FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

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VIA ELECTRONIC MAIL

July 5, 2013

Elizabeth M. Murphy
Secretary
Securities Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Duties of Brokers, Dealers, and Investment Advisers, Release No. 34-69013; IA-3558; File No. 4-606

Dear Ms. Murphy:

On March 1, 2013, the Securities and Exchange Commission (SEC) released a request for data and other information (RFI) relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers.[1] The SEC intends to use the information provided to inform the consideration of alternative standards of conduct for broker-dealers and investment advisers when providing personalized investment advice to retail customers. The SEC also intends to use this data and information to consider potential harmonization of certain other aspects of regulation of broker-dealers and investment advisers. The Financial Services Institute[2] (FSI) appreciates the opportunity to provide data and comments on this important proposal.

<u>Background on FSI Members</u>
The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisers are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

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[1] Release 34-69013, 78 FR 14848, *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-03-07/pdf/2013-05222.pdf.
[2] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisers, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 100 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 35,000 Financial Adviser members.

In the U.S., approximately 201,000 independent financial advisers – or approximately 64% percent of all practicing registered representatives – operate in the IBD channel.[3] These financial advisers are self-employed independent contractors, rather than employees of the IBD firms. These financial advisers provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisers are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisers affiliated with IBDs is comprised of clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisers are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[4] Independent financial advisers get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisers have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisers. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisers play in helping Americans plan for and achieve their financial goals. FSI's primary goal is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

<u>Comments</u>

FSI appreciates the opportunity to provide data and information that may inform the SEC's work in this important area. Of the over 100 firms FSI counts among its membership, over ninety percent are dually registered firms that offer both brokerage and advisory services to clients. As a result, FSI is uniquely positioned to provide an informed perspective on the market for personalized investment advice provided to retail clients. What follows are FSI's responses to the SEC's specific questions included in the RFI.

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[3] Cerulli Associates at http://www.cerulli.com/.
[4] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisers.

PRELIMINARY COMMENTS

The Market for Financial Advice and Services

Financial products and services are complex. Investors face a massive amount of available options and conflicting information that can be overwhelming and confusing; even very highly-skilled experts and experienced investors can become lost in this ever-changing landscape of financial products and services. As a result, retail investors often find they need the help and guidance of a broker, dealer, investment adviser, affiliated registered representative, or investment adviser representative (collectively referred to as Financial Advisers) to help them make the right choices to achieve their financial goals. Nearly all Financial Advisers realize that their livelihoods depend on sustaining their reputations in the community and among their clients. Financial Advisers dedicate themselves to act in the best interests of their clients, without regard to whether the legal standard of care they owe complies with "just and equitable principles of trade" or that of a fiduciary. As a result, these Financial Advisers obtain information on each client's investment objectives, risk tolerance, financial situation, and other needs. They educate their clients on the various product and service options available to them through in-person meetings, disclosure documents, and other communications. Once the client is familiar with the options available, the Financial Adviser makes suitable recommendations based upon the information provided by the client and facilitates the implementation of the client's informed decision-making. After the initial investment, the Financial Adviser insures that their client understands the account statements and other information related to their investments. Financial Advisers also keep abreast of market developments, review the client's portfolio periodically, and recommend changes as appropriate. The Financial Adviser designs a system of supervision to insure compliance with state and federal statutory and regulatory requirements. As with every industry, however, the marketplace for financial services and products contains a small number of unscrupulous individuals who take advantage of the trust clients place with them. This may be in the form of directing clients to higher-priced financial products that generate more compensation for the Financial Adviser, or misrepresenting material conflicts of interest that may exist. Some Financial Advisers go even farther by diverting their clients' funds for their own use. Unfortunately, a few bad apples can tarnish the reputation of all Financial Advisers, eroding trust in the markets and confidence in the unbiased professional advice that Financial Advisers can provide and that benefit retail investors.

For these reasons, FSI welcomes this opportunity to provide the SEC with data that can inform decisions with regard to the future regulation of the financial services industry. FSI's members are committed to a regulatory environment that achieves three important goals:

1) Investor access to financial advice and services;
2) Investor choice between available providers of advice and services; and
3) Robust and effective investor protections.

FSI and its members believe that a uniform fiduciary standard of care, plainly articulated conduct rules, effective customer disclosures, and balanced regulatory supervision efforts will achieve all three of these goals and promote an environment that provides widespread benefits to all stakeholders.

Data Methodology

As a caveat, it is obligatory that FSI discuss some of the limitations with the SEC's data request. While we are strong supporters of cost-benefit analysis and empirical foundations for rulemaking, we have concerns that, based upon the data that the SEC is requesting, the responses are unlikely to lead to meaningful conclusions as it relates to financial professionals' standards of care. For example, the SEC has requested data comparing customer returns under the two standards. The responses to this request are unlikely to give a complete and informative empirical basis for the SEC to rely upon. The data on customer returns cannot reflect, for example, situations where a financial professional gives his or her client advice that the client decides not to take, nor the impact of the individualized investment objectives of each customer in the data sample. While firms do categorize investors based upon the investment objectives these customers attest to when opening a new account, these categories (such as "growth," "aggressive growth", or "income") are inadequate for providing a complete rendering of an investor's financial goals. It is for this reason that a Financial Adviser must work with clients to balance their goals with the available investment options and their inherent risks. In addition, different firms use different labels to categorize their clients' investment objectives, and often use different labels to describe the investment objectives of advisory accounts and brokerage accounts. Where applicable, FSI has synthesized and aggregated the data from firms and the different account types in order to group together the different categories firms use to describe the same or closely aligned investment objectives. This has made an already imprecise measure even more inexact despite the best efforts of FSI and our member firms. Based upon the categories of data requested, FSI is left to assume that the SEC intends to compare the results from the different regimes and pit the two standards together using quantitative measures. The SEC's underlying assumption appears to be that the quantitative data will reveal trends or characteristics about the market for financial advice and perhaps the superiority of one business model over than another. We respectfully disagree with such an assumption, as it fails to recognize that each retail client has different investment knowledge, risk tolerance, and specific financial goals.

The Benefits of Financial Advice

What is indisputable, however, is that Financial Advisers provide a significant benefit to the financial future of investors. Preserving the characteristics that allow for different business models to expand the availability of financial advice to investors, while ensuring robust investor protection, must be at the forefront of the SEC's analysis. Recent research has highlighted the fact that financial advisers provide significant value to investors. A recent Vanguard Group study found, after analyzing the financial performance of 58,168 self-directed IRA investors over five years, that few investors ended up achieving the total return benchmarks they should have.[5] This was due to the tendency of investors to move money in and out of portfolios over time. The study highlights the value of Financial Advisers in preventing this behavior, finding that "[s]uch advisers 'can act as emotion circuit breakers in bull or bear markets by circumventing their clients' tendencies to chase returns or run for cover in emotionally charged markets.'"[6] An "adviser's alpha (that is, added value) is more aptly demonstrated by the ability to effectively act as a wealth manager, financial planner, and behavioral coach – providing discipline and reason to clients

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[5] Weber, Stephen M., *Most Vanguard IRA investors shot par by staying the course: 2008-2012,* Vanguard Research, pp. 1-3, May 2013, *available at:* https://personal.vanguard.com/pdf/s801.pdf.
[6] *Id.* at 8.

who are often undisciplined and emotional – than by efforts to beat the market."[7] "On their own, investors often lack both understanding and discipline, allowing themselves to be swayed by headlines and advertisements surrounding the 'investment du jour' – and thus often achieving wealth destruction rather than creation."[8] The financial adviser thus adds significant value, or "alpha" to the investor "because the greatest obstacle to clients' long-term investment success is likely *themselves*."[9]

Coordination with the Department of Labor

While we commend the SEC for diligently approaching its work on the standard of care for broker-dealers and investment advisers, recent regulatory initiatives originating at the Department of Labor (DOL) raise many concerns with regard to a uniform fiduciary standard for personalized investment advice. The DOL is currently working on a rule re-proposal that would create a new definition of "fiduciary" under the Employee Retirement Insurance Security Act (ERISA).[10] This new regulation promises to significantly impact the regulatory burden of firms and Financial Advisers with regard to retirement advice, particularly concerning individual retirement accounts (IRAs). The DOL's proposal would likely restrict investor access to advice by eliminating their ability to compensate Financial Advisers through commissions generated on the sale of investment products. It would also limit investor's options for how they decide to pay for services, as many clients prefer to "pay as they go" for services received rather than committing to ongoing fees during periods of inactivity. The consequences of this proposal would have the most impact on investors with smaller IRA accounts. The result will be a restriction in access to advice and a decrease in retirement investing.

Financial Advisers are particularly critical when saving for retirement. According to a survey conducted by ING, individuals who spent at least some time working with a Financial Adviser had saved, on average, more than twice the amount for retirement than those that had not spent time with one.[11]A 2013 retirement study highlighted that Americans saving for retirement who currently work with a Financial Adviser have more retirement peace of mind than those that do not. [12] More than 6 in 10 Americans (63%) admit their financial planning needs improvement in 2013, with confusion, lack of time, and not knowing where to receive appropriate help with investing being the primary obstacles to improvement.[13] With individual retirement accounts (IRAs) containing the largest share of retirement savings of Americans, and with over 40% of households owning assets held in at least one type of IRA, investors without the benefit of a Financial Adviser are at a significant disadvantage, given that close to half of investors lacked a basic

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[7] Donald Bennyhoff & Francis M. Kinniry Jr., *Advisor's Alpha,* Vanguard Research, pp. 2-3, April 2013, *available at:* https://advisors.vanguard.com/iwe/pdf/ICRAA.pdf
[8] *Id.* at 10.
[9] *Id.*
[10] Department of Labor, *Definition of the Term "Fiduciary" Proposed Rule*, http://www.dol.gov/ebsa/regs/cmt-1210-AB32.html (last visited July 3, 2013).
[11] ING Retirement Research Institute, *Working with an Advisor, Improved Retirement Savings, Financial Knowledge and Retirement Confidence!,* 2010, p. 6, *available at:* http://www.ingretirementresearch.com.
[12] Merrill Lynch Wealth Management, *Americans' Perspectives on New Retirement Realities and the Longevity Bonus: A 2013 Merrill Lynch Retirement Study, conducted in partnership with Age Wave*, p. 13, January 2013, *available at:* http://wealthmanagement.ml.com/publish/content/application/pdf/GWMOL/2013_Merrill_Lynch_Retirement_Study.pdf.
[13] Northwestern Mutual, *Planning & Progress 2013: Financial Planning Obstacles,* p. 3, January 2013, *available at:* http://www.northwesternmutual.com/learning-center/studies-and-reports/Documents/financial_planning_obstacles.pdf

understanding of what IRAs are and how they are used.[14] We fear, however, that the DOL's proposal would restrict access to Financial Advisers to the great detriment of investors who are saving for their retirement.

We share the views of other commenters who have expressed that, absent additional information, clarity, and coordination between the two agencies, it is nearly impossible to assess the full impact, costs and benefits, and other important issues facing investors and firms due to the DOL's anticipated fiduciary rulemaking.[15] We recommend that the SEC take further steps to coordinate with the Department of Labor, and that any subsequent regulation originating from either agency must go to great lengths to describe the interaction between the two agencies' rulemaking. This desire was expressed recently by thirty-two members of the Congressional Black Caucus, Congressional Hispanic Caucus, and Congressional Asian Pacific American Caucus (collectively known as the Tri-Caucus) who wrote to the DOL encouraging interagency coordination on this issue to avoid uncertainty and disruption in the marketplace.[16]

Absent coordination between the agencies, we fear the results of the RFI will be rendered meaningless, as the DOL proposal's impact on the marketplace for financial advice will make much of the data obsolete. The SEC and DOL's future regulatory framework must seek to expand access to financial advice rather than contract it. However, because of the severe uncertainty facing advisers and firms, and the lack of coordination between the agencies, the unfortunate trend appears to be the restriction of access to financial advice. The impact of this restriction cannot be overstated.

The Tri-Caucus letter highlights the importance of maintaining access to financial advice, particularly for underserved and minority communities, which would be threatened under by DOL's proposal. This concern is based firmly in reality. According to an Ariel/Hewitt Study[17], "a racial and ethnic gap in retirement savings account usage persists, continuing to put large groups of employees at increased financial risk for their retirement years."[18] African Americans in particular are significantly underserved by Financial Advisers, according to a study conducted by the Joint Center for Political and Economic Studies. More than a fourth of African Americans (27%) compared with nearly half of whites (49%) reported owning stocks or mutual fund shares. Further, one of only every six African Americans (17%) but more than one of every four whites (27%) reported owning bonds.[19] This significant disparity represents the degree to which minority groups, and particular African Americans and Hispanics, could benefit from the advice of Financial Advisers. In a study conducted by Prudential, African Americans that worked with a Financial Adviser were found to be more financially confident than those that did not.[20] Unfortunately, African Americans were found not only less likely to have a Financial Adviser (19% v. 30%), but also less likely to

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[14] TIAA-CREF, *TIAA-CREF survey reveals individuals are missing out on savings and tax benefits of IRAs,* March 27, 2013, *available at:* https://www.tiaa-cref.org/public/about/press/about_us/releases/articles/pressrelease451.html

[15] *See* Comments by Kent A. Mason, Davis & Harmon LLP (April 11, 2013), *available at* http://www.sec.gov/comments/4-606/4-606.shtml.

[16] *See* Letter to Hon. Seth Harris from Rep. Frederica S. Wilson, et al, *available at* http://www.financialservices.org/uploadedFiles/FSI-Letter-to-DOL-on-Fiduciary-Redefinition-2013.pdf.

[17] Ariel/Aon Hewitt Study, *401(k) Plans in Living Color: A Study of 401(k) Savings Disparities Across Racial and Ethnic Groups,* 2012, *available at:* http://www.arielinvestments.com/images/stories/PDF/arielhewittslides_finalweb_7.3.pdf

[18] *Id.* at 2.

[19] Wilhelmina A. Leigh Ph.D. and Anna L. Wheatley, *Retirement Savings Behavior and Expectations of African Americans: 1998 and 2009*, Joint Center for Political & Economic Studies, January 2010, p. 4, *available at:* http://www.jointcenter.org/sites/default/files/upload/research/files/Retirement%20Savings%20and%20Behavior.pdf

[20] Prudential Research, *The African American Financial Experience,* The Prudential Insurance Company of America, 2013-2014 Report, p. 16, *available at:* http://www.prudential.com/media/managed/aa/AAStudy.pdf

have ever been contacted by one (48% v. 55%).[21] This data illustrates the underserved nature of the African American investor community and minority groups in general. It also demonstrates the importance of supporting policies and regulations that expand financial advice to more individuals and families, rather than those that will restrict access.

As the SEC moves forward, it is imperative that it coordinate with the DOL to ensure that all investors have access to the benefits of professional financial advice and that regulatory uncertainty and lack of coordination do not lead to disastrous results for America's retail investment community.

REQUEST FOR DATA AND OTHER INFORMATION RELATING TO THE CURRENT MARKET FOR PERSONALIZED INVESTMENT ADVICE

> *How do firms that offer both brokerage and advisory accounts advise retail customers about which type of account they should open?*

Many IBD firms that provide both brokerage and advisory services provide important information to a customer that properly distinguishes the differences between the different regulatory standards. Customers are asked to consider important questions about their individual financial goals and expectations as it relates to the relationship they have with their Financial Adviser. These questions include:

- Do you want or need a Financial Adviser to manage your investment portfolio?
- Do you prefer instead to make the investment decisions yourself and are just looking for the Financial Adviser to execute on your orders?
- Do you want to engage a Financial Adviser as a fiduciary with a duty to provide ongoing investment services?
- Do you desire instead only occasional advice or recommendations on particular investments from a Financial Adviser?
- What do you expect will be the number and size of the holdings and transactions in your portfolio?
- Do you plan to hold a number of securities and to be transacting and rebalancing the portfolio on a frequent basis?
- Do you plan to buy only a few securities and follow a buy and hold strategy for a long period of time without ongoing advice from a financial adviser?
- Do you wish to work with a Financial Adviser where the fee is consistent, and not tied to the number of transactions in the account?
- Do you prefer instead to pay your Financial Adviser for each transaction that you place?[22]

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[21] *Id.* at 18.

[22] *See*, *e.g.*, "Working with an LPL Financial Advisor: The Choice Between Advisory Services and Brokerage Services," *available at* http://lplfinancial.lpl.com/Documents/PDF/WorkingWithAnLPLFinancialAdvisor.pdf.

Data and other information showing the different characteristics of each type of account

The following data was submitted by FSI member firms and has been aggregated by FSI to preserve their anonymity. Firms submitted data from both their fee-based advisory accounts as well as brokerage accounts. The total number of customer accounts in the data sample totaled over six million accounts, with a ratio of ten brokerage accounts for every one fee-based advisory account. No data was excluded from the data sample, however, the section on customer returns is based on a smaller sample of customer accounts due to the fact that only a few member firms who submitted data to FSI have the available technology infrastructure to compile, calculate, and produce reports for customer returns in the format requested by the SEC for the purposes of its RFI.

Investable Income (percentage of total accounts for each account type)	***Fee-Based Advisory Accounts***	***All other Brokerage Accounts***
Less Than $25,000	7.52%	18.10%
$25,000 - $50,000	17.89%	25.25%
$50,000 – $100,000	34.26%	32.59%
$100,000 - $250,000	32.39%	19.65%
$250,000 and above	7.94%	4.42%
Age (for joint accounts, using average age)	***Fee-Based Advisory Accounts***	***All other Brokerage Accounts***
18 – 24	0.52%	1.79%
25 – 34	2.42%	4.92%
35 – 44	8.74%	10.39%
45 – 54	19.48%	17.41%
55 – 64	31.61%	23.93%
65 and above	37.24%	41.55%
Investment Experience	***Fee-Based Advisory Accounts***	***All other Brokerage Accounts***
None	4.37%	6.51%
Limited	34.05%	34.34%
Good	56.20%	47.84%
Extensive	3.57%	5.13%

Net Worth	***Fee-Based Advisory Accounts***	***All other Brokerage Accounts***
$0 - $50,000	1.94%	17.49%
$50,000 - $100,000	3.56%	8.42%
$100,000 - $500,000	36.56%	39.76%
$500,000 - $1,000,000	33.05%	19.77%
$1,000,000 and above	24.89%	14.56%
Investment Horizon	***Fee-Based Advisory Accounts***	***All other Brokerage Accounts***
Near Term (Less than 1 year)	1.64%	2.99%
Short (1-5 years)	3.50%	5.42%
Intermediate (5-10 years)	11.91%	15.26%
Long (over 10 years)	82.96%	76.33%

This data reflects important characteristics in the market for financial products and services that the SEC must weigh carefully in assessing its future regulatory priorities. One important area is the different types of customers serviced under the two regimes. While 25.9% of brokerage accounts service clients with a net worth under $100,000, only 5.5% of fee-based advisory accounts fall into this demographic. This highlights the fact that different business models and compensation structures provide services to different client demographics, and preserving the benefits of these different business models is vital to ensuring investor access to financial advice. Another important trend reflected in the data is the ratio of investors approaching or already past the age of retirement. The percentage of accounts with customers aged forty-five and above is 88.3% for fee-based advisory accounts and 82.89% for brokerage accounts. This highlights the importance of preserving financial advice provided to retirement account holders, and further underscores the importance for the SEC and DOL to expand their coordination in order to ensure that investors' ability to save for retirement is not threatened by unduly burdensome and inconsistent regulatory requirements.

> *Data and other information describing the extent to which different rules apply to similar activities of broker-dealers and investment advisers, and whether this difference is beneficial, harmful or neutral from the perspectives of retail customers and firms*

FSI believes that, based upon the data, the existing regulatory system in place for broker-dealers is far superior to that for RIAs in providing effective supervision. The existence of a well-funded, experienced, self-regulatory authority dedicated to the supervision of broker-dealers and their associated persons allows for more frequent examinations of these regulated entities. The SEC and the Financial Industry Regulatory Authority (FINRA) examine more than half of the registered broker-dealer firms subject to their jurisdiction each year.[23] This active broker dealer examination program is in stark contrast to the current state of affairs for registered investment advisers. The SEC reported that, in fiscal year 2012, the agency examined only 8 percent of investment advisers.[24] In addition, approximately 38 percent of investment advisers registered with the SEC have never been examined.[25] State examination program quality varies widely, but some state regulators appear to be overwhelmed by the volume of RIAs requiring their supervision. As a result, it is clear to us that broker-dealer compliance with the existing legal and regulatory standards is more frequently tested than that of RIAs. While frequency of examination is not the equivalent of effectiveness, we believe it is an essential component of effective regulatory supervision.

In addition, the current regulatory framework for broker-dealers is multilayered. The nearly 4,250 brokerage firms,[26] 162,155 branch offices,[27] and approximately 629,525[28] registered securities representatives are subject to supervision by: The professional broker-dealer compliance staff of their broker-dealer firm, FINRA, the SEC, and state securities regulators. As stated above, the SEC and FINRA examine more than half of these registered broker-dealer firms each year. While improvements can certainly be made, and are being made, to the effectiveness of these examinations, it is hard to sustain an argument that they do not occur with sufficient frequency. This layered and frequent broker-dealer supervision and examination program is unparalleled in the investment adviser world. The over 17,000 state registered investment advisers[29] and 10,511 federally registered investment advisers[30] are subject to supervision by: A compliance officer, who may be the investment adviser himself, and either the SEC or a state securities regulator. Even a strong state registered investment adviser examination program cannot match the regularity of broker-dealer exams. For example, the State of Texas indicates that they "try to get to every [investment] adviser once every five years."[31] In examining only 8 percent of registered investment advisers in fiscal year 2012, the SEC actually fell below its performance target for the year which was to examine 9% of investment advisers.[32] Simply put, registered investment adviser firms go unsupervised by their regulators for long periods.

Although broker-dealers and RIAs are subject to different regulatory schemes, they are often subject to very similar regulatory requirements. One example is that broker-dealers and investment advisers are each required to make suitable recommendations to their clients. Attached as Exhibit A to this comment letter is a detailed summary of other overlapping regulatory requirements for broker-dealers and RIAs compiled by FSI.

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[23] Testimony of Rick Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority, before the U.S. House of Representatives Committee on Financial Services, *available at* http://www.finra.org/Newsroom/Speeches/Ketchum/P126815/

[24] U.S. Securities and Exchange Commission, *Fiscal Year 2012 Agency Financial Report* at 41 (November 15, 20120), *available at* http://www.sec.gov/about/secpar/secafr2012.pdf.

[25] Ketchum, *supra* note 23.

[26] About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited July 3, 2013.)

[27] *Id.*

[28] *Id.*

[29] North American Securities Administrators Association, "The IA Switch: A Successful Collaboration to Enhance Investor Protection" (May 2013) at 2, *available at* http://www.nasaa.org/wp-content/uploads/2011/08/IA-Switch-Report.pdf.

[30] Investment Advisor Association, "2012 Evolution Revolution," at 8, *available at* http://www.nrs-inc.com/PageFiles/1207/Evolution%20Revolution%202012.pdf.

[31] Kara Scannell, *States Will be Hedge-Fund Police*, Wall St. J., August 19, 2010, *available at* http://online.wsj.com/article/SB10001424052748704557704575437663904234590.html.

[32] SEC Report, *supra* note 24, at 41.

Data and other information describing the types of securities broker-dealers or investment advisers offer or recommend to retail customers, and data and other information describing and comparing the security selections of retail customers who are served by financial professionals subject to the two existing regulatory regimes.

Types of Securities held (as a percentage of total assets held):	***Fee-Based Advisory Accounts***	***All other Brokerage Accounts***
Alternative Investment	2.02%	2.85%
Cash or Cash Equivalent	8.15%	9.23%
Equity	10.77%	18.47%
Fixed Income	3.28%	7.54%
Mutual Fund	71.61%	60.14%
Other (includes ETFs, Options, Currency)	4.18%	1.77%
Investment Objectives	***Fee-Based Advisory Accounts***	***All other Brokerage Accounts***
Aggressive (Speculation)	2.74%	3.35%
Capital Appreciation	72.56%	66.35%
Income	19.22%	29.12%
Preservation of Capital	5.45%	1.16%
Trading Profits	.04%	.02%

Data and other information describing and analyzing retail customer returns (net and gross of fees, commissions, or other charges paid to a broker-dealer or investment adviser) generated under the two existing regulatory regimes.

Customer Returns (time-weighted average annualized)	***Fee-Based Advisory Accounts***			***All other Brokerage Accounts***		
	1 Year Return	***3 Year Return***	***5 Year Return***	***1 Year Return***	***3 Year Return***	***5 Year Return***
Aggressive (Speculation)	11.4518	8.0492	1.0461	28.2704	5.6964	2.0191
Capital Appreciation	13.6293	7.6906	1.1202	16.4945	9.1224	1.9102
Income	10.4449	6.7667	1.8977	11.6049	7.7949	3.0256
Other	11.2255	6.3801	2.0919	16.3676	9.5888	1.8466
Preservation of Capital	10.21	6.3812	1.5523	11.5787	7.311	1.7047
Trading Profits	13.9521	7.8411	0.992	18.0464	4.0878	-0.005

The data provided above gives the average annualized returns for customer accounts over the prior one-year, three-year, and five-year periods. This data comes from a smaller sample than the demographic data provided. It must be reiterated, however, that this data is unlikely to be significantly meaningful for the SEC's analysis. Many factors contribute to customer returns beyond the type of account held. In addition, customer return data is unlikely to fully represent the benefits Financial Advisers provide to their clients, such as helping them plan and save for retirement, avoid common investing errors, and remain true to a consistent program of investing.

Data and other information related to the ability of retail customers to bring claims against their financial professional under each regulatory regime.

FSI believes that both retail customers and financial firms are served fairly through the FINRA Dispute Resolution System. Although we have significant concerns with certain recent amendments to the FINRA Arbitration Code, we believe that the data released by FINRA supports the conclusion that arbitration serves as a favorable forum for retail customers. A survey conducted in 1999 found that 93 percent of those surveyed (50 percent of whom were investors), believed their arbitration case was handled fairly without bias.[33] In addition, in 2012 approximately 78 percent of customer claimant cases resulted, through settlements or awards, in monetary or non-monetary recovery for the investor.[34] A survey of FSI members on securities arbitration conducted in 2010 found, among several other conclusions, that:

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[33] Securities Industry and Financial Markets Association (SIFMA), *White Paper on Arbitration in the Securities Industry* (October 2007), *available at* http://www.sifma.org/uploadedfiles/societies/sifma_compliance_and_legal_society/whitepaperonarbitration-october2007.pdf (citing Gary Tidwell et al, *Party Evaluation of Arbitrations: An Analysis of Data Collected from NASD Regulations* at 3, August 5, 1999).

[34] FINRA Dispute Resolution Statistics, *available at* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/ (last visited July 3, 2013).

- FINRA Arbitration is cost-effective; and
- In comparison to litigated cases in the courts, FINRA Arbitrations generally reach the merits hearing more quickly, thereby saving participants' time and money.[35]

REQUEST FOR DATA AND OTHER INFORMATION RELATING TO A UNIFORM FIDUCIARY STANDARD OF CONDUCT AND ALTERNATIVE APPROACHES

For the purposes of advancing the concept of a uniform fiduciary standard, the SEC has provided several assumptions. We provide our comments on selected assumptions of the SEC's hypothetical uniform fiduciary standards below:

Different business models

The SEC assumes that a hypothetical uniform fiduciary standard would "accommodate different business models and fee structures" and permit broker-dealers to receive commissions and compensation from principal trading. We strongly support this assumption as it reflects the stated goal of maintaining access for different types of investors and maintain investor choice. As reflected in the data provided above, fee-based advisory accounts typically service higher-net worth clients, while broker-dealers are more likely than fee-based accounts to provide services to a wider range of investors not typically serviced by investment advisers. Preserving different business models provides underserved investors and underserved communities with the opportunity to benefit from financial advice. Beyond serving more types of investors, preserving different business models also gives customers more choices, as some clients prefer to pay as they go for services received rather than committing to ongoing fees during periods of inactivity.

Continuing Duty of Care

The SEC assumes that a hypothetical uniform fiduciary standard would impose no general requirement of a continuing duty of care or loyalty to a retail customer after providing him or her personalized investment advice about securities. FSI strongly supports this assumption, however, requests that the SEC provide further clarification regarding instances where conditions may impose a continuing duty of care beyond a specific point of time. This clarification is particularly important for FSI members who offer both advisory and brokerage services to a client holding both types of accounts.

Duty of Loyalty

In discussing the characteristics of a uniform fiduciary standard, the SEC makes several assumptions with regard to the duty of loyalty. The first of these assumptions concerns disclosure. While we agree with the premise that all material conflicts of interest must be disclosed and when possible eliminated, we are less

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[35] Financial Services Institute and Briggs and Morgan, P.A., "The Efficacy of Securities Arbitration and Proposals for Change" (April 2010), *available at* https://www.financialservices.org/uploadedFiles/FSI_Content/Advocacy_Action_Center/Resources_and_Reference/White_Papers/fsi_white_paper_april2010_final.pdf.

supportive of the suggestion that a general relationship guide similar in substance to Form ADV Part 2 be delivered at the point of engagement. As we discuss later in our comments on the harmonization of broker-dealer and investment adviser requirements, investors should receive concise, consolidated disclosure documents written in plain English. We support a two-tiered disclosure regime, similar conceptually to the summary and full prospectus permitted for mutual fund disclosure.

Non-Cash Compensation

In the discussion regarding the duty of loyalty, the SEC assumes that the uniform fiduciary standard would prohibit the receipt or payment of non-cash compensation (e.g., trips and prizes) in connection with the provision of personalized investment advice about the purchase of securities. We do not believe this assumption is well grounded in available evidence, particularly with regard to conflicts of interest. Under current FINRA rules, broker-dealers are permitted to provide non-cash compensation to registered persons. Furthermore, the Adviser Act does not strictly prohibit non-cash compensation provided to investment adviser representatives. We, therefore, cannot support an inclusion of this new requirement without further explanation of the evidence relied upon by the SEC in proposing this wholesale prohibition of non-cash compensation.

Uniform Fiduciary Standard of Care Recommended by FSI

FSI supports a universal fiduciary standard of care applicable to all Financial Advisers who provide personalized investment advice to retail clients. We do not support applying the standard of care derived from the Advisers Act, or other Advisers Act requirements, to broker-dealers and their registered representatives. There is no provision in the Advisers Act that expressly applies a fiduciary duty to investment advisers. Instead, the United States Supreme Court in *SEC v. Capital Gains Research Bureau* held that the Advisers Act imposes a fiduciary standard of care on investment advisers,[36] but its specific application to investment adviser activities has been developed through other fact specific case law. The courts in these cases did not contemplate the application of their decisions to the activities and services offered by broker-dealers. FSI recognizes that a single fiduciary standard of care will promote and enhance investor protection. However, attempting to solve the inconsistencies in the competing standards of care by transferring the standards and requirements developed over decades for investment advisers to the broker-dealer world - a world that has its own history, business practices, and clientele - is fraught with difficulty. It is a mistake to assume the existing investment adviser case law can be easily translated into clear conduct rules for broker-dealers and registered representatives. Simply 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. Firms cannot control costs if they do not know what is expected of them. As a result, we would expect firms to react to the imposition of the Adviser's Act standard by limiting their services solely to investors who offer significant profit potential, thereby reducing investor access to products and services.

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 universal fiduciary standard of care. The universal fiduciary standard of care must be carefully designed to

[36] 375 U.S. 180, 189 (1963).

promote access to advice and preserve investor choice while enhancing investor protection. For these reasons, FSI supports a standard of care that would require a Financial Adviser providing personalized investment advice concerning securities to a retail customer to:

- 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;
- Disclose material conflicts of interest, avoid them when possible, and obtain informed customer consent to act when such conflicts cannot be reasonably avoided; and
- Provide advice with skill, care, and diligence based upon information that is known, or should be known, about the customer's investment objectives, risk tolerance, financial situation, and other needs.

This standard of care could be applied to broker-dealer firms and registered representatives by amending existing FINRA Rule 2010[37] as follows:

> *Standards of Commercial Honor and Principles of Trade*
>
> "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade. When providing personalized investment advice to retail customers, members shall: (a) Act in the best interest of the customer without regard to the financial or other interest of the member providing the advice; (b) Disclose material conflicts of interest, avoid them when possible, and obtain informed customer consent to act when such conflicts cannot be reasonably avoided; and (c) Provide advice and service with skill, care, and diligence based upon information that is known, or should be known, about the customer's investment objectives, risk tolerance, financial situation, and needs."

These standards conform to the assumptions that the SEC has laid out as a starting framework for discussion of a uniform fiduciary standard of care in this RFI. Investor access will be preserved through the development of clear conduct rules that allow firms to understand what is expected of them and plan accordingly. FINRA should use its existing rulemaking processes to amend its current rules and adopt additional ones that are consistent with the universal standard of care and enforced prospectively. IBD and other broker-dealer firms should have an opportunity to comment on the rule proposals because these comments are often helpful in alerting FINRA to unintended consequences of their proposed rulemaking. While this process moves forward, broker-dealer firms and registered representatives would have clear guidance as to their obligations through reference to the current FINRA rules. They would also have the opportunity to plan for future changes due to their knowledge of FINRA's rulemaking efforts. In this way, FINRA and the SEC will avoid inhibiting the creativity and innovation that is essential to the development of efficient solutions to investor needs that expand access to advice.

Access to personalized investment advice can be preserved by giving Financial Advisers clear conduct rules outlining their specific obligations under the new standard of care. Clarity will allow Financial Advisers the ability to plan effectively to meet the regulators' expectations of them. As stated previously,

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[37] FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade").

FINRA and the SEC should use their rulemaking processes to amend its existing rules and adopt additional ones that are consistent with the standard of care and enforced prospectively. While this process moves forward, broker-dealer firms and registered representatives would have clear guidance as to their obligations through reference to the current FINRA rules. As a result, we encourage the SEC to delegate responsibility for any broker-dealer rulemaking necessary to implement the new standard of care to their primary regulator, FINRA.

Effective Disclosure

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:

<u>First Tier</u>: 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:

- The standard of care owed by the broker-dealer to each client;
- The nature and scope of the business relationship between the parties, the services to be provided, and the duration of the engagement;
- A general description of the nature and scope of compensation to be received by the broker-dealer;
- A general description of any material conflicts of interest that may exist between the broker-dealer and investor;
- 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
- 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;

- 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
- A description of the means by which a customer can obtain more detailed information regarding these issues, free of charge.

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 detailed schedule of typical fees and service charges;
- 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
- 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.

REQUEST FOR DATA AND OTHER INFORMATION RELATING TO POTENTIAL AREAS FOR FURTHER REGULATORY HARMONIZATION

FSI supports harmonization of broker-dealer and investment adviser regulation. The SEC's Section 913 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.[38] 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 investors will be provided 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 a difference existed.[39] 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

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[38] SEC Staff Study Investment Advisers and Broker-Dealers (January 2011) at 129, *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf.
[39] Angela A. Hung, et al, RAND Institute for Civil Justice, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* at 113, *available at* http://www.rand.org/content/dam/rand/pubs/technical_reports/2008/RAND_TR556.pdf.

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. Attached as Exhibit B is FSI's Memorandum provided to the IA-BD Study Group in April 2012 detailing specific areas for regulatory harmonization. We encourage the SEC to implement a uniform fiduciary standard contemporaneously with its regulatory harmonization efforts. The marketplace for financial advice is less likely to encounter disruption and confusion if one business model is not disadvantaged by incongruous regulatory burdens. Therefore, imposing a uniform fiduciary standard while simultaneously harmonizing broker-dealer and investment adviser regulations provides investors and the industry with the most efficient path forward.

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.

<u>Conclusion</u>
We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with the SEC on this and other important regulatory efforts.

Thank you for your consideration of our comments. Should you have any questions, please contact me at [redacted]

Respectfully submitted,

David T. Bellaire, Esq.
Executive Vice President & General Counsel

EXHIBIT A

CHART OF OVERLAPPING COMPLIANCE REQUIREMENTS FOR DUALLY REGISTERED BROKER-DEALERS AND REGISTERED INVESTMENT ADVISERS

The chart below summarizes areas where independent broker-dealers, who are dually registered with the SEC as broker-dealers and registered investment advisers, find themselves applying overlapping compliance requirements to their activities. These requirements arise from the broker-dealer regulatory scheme, contained in the Securities Exchange Act of 1934 (the "1934 Act") and NASD/FINRA Rules; and the investment adviser regulatory scheme, set forth in the Investment Advisers Act of 1940 (the "1940 Act"). This list is broken down by: 1) the topic/area of interest; 2) the broker-dealer (BD) requirement; 3) the registered investment advisers (RIA) requirement; and 4) a comparison of the compliance burden created by the competing requirements. The areas of interest are not listed in any particular order.

Area of Interest	BD Requirement	RIA Requirement	Compliance Burden
1. Supervision	Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules.[1]	Registered investment advisers must adopt and implement written policies and procedures reasonably designed to prevent violation, by its supervised persons, of the Act and the rules that the Commission has adopted under the Act.[2]	In general, there are similar burdens for BDs and RIAs. However, BDs are subject to more detailed technical requirements that complicate the job of demonstrating compliance, while RIA supervision is principles based and the nature and complexity of supervisory programs differs significantly depending on the RIA's business model.
2. Advertising	Depending on the type of communication with the public (Advertisement, Sales Literature, Correspondence,	It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning the Act, for any registered investment adviser to distribute any	BDs have more detailed, rules based requirements that complicate the job of demonstrating compliance, while RIA

	Institutional Sales Material, Public Appearance, and Independently Prepared Reprint), there are different review, approval, and retention periods prescribed by NASD Conduct Rules, Notice to Members (NTM), and interpretive releases.[3]	advertisement: which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser; or which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person; or which represents, directly or indirectly, that any graph, chart, formula or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which contains any statement to the effect that any report, analysis, or other service will be furnished free or without charge, unless such report, analysis or other service actually is or will be furnished entirely free and without any condition or obligation, directly or indirectly; or which contains any untrue statement of a material fact, or which is otherwise false or misleading.[4]	supervision is more principles based. RIA regulations prohibit the use of testimonials; past specific recommendations; charts, graphs, and formulas; free services unless they are entirely free; and misleading pieces. Additionally, most of the guidance that is available is based upon interpretative guidance, no action letters, and enforcement cases, rather than rules and regulations. In general, BDs can use a wider array of advertising materials. However, such materials must comply with Rule 2210, undergo the review and approval process at the broker-dealer, and possibly an additional review by FINRA.
3. Record Retention Periods	Broker-dealers are required to make, maintain and disseminate records and reports prescribed by the SEC as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the 1934 Act.[5] Rules 17a-3 and 17a-4 under the 1934 Act specify	Section 204 under the 1940 Act requires investment advisers to make and keep records for prescribed periods, furnish copies thereof, and make and disseminate reports as the SEC may prescribe as necessary. Rule 204-2 under the 1940 Act identifies the books and records that are required to be made and kept. Most records are required to be maintained for a period of not less than five years from the end of the fiscal year during	Record retention periods vary between BDs and RIAs. BDs are required to keep the following records for the stated periods: **Six year**: records of original entry (blotters), customer account records, financial records, and cash records; **Three years:**

	minimum requirements with respect to the records that must be generated or kept by broker-dealers and the periods for which such records and other documents must be preserved. Most of the records must be retained in an easily accessible place for the first 2 years after their creation. Certain of these records must be retained permanently; others may be discarded after a period of time. For purposes of the 1934 Act, records include accounts, correspondence, memoranda, tapes, disks, papers, books, and other documents or transcribed information of any type, whether recorded in ordinary or machine language.[6]	which the last entry was made on the records, the first two years in an appropriate office of the investment adviser (unless otherwise noted).[7] All records must be kept on a "current" basis and must contain true and accurate representations of the facts. The SEC staff takes the position that the term "current" is not a fixed concept, but may vary with the circumstances of an advisory business and the nature of the records being kept.[8] Although Rule 204-2 covers a variety of records, maintenance of these records fall into three categories based on the functions of the investment adviser. The categories are (i) records relating to all investment advisers, (ii) additional records that must be kept by an adviser with custody of client funds or securities, and (iii) records an investment adviser rendering investment supervisory or management services must maintain for the portfolios it supervises or manages. Furthermore, Rule 204-2 permits an adviser that is also a registered broker-dealer to substitute or rely on records maintained under the 1934 Act for substantially similar records required to be kept by Rule 204-2.	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; and **Permanent:** corporate records and fingerprint cards. RIAs are required to keep the following records for the stated period: **Five years:** 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; and **Three years:** corporate records. BDs must comply with the strict WORM technology, indexing and regulatory notice requirements of SEC Rule 17a-4(f), while RIAs are permitted to maintain electronic records if they establish and maintain certain procedures described under 204-2 and Release IA-1945 without specific

			requirements for WORM technology or notice filing.
4. Annual Testing Requirement	Broker-dealers shall designate and specifically identify to NASD one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify, on an annual basis, that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons.[9] The designated principal must submit to the member's senior management no less than annually, a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.[10]	At least annually, registered investment advisers must review the adequacy of the policies and procedures established and supervise the effectiveness of their supervisory system.[11]	Generally, there are similar burdens for BDs and RIAs. However, BDs have more detailed technical requirements that complicate the job of demonstrating compliance, while RIA testing is principles based. For example, there are no formal requirements for the means by which testing for RIAs is to be completed, who must see the results of the testing, and what, if any, corrective action must be taken. BDs must prepare a written report while no such requirement exists for R IAs, and CEOs of BDs must certify annually to the adequacy of the procedures. No such certification is required for RIAs.
5. Outside Business Activity (OBA) – Disclosure	No person associated with a broker-dealer in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive	Registered investment advisors have a fiduciary duty to disclose all real and potential conflicts of interests to clients as well as all material arrangements. At times, this broad requirement encompasses outside business activities the registered investment advisor considers	Registered representatives are required to provide prompt written notice to the BD when they engage in an OBA. Investment advisor representatives are required to disclose all

	investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. [12]	non-advisory. The anti-fraud provisions of the Investment Advisers Act of 1940 and most state laws impose a duty on investment advisers to act as fiduciaries in dealings with their clients.	real and potential conflicts of interests to clients. The RIA firm itself must disclose OBAs on its Form ADV Part II, Schedule F and it must disclose its affiliations that are material to the RIA's business.
6. Anti-Money Laundering Program	Each BD shall develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the Bank Secrecy Act (BSA)[13] and the implementing regulations promulgated thereunder by the Department of the Treasury. Each member's anti-money laundering program shall, at a minimum, establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the Bank Secrecy Act, provide an annual (on a calendar-year basis) independent testing, and designate and identify to NASD the individual or	There is no requirement for RIAs to have an AML program at this time. A rule was proposed in 2003, but it has since been withdrawn. An investment adviser that is "willfully blind" to money laundering that is occurring within accounts that it manages may be subject to criminal liability.[15]	BDs have to create, design, and implement an AML program to comply with NASD Rule 3011 and the BSA. RIAs do not have to create an AML program.

	individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program; and provide ongoing training for appropriate personnel.[14]		
7. Business Continuity Plans (BCP)	Each member must create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption. Such procedures must be reasonably designed to enable the member to meet its existing obligations to customers. In addition, such procedures must address the member's existing relationships with other broker-dealers and counter-parties. The business continuity plan must be made available promptly upon request to NASD staff. The BCP plan must be reviewed annual to determine if any modifications are necessary.[16]	No formal rule on point for RIA BCP. However, the SEC stated in the rule release of 206(4)-7 that "an adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel. The clients of an adviser that is engaged in the active management of their assets would ordinarily be placed at risk if the adviser ceased operations."[17]	There are similar burdens for BDs and RIAs, except BDs have detailed technical requirements that complicate the job of demonstrating compliance, while RIAs BCP requirements are principles based and rely upon case law establishing the fiduciary duty to its client.
8. Standard of Care	In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such	Registered investment advisors have a fiduciary duty to their clients. [19]	The fiduciary duty owed by RIAs and Investment Advisor Representatives (IARs) to their clients would appear, on its face, to be a higher compliance burden than the suitability obligation

	customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.[18] There are also additional product specific suitability considerations that carry a greater compliance burden (i.e. variable annuity sales, direct participate programs, penny stock transactions).		owed by Registered Representative (RRs) of a BD. However, FINRA 2821 (Variable Annuities) and other product specific requirements may approach or even surpass the obligations owed by an RIA to his client.
9. Compensation	In securities transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking	"Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities…[23] Generally speaking, advisory fees above 2% require an IAR to make a disclosure to clients and advisory fees of 3% or not allowed.[24]	RRs of BDs are generally compensated on a transaction-by-transaction basis, while IARs of an RIA are compensated with a fee, which is usually a percentage of a client's total assets under management. RRs are generally held to a 5% commission / mark up, while IARs are held to a 2.9% or lower advisory fee based on assets under management.

	into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefore. [20] RRs of a BD are prohibited from accepting fee-based compensation from customers on brokerage accounts.[21] Generally, RRs cannot earn a commission in excess of 5% of the transaction.[22]		
10. Customer Disputes	Parties may arbitrate a dispute under the FINRA Code of Arbitration Procedures if: the parties agree in writing to submit the dispute to arbitration under the Code after the dispute arises; and the dispute is between a customer and a member, associated person of a member, or other related party; and the dispute arises in connection with the business activities of a member or an associated person, except disputes	There is no rule in the 1940 Act that addresses resolution of customer and internal claims.	BDs can resolve disputes with customers and employees of the BD in binding arbitration through the auspices of FINRA's Dispute Resolution Department if they are contracted to do so. BDs are required to arbitrate disputes with any associated person or another member firm. RIAs can resolve disputes in the following forums: arbitration (Not FINRA DR), county court, state court, and/or federal

	involving the insurance business activities of a member that is also an insurance company. [25] Except as otherwise provided in the Code, a dispute must be arbitrated under the Code if the dispute arises out of the business activities of a member or an associated person and is between or among: Members; Members and Associated Persons; or Associated Persons.[26]		court. FINRA arbitration offers a low cost alternative to court with relaxed rules of evidence and fewer barriers to entry.
11. Privacy	Regulation S-P applies to BDs.	Regulation S-P applies to RIAs.	Both BDs and RIAs are held to the same standard with respect to privacy issues. Noteworthy, is the fact that RIA contracts generally cannot be assigned to another IAR… However, transfer of securities accounts, especially those of RRs of Independent BDs, has become very complicated and burdensome due to Regulation S-P.
12. Account Records	Blotters (or other records of original entry) containing an itemized daily record with information as to all orders taken for securities purchases and sales, including redemption requests, transfers and exchanges, premium payments, policy loan	Rule 204-2 requires an RIA to maintain records separately for each client reflecting purchases and sales (client "posting pages").[29]	BDs are required to enter each transaction into a blotter, while RIAs have to create posting pages. While there is no formal requirement for an adviser to maintain a trade blotter, however there seems to be an expectation by

	requests, policy loan repayments, withdrawal requests, surrender requests, and death benefit payments; all receipts and disbursements of cash; and other debits and credits.[27] With some exceptions, BDs must obtain an account record containing specific client information, and the information contained in the account record must be provided to new clients within 30 days of opening the account, to all clients within 30 days of an update to the client's investment objectives, and to all clients at least every three years thereafter.[28]		the SEC that the adviser will maintain the said record. This is evidenced in the review of a recent SEC exam request letter where transactional data (such as those on a blotter) are requested. RIA's do not have a requirement to obtain an account record containing specific information, nor provide copies to RIA clients on any predetermined basis or timeline exists.
13. Trade Monitoring	All firms are required to establish, maintain, and enforce supervisory systems and procedures that are designed to address all areas of a member's business.[30] A key aspect of these supervisory procedures is exception and other compliance reports that a member creates to help meet these supervisory responsibilities. In a fully disclosed clearing	The SEC staff has indicated that, to comply with Rule 206(4)-7, "[e]ach adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred."[32] Specifically, the SEC proposed that advisers should complete "an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation	RIAs are held to a higher standard of care given their fiduciary duty. However, BDs have more detailed technical requirements that complicate the job of demonstrating compliance, while RIAs regulation is primarily principals based pursuant to Rule 206(4)-7 of the 1940 Act. BDS are concerned with churning (excessive trading of customer accounts in an effort to earn

	arrangement, the clearing member generally provides exception reports that are available to assist the introducing member in carrying out its supervisory obligations.[31]	of investment opportunities, or other breaches of fiduciary responsibilities)."[33]	commissions),[34] while RIAs are concerned with reverse churning (where the firm places buy and hold clients in managed accounts).[35]
14. Insider Trading	It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange: to employ any device, scheme, or artifice to defraud; to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.[36]	Every investment adviser shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser.[37]	There are similar burdens for BDs and RIAs with respect to insider trading, except BDs have detailed technical requirements that complicate the job of demonstrating compliance, while the RIAs rule is principles and based upon case law establishing a fiduciary duty to its client.
15. Personal Trading	A person associated with a member who opens a securities account or places an order for the purchase or sale of securities	All "Access Persons" of an investment advisor registered with the SEC shall report, and the investment advisor shall review, their personal securities transactions and holdings	There are similar burdens for BDs and RIAs with respect to personal trading by RRs and RIA access persons. However,

	with a broker/dealer, a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall notify his or her employer member in writing, prior to the execution of any initial transactions, of the intention to open the account or place the order; and upon written request by the employer member, request in writing and assure that the notice-registered broker/dealer, investment adviser, bank, or other financial institution provides the employer member with duplicate copies of confirmations, statements or other information concerning the account or order.[38]	periodically. SEC Rule 204A-1 defines "Access Person" to mean any supervised persons of an investment advisor who (1) has access to nonpublic information regarding any advisory clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund, or (2) is involved in making securities recommendations to advisory clients, or who has access to such recommendations that are nonpublic.[39]	BDs have detailed technical requirements that complicate the job of demonstrating compliance which requires duplicative statements be sent to the BD for its associated persons. The purpose of the member's request for duplicate statements of its registered persons would be to comply with NASD Rule 3010, which obligates a member firm to supervise its registered persons. An RIA is required to have all access persons self report their securities holdings. Again, the RIA rules are more principles based and based on the fiduciary duty to a client.
16. Best Execution	In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing	As a fiduciary, an adviser has an obligation to obtain "best execution" of clients' transactions. In meeting this obligation, an adviser must execute securities transactions for clients in such a manner as to insure the clients' total cost or proceeds in each transaction is the most favorable under the circumstances.[41] In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial	There are similar compliance burdens for BDs and RIAs with respect to best execution for a customer transaction. However, the RIA rules are principles based and proceed from case law establishing a fiduciary duty to the client. Given the existence of the fiduciary duty, IARs are able to avoid or limit their best execution obligation if they

	market conditions. Among the factors that will be considered in determining whether a member has used "reasonable diligence" are: (A) the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications; (B) the size and type of transaction; (C) the number of markets checked; (D) accessability of the quotation; and (E) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member. [40]	responsibility, responsiveness to the adviser, and the value of any research services provided.[42] However, IARs can disclose to their clients that they may not achieve best execution for their clients and avoid liability if they obtain informed client consent.	disclose this to their clients.
17. Principal Trading	A principal trade occurs when a brokerage house buys securities on the secondary market with the strategy to hold long enough for a price appreciation. There is no prohibition in place that prohibits this type of transaction by a BD.	In light of a recent court decision vacating Rule 202(a)(11)-1 under the 1940 Act, the SEC has adopted temporary Rule 206(3)-3T to establish an alternative method for investment advisers who are dually registered with the SEC as both advisers and broker-dealers to meet the requirements of the 1940 Act when they act in a principal capacity in transactions with certain of their advisory clients. The Temporary Rule was effective September 30, 2007 and will expire on December 31, 2009. Prior to this temporary rule, investment advisers were prohibited from acting "as [a] principal for his own account, knowingly to sell any security to	Prior to the enactment of the temporary rule, set to expire on December 31, 2009, all RIAs were prohibited from engaging in principal trading. Principal trading is, however, core to the business of many broker-dealers. This is appropriate in light of broker-dealer's traditional role as liquidity providers.

		or purchase any security from a client…, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.”. [43]	
18. Referral Fees / Solicitors Fees	FINRA prohibits members from paying persons not registered with a member firm a commission or fee derived from a securities transaction, including a referral fee or solicitation fee. Payments that are transaction-based made by members who are registered broker/dealers to non-registered persons are prohibited. [44]	A “solicitor” is “any person who directly or indirectly, solicits any client for, or refers any client to, an investment adviser.”[45] As such, activity which seeks to steer a prospective client to an adviser will be deemed solicitation activity. In addition, a person could be engaged in solicitation activity by supplying the names of prospective clients to an adviser, even if he or she does not specifically recommend to the client that he retain that adviser. It is unlawful for any investment adviser to pay a cash fee, directly or indirectly, to a solicitor with respect to solicitation activities unless: 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;…[46]	BDs are prohibited from paying a referral fee to a person who is not licensed with a FINRA member firm, but RIAs can pay solicitor fees to individuals if they meet the requirements set forth in the 1940 Act.

19. Custody	Rule 15c3-3 of the 1934 Act governs a broker-dealer's acceptance, custody and use of a customer's securities. Rule 15c3-3 is intended to ensure that a broker-dealer in possession of customers' funds either deployed those funds "in safe areas of the broker-dealer's business related to servicing its customers" or, if not deployed in such areas, deposited the funds in a reserve bank account to prevent commingling of customer and firm funds. Rule 15c3-3 seeks to inhibit a broker-dealer's use of customer assets in its business by prohibiting the use of those assets except for designated purposes. The Rule also aims to protect customers involved in a broker-dealer liquidation. If a broker-dealer holding customer property fails, Rule 15c3-3 seeks to ensure that the firm has sufficient reserves and possesses sufficient securities so that customers promptly receive their property and there is no need to use the SIPC fund. NASD Conduct Rule 3020 requires members to maintain fidelity bonds to insure	Under 206(4)-2, an RIA is generally deemed to have custody of client assets when the RIA holds or has possession of those assets or has the authority to obtain possession of the assets. An RIA has custody of a client's account where the RIA or one of its supervised persons has the authority to transfer assets in the account to itself. If an RIA has custody of client assets, the RIA is required to implement controls designed to protect client assets from being lost, misused, misappropriated or subject to the RIA's financial reserves. The rule contains two primary protections. First, the RIA is required, subject to certain limited exceptions, to place the assets with a "qualified custodian," which includes, among others, banks and registered broker-dealers. Second, an RIA with custody of client assets that maintains the assets with a qualified custodian is generally required to have a reasonable belief that the qualified custodian delivers account statements directly to each client at least quarterly.	Both BDs and RIAs have rules and regulations that direct their actions with respect to custody of client funds. BDs have to place the customer funds in a safe area related to the servicing of the customer or in a reserve bank account. RIAs with custody have to implement controls designed to protect client assets from being lost, misused, misappropriated, or subject to the RIA's financial reserves. Again, BDs have detailed technical requirements that complicate the job of demonstrating compliance, while RIAs have more principles based rules.

	against certain losses and the potential effect of such losses on firm capital. The Rule applies to all members with employees who are required to join SIPC and who are not covered by the fidelity bond requirements of a national securities exchange.		
20. Examination	The SEC and industry-funded regulators examine more than half of the approximately 4,900 registered broker-dealer firms each year.	The Securities and Exchange Commission (SEC) projects that fewer than 10 percent of the more than 11,000 registered investment adviser firms will be examined during fiscal years 2009 and 2010.[47]	BDs will have one or more regulatory visit in a two-year period, while RIAs may have only one regulatory visit in a ten-year period.[48]
21. Continuing Education	Each registered person shall complete the Regulatory Element on the occurrence of their second registration anniversary date and every three years thereafter, or as otherwise prescribed by NASD.[49] Each member must maintain a continuing and current education program [Firm Element] for its covered registered persons to enhance their securities knowledge, skill, and professionalism.[50]	There is no rule related to continuing education under the 1940 Act.	RRs of a BD have regulatory element and firm element continuing educations requirements. IARs of an RIA have no requirement for continuing education under the 1940 Act.
22. Licensing	RRs of a BD are required to take, pass, and obtain a Series 7 (or Series 6 to sell only investment company or variable annuity products) in order to sell securities	IARs and RIAs do not have a standardized licensing examination under the 1940 Act. Although, in order to offer advice concerning securities products in a majority of states, IARs must obtain a Series 65 or 66 (Uniform Investment Adviser Law	RRs are required to take and pass a liciensing exmainaiton in order to sell securities products, while IARs are not required to take a standardized licensing

	products.[51]	Examination), which is a combination of the Series 63 and 65. Series 65 or 66 exams are often waived by the majority of states if the IAR holds one of several acceptable professional designations such as CFP, CFA, ChFC, PFS or CIC.	examination.

[1] NASD Conduct Rule 3010.

[2] Rule 206(4)-7 of the Rules and Regulations promulgated under the 1940 Act.

[3] NASD Conduct Rule 2210, IM-2210-1 through IM-2210-8, Rule 2110, Rule 3110, Rule 2330, MSRB Rule G-21, NTM 92-38, 93-73, 93-85, 95-74, 96-50, 98-3, 98-107, 99-16, 00-15, 00-21, 02-39, 03-17, 03-38, 04-36, 06-48, and 09-10.

[4] Rule 206(4)-1 of the Rules and Regulations promulgated under the 1940 Act

[5] Section l7(a)(i) under the 1934 Act.

[6] Section 3(a)(37) under the 1934 Act.

[7] Rule 204-2(e) of the Rules and Regulations promulgated under the 1940 Act.

[8] See, e.g., American Asset Management Company, SEC No-Action Letter (July 23, 1987 and William P. Frankenhoff, Inc., SEC No-Action Letter (August 24, 1987).

[9] NASD Conduct Rule 3012.

[10] FINRA Rule 3130.

[11] Rule 206(4)-7 of the Rules and Regulations promulgated under the 1940 Act.

[12] NASD Conduct Rule 3030

[13] 31 U.S.C. 5311, *et seq*.

[14] NASD Conduct Rule 3011.

[15] 18 U.S.C. §§ 1956 and 1957.

[16] NASD Conduct Rule 3510.

[17] SEC Release Nos. IA 2044; IC-26299 Final Rule: Compliance Programs of Investment Companies and Investment Advisers

[18] NASD Conduct Rule 2310

[19] S.E.C. v Capital Gains Research Bureau, 375 U.S. 180 (1963). *See generally,* the Anti-Fraud provisions of the 1940 Act

[20] NASD Conduct Rule 2440

[21] *Financial Planning Ass'n* v. S.E.C., 2007 WL 935733, C.A.D.C. (March 30, 2007)

[22] *See generally,* IM-2440-1 (In 1943, the Association's Board adopted what has become known as the "5% Policy" to be applied to transactions executed for customers. It was based upon studies demonstrating that the large majority of customer transactions were affected at a mark-up of 5% or less. The Policy has been reviewed by the Board of Governors on numerous occasions and each time the Board has reaffirmed the philosophy expressed in 1943. Pursuant thereto, and in accordance with Article VII, Section 1(a)(ii) of the By-Laws, the Board has adopted the following interpretation under 2440).

[23] Rule 202 of the 1940 Act

[24] *See*, Berkman Ruslander et. al., SEC No-Action Letter, 1977 SEC No-Act. LEXIS 68 (Jan. 6, 1977); Shareholder Services Corp., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 159 (Feb. 2, 1989); BISYS Fund Services, Inc., SEC No-Action Letter, 1999 SEC No-Act. LEXIS 720 (Sept. 2, 1999).

[25] Code of Arbitration Procedure for Customer Disputes, Rule 12200.

[26] Code of Arbitration Procedure for Industry Disputes Rule 13200

[27] Rule 17a-3(a)(1) under the 1934 Act.

[28] Rule 17a-3(a)(17)(i)(A) under the 1934 Act.

[29] Rule 204-2 under the 1940 Act.

[30] NASD Conduct Rule 3010.

[31] Notice to Members 99-54, pursuant to NASD Conduct Rule 3010.

[32] Securities and Exchange Commission; "Compliance Programs of Investment Companies and Investment Advisers"; Final Rule. 68 Fed. Reg. 74714 - 74730 (December 24, 2003).

[33] *Id.*

[34] IM-2310-2

[35] *See* FINRA Fines Robert W. Baird & Co. $500,000 for Fee-Based Account, available at http://www.finra.org/Newsroom/NewsReleases/2009/P117860. (

[36] Rule 10b-5 of the Rules and Regulations promulgated under the 1934 Act, NASD Conduct Rule 3010 and 2110.

[37] Rule 204A under the 1940 Act.

[38] NASD Conduct Rule 3050(d).

[39] Rule 204A under the 1940 Act.

[40] NASD Conduct Rule 2320(a)(1).

[41] *See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, SEC Rel. No. 34-23170 (Apr. 23, 1986), 51 Fed. Reg. 16004 (Apr. 30, 1986) at Section V. S*ee also Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, Rel. No. IC-26313 (Dec. 18, 2003) at 16.

[42] *Id.*

[43] Rule 206(3) of the 1940 Act.

[44] NASD Conduct Rule 2420.

[45] Rule 206(4)-3 of the 1940 Act.

[46] *Id.*

[47] *See* Richard Ketchum Speech at The Exchequer Club, June 17, 2009, available at http://www.finra.org/Newsroom/Speeches/Ketchum/P119009

[48] *Id.*

[49] NASD Conduct Rule 1120(a).

[50] NASD Conduct Rule 1120(b)(2)(A).

[51] *See generally, http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/RegisteredReps/Qualifications/p011051*

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,

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[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

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[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.