dealers engaging in this practice. Investment advisers, however, are prohibited from acting as a principal for their own account by selling a security to a client (or purchasing a security from a client) without having first disclosed that they are acting as principal and obtaining the written consent of the client prior to the transaction.[20] This prohibition does not apply to any transactions involving broker-dealers, so long

[19] See Advisers Act 206(4)-2.
[20] Advisers Act Section 206(3)(b).

as the broker-dealer is not acting as an investment adviser with respect to such transaction.[21]

As many investment advisers are dually registered as broker-dealers, the SEC had recently adopted Temporary Rule 206(3)-3T to establish an alternative method for such dual registrants to meet the requirements of the 1940 Act when they act in a principal capacity in transactions with any of their advisory clients. The Temporary Rule was effective from September 30, 2007 and will on December 31, 2012.[22] We would suggest an assessment of whether the Temporary Rule 206(3)-3T can be maintained in some form to accomplish such transactions in the dual role environment.

Solicitors and Referral Fees

Under current FINRA rules, a broker-dealer is prohibited from paying any person that is not registered with it any commission or fee that is derived from a securities transaction.[23] Included in this prohibition are referral and solicitation fees. In contrast, investment advisers can pay solicitation or referral fees as long as certain Advisers Act requirements are met.[24] Furthermore, the solicitor and the investment adviser must have a written agreement detailing the nature of the relationship and which must provide disclosure to prospective clients up-front.[25] The solicitor does not have to register under the Advisers Act for its conduct as a solicitor, unless it otherwise meets the definition of investment adviser.

Harmonization of the requirements regarding the use of solicitors or paying referral fees would increase investor awareness and understanding of potential conflicts of interest and could potentially create better supervision of the activities of solicitors.

Examination

The SEC and industry-funded regulators examine more than half of registered broker-dealer firms each year. However, the SEC projected that fewer than 10 percent of the more than 11,000 registered investment adviser firms will be examined during fiscal years 2009 and 2010.[26] The result is that broker-dealers will have one or more regulatory visits in a two-year period, while investment advisers may have only one regulatory visit during a ten-year period.[27] As noted above, in

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[21] Id.
[22] See http://www.sec.gov/info/smallbus/secg/206-3-3-t-secg.htm.
[23] NASD Conduct Rule 2420.
[24] These requirements include: the investment adviser is registered under the Act; the solicitor is not a person (A) subject to a Commission order issued under section 203(f) of the 1940 Act, or (B) convicted within the previous ten years of any felony or misdemeanor involving conduct described in section 203(e)(2)(A) through (D) of the Act, or (C) who has been found by the Commission to have engaged, or has been convicted of engaging, in any of the conduct specified in paragraphs (1), (5) or (6) of section 203(e) of the Act, or (D) is subject to an order, judgment or decree described in section 203(e)(4) of the Act; and such cash fee is paid pursuant to a written agreement to which the adviser is a party;… (See Rule 206(4)-3 of the Advisers Act).
[25] Id.
[26] See Richard Ketchum Speech at The Exchequer Club, June 17, 2009, available at http://www.finra.org/Newsroom/Speeches/Ketchum/P119009.
[27] Id.

order to ensure that investors are truly protected, harmonization of examination frequency is necessary.

Conclusion

With significant attention being focused on the need for harmonization of the standard of care between broker-dealers and investment advisers, we urge the SEC not to lose focus on the important need of harmonizing regulatory requirements as well, as it progresses forward on the fiduciary duty. 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 well over 100 broker-dealer members (many of which are also dually registered as investment advisers) 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.