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The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers

Dear Chairman Clayton:

Vanguard¹ appreciates the opportunity to provide comments on your request for an updated assessment of the standards of conduct for investment advisers and broker dealers.² Vanguard believes that retail investors should always receive investment advice that is in their best interest. Providers of ongoing and point-in-time retail investment advice should be held to a fiduciary duty, without regard to the nature of the provider or the type of retail client account at issue. Accordingly, we urge the Securities and Exchange Commission (the “Commission”) to take the following actions:

- **The Commission should adopt a best interest standard of conduct for broker-dealers who provide recommendations.** We urge the Commission to create a best interest standard of conduct for broker-dealers providing investment recommendations to retail investors. The adoption of a best interest standard will promote consistency in investor experience by harmonizing the duties owed by broker-dealers and investment advisers. While a new best interest standard applicable to broker-dealers should be consistent in core principles with

¹ Vanguard is one of the world’s leading asset managers, managing over \$4 trillion for institutional and retail investors. Vanguard manages over \$1 trillion in defined contribution and defined benefit plan assets and provides recordkeeping and administrative services for over 4 million participants in over 8,400 defined contribution plans. We also record keep over \$600 billion for over 6 million individual retirement account (“IRA”) investors. We provide fiduciary investment advice to IRAs and other clients through Vanguard Personal Advisor Services, which currently has approximately \$80 billion in assets under advisement across all client types. We also provide fiduciary investment management to retirement plan participants through the Vanguard Managed Account Program, an investment management service based on systems and methodology developed and maintained by Financial Engines Advisors, LLC. Vanguard Managed Account Program manages over \$20 billion on a discretionary basis.

² Chairman Jay Clayton, *Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers* (June 1, 2017), available at <http://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31> (“Statement”).

other fiduciary standards, the Commission's rulemaking should recognize and preserve the unique service offerings made available by those firms in order to protect investor choice.

- **The Commission should preserve the protections codified in the Investment Advisers Act.** With regard to the standards governing investment advisers, Vanguard believes that the existing principles-based rules, body of precedents and interpretive guidance born out of the Investment Advisers Act's³ (the "Advisers Act") 77-year history are well suited to govern the current and future course of investment advisory offerings, including hybrid and robo-advisory services offered under the Advisers Act. The standards governing investment advisers are tailored to the unique services provided by these firms, which are distinct from brokerage offerings. While the core duty owed to retail clients from investment advisers and broker-dealers can, and should, be made consistent, it is important for the Commission to maintain separate regulatory regimes that recognize differences in business models.
- **The Commission should work with other regulators to promote a consistent best interest standard.** The Commission and the Department of Labor (the "Department") should coordinate closely to fashion a fiduciary requirement for retail investment advice that is based upon the same core principles across regulatory regimes in the brokerage, investment advisory and retirement marketplaces. Further, the Commission should work closely with state regulators through the North American Securities Administrators Association ("NASAA") to ensure that state-level fiduciary standards applicable to retail investment advice are not created in conflict with federal principles. By coordinating its efforts, the Commission can assist in developing a best interest standard that provides similar protections and a similar experience to investors across account types.

I. Background

The obligations of different types of investment professionals to different types of clients have been the subject of significant scrutiny and change over the past 11 years. These efforts have advanced important investor protections but also have created differing standards for services to clients depending on the nature of services and type of account. This variation leads to client confusion and requires individual investors to negotiate a variety of very unique regulatory regimes.

We support the Department's updated definition of fiduciary advice for the modern retirement marketplace.⁴ Investors deserve the protection of a best interest standard governing retirement

³ 15 U.S.C.A. § 80b-1, et seq. (1940).

⁴ See 81 Fed. Reg. 20946 (April 8, 2016) (the "DOL Fiduciary Rule"). See also, e.g., Vanguard's August 7, 2017 comment letter, available at <https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB82/00520.pdf>, and Vanguard's April 17, 2017 comment letter, available at

account rollover recommendations, as it is one of the most important financial decisions to be made in their lives. We believe that the Commission must now evaluate its own standards, because portions of the DOL Fiduciary Rule as yet to be implemented have the potential to introduce regulatory requirements without corollaries in the standards governing broker-dealers and investment advisers. Since investment advisers and now retirement advisers are both subject to a best interest standard, there seems to be little justification for considering a suitability standard sufficient for investment recommendations made by broker-dealers.

In addition, Nevada recently imposed a state-mandated fiduciary duty to federally registered broker dealers and investment advisers,⁵ and authorized the drafting of state rules defining that duty.⁶ The scope of this new duty is currently not defined. Other states are reported to be considering similar changes.⁷ We are concerned that without coordinated regulatory effort, retail investors may be required to navigate unique standards that differ at both the federal and state levels. We strongly believe that retail investors deserve to receive advice that is in their best interest, and prompt action by the Commission combined with close regulatory coordination can ensure that services are rendered pursuant to duties that are consistent across the retail investing landscape.

II. The Commission should fashion a best interest standard of conduct for broker-dealers who make recommendations to retail investors that preserves investor choice

The Commission should establish a best interest standard of conduct for broker-dealers providing investment recommendations to retail investors. Rather than permitting broker-dealers to rely solely on the customer-specific⁸ and quantitative suitability tests⁹ of the Financial Industry Regulatory Authority's ("FINRA") rule, which merely require that recommendations be "suitable" when made, the best interest standard should require that a recommendation to a retail customer must be in that customer's best interest at the time a recommendation is made. The standard should incorporate the following components, each of which would need to be satisfied when providing a recommendation to a retail client:

- **Duty of loyalty:** A recommendation to a retail client should not put the broker-dealer's interests above the client's interests. Material conflicts of interest should either be mitigated or disclosed, depending on the nature and severity of the conflict.

<https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB79/01370.pdf>.

⁵ Nev. Rev. Stat. Ann. § 628A.010 (June 2, 2017).

⁶ Id. § 90.

⁷ See "Other States Considering Their Own 'Fiduciary Rules' After Nevada's Becomes Law," *WealthManagement.com* (June 26, 2017), available at <http://www.wealthmanagement.com/industry/other-states-considering-their-own-fiduciary-rules-after-nevada-s-becomes-law>.

⁸ See FINRA Rule 2111.05(b) (May 2014).

⁹ See FINRA Rule 2111.05(c).

- **Duty of care:** A recommendation to a retail client should be made using reasonable care, diligence, skill and prudence. The information required to be gathered under FINRA's suitability rule provides a logical foundation for the Commission on this point.¹⁰
- **Reasonable compensation:** Direct and indirect compensation received by a broker-dealer or its associated persons in connection with a recommendation or a service provided to a retail client should be reasonable in light of the services performed.
- **Enhanced disclosure:** A broker-dealer should provide comprehensive disclosures intended to convey the nature and scope of the duty owed to a retail client, the types of direct and indirect compensation to be received by the broker-dealer or its associated persons in connection with a recommendation or a service provided to a retail client, and the existence of any material unmitigated conflicts of interest. Disclosures should be provided to a retail client before or at the time recommendations are made.
- **Application of standard:** The best interest standard should be triggered when a recommendation, as defined by FINRA,¹¹ is made to a retail client; this formulation would recognize the episodic nature of the broker-dealer's interactions with retail clients and impose a commensurate duty that broker-dealers could reasonably satisfy.
- **Enforcement:** Mandatory class action rights to enforce the standard are unnecessary, because the Commission and FINRA both have examination and enforcement authority over broker-dealers.

The new standard should be implemented in a manner that preserves investor choice while prohibiting conduct that is inconsistent with a client's best interests.¹² Specifically, the standard should be carefully developed to recognize that certain business practices, such as charging commissions, are not per se incompatible with operating under a fiduciary duty. Instead, the standard should focus on the receipt of unreasonable or undisclosed compensation. A true principles-based best interest standard should target the behaviors and activities that are inconsistent with serving in a fiduciary capacity, and require clear and comprehensive disclosure of all other matters having a material impact on an advisory relationship.

A principles-based approach should also provide definitive yet broad standards to ensure investor protection while at the same time promoting continual industry innovation. A principles-based rule can help promote industry innovation by bringing focus to the behaviors or practices the Commission concludes should be promoted or prevented, rather than establishing specific requirements for any particular current products or services.¹³ If a principles-based best interest standard is created, retail clients will enjoy the protections of a fiduciary duty while maintaining

¹⁰ See FINRA Rule 2111(a).

¹¹ See *id.*, see also *Know Your Customer and Suitability*, FINRA Regulatory Notice 11-02 (Jan. 2011) and *Online Suitability*, NASD Notice to Members 01-23 (April 2001).

¹² Note, for example, the industry trend away from providing commission based account arrangements in response to the DOL Fiduciary Rule. See ICI Comment Letter, p. 4.

¹³ In particular, we would caution the Commission against creating standards based on product type, such as T-shares or clean shares, as opposed to the characteristics of the product that mitigate particular conflicts (such as levelized or limited individual compensation). See Vanguard's August 7, 2017 comment letter to the Department, p. 9.

access to traditional broker-dealer services such as episodic advice, commission-based accounts and principal trading.

III. The Commission should preserve the standards applicable to advisers under the Advisers Act, which adequately regulate traditional and emerging advisory service offerings

As noted in the Statement, a host of firms have created automated advisory services providing algorithmic-based investment management to clients.¹⁴ Most of these services are offered through federally registered investment advisers. You inquired in the Statement whether retail investors' perceptions were out of step with the actual obligations owed by these services.¹⁵

Investor perceptions are shaped by the manner in which investment advisory services are presented to clients, and the Advisers Act requires clear disclosures that do not depend on the way advisory services are provided. Specifically, under the Advisers Act brochure rule,¹⁶ firms are required to provide clients with comprehensive disclosures about the nature of their advisory business, fees and compensation, types of clients, methods of analysis, investment strategies, key risks, disciplinary information, material affiliations, ethics policies, brokerage practices, account oversight, client referral practices, custody, willingness to exercise investment discretion, and authority to vote proxies.¹⁷ Brochures are both required to be delivered to clients prior to entering into an advisory contract and publicly available on the Commission's Investment Adviser Public Disclosure website.¹⁸ The Commission's instructions for completing the brochure state that

“[u]nder federal and state law, you are a fiduciary and must make full disclosure to your *clients* of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your *clients* that could affect the advisory relationship.”¹⁹

In the brochure of our hybrid offer, Personal Advisor Services[®] offered through Vanguard Advisers, Inc. (“VAI”), we explicitly state on the first page that “VAI has a fiduciary duty to act in its clients' best interests... .”²⁰ To the extent the Commission perceives that there may be investor confusion regarding the standards applicable to these offers, the confusion is not arising as a result of a lack of relevant and available information. The Commission should address any

¹⁴ Statement, p. 4.

¹⁵ Id.

¹⁶ 17 C.F.R. § 275.204-3 (2016).

¹⁷ See Form ADV, Uniform Application for Investment Adviser Registration, Part 2: Uniform Requirements for the Investment Adviser *Brochure* and *Brochure Supplements*, Commission website, available at <https://www.sec.gov/about/forms/formadv-part2.pdf>.

¹⁸ 17 C.F.R. § 275.204-3.

¹⁹ Form ADV, Uniform Application for Investment Adviser Registration, Part 2: Uniform Requirements for the Investment Adviser *Brochure* and *Brochure Supplements*, p. 1.

²⁰ Vanguard Personal Advisor Services Brochure, p.1, Commission website, available at https://adviserinfo.sec.gov/IAPD/Content/Common/crd_iapd_Brochure.aspx?BRCHR_VRSN_ID=450293.

perceived confusion by publishing additional investor guidance about the importance of reviewing the advisory brochure of any adviser, whether human, hybrid or robo, in advance of retaining a service.

While hybrid and robo-advisory services differ from traditional services provided solely by human advisers, the Commission should also recognize that the greatest innovation of these offerings is not their ability to use algorithms to develop investment recommendations (which is a practice that has existed in the industry for years). Instead, their innovation is their ability to deploy technology to serve client accounts at scale which allows them to be offered at attractive price points to retail investors. And while technology may change the manner in which a hybrid or robo-advisory offer carries out tasks, these services must perform the same advisory functions – pursuant to the same fiduciary obligations – as those provided by human advisers.

The investment advisory business model is significantly different from that of a broker-dealer. Advisers generally provide ongoing advice for a fee, take discretion over client accounts, and engage other entities to carry client accounts and handle client trading. The Advisers Act standards have been fashioned with those distinctions in mind. It is important that the Commission maintains different sets of standards applicable to investment advisers and broker-dealers that are appropriately tailored to effectively regulate the different models. Since the Advisers Act has a rich history of rules, precedents and interpretive guidance that is flexible and principles-based, and applicable whether advisory functions are carried out through a hybrid, robo- or human advisory offering, we do not believe that the Commission should undertake any rulemaking to close nonexistent regulatory gaps for advisory offers. Instead, the Commission should continue to collaborate with the industry to identify whether additional guidance should be issued, such as the helpful guidance released by the Commission's Division of Investment Management earlier this year.²¹

IV. The Commission should coordinate on the creation of a principles-based best interest standard of conduct applicable across regulatory regimes

Unless coordinated rulemaking is undertaken by the Commission and the Department, retail investors will need to navigate a suitability standard for broker-dealers providing episodic investment recommendations,²² a principles-based fiduciary duty for investment advisers,²³ and a prohibited transaction-based fiduciary standard for retirement advice providers.²⁴ While the current federal and self-regulatory organization standards are different in application, the core principles of each are geared toward ensuring that retail investors receive investment advice that is in their best interests. The Department and Commission should build upon this common ground to fashion a fiduciary requirement for retail investment advice that is consistent in core principles across regulatory regimes to the greatest possible extent in the brokerage, investment advisory and retirement marketplaces.

²¹ See *Robo-Advisers*, IM Guidance Update No. 2017-02 (February 2017), available at <https://www.sec.gov/investment/im-guidance-2017-02.pdf>.

²² See FINRA Rule 2111 (May 1, 2014).

²³ 15 U.S.C.A. § 80b-6 (1940) and *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

²⁴ 81 Fed. Reg. 20946.

To accomplish the first step in this effort, we've urged the Department to consider a series of revisions to the DOL Fiduciary Rule that would significantly simplify the Best Interest Contract ("BIC") Exemption and adopt a streamlined exemption providing flexible, principles-based conditions for arrangements that are designed to mitigate individual conflicts of interest and promote transparency.²⁵ If the Department takes these steps, the changes will pave the way for the Commission's adoption of a best interest standard of care applicable to broker-dealers providing investment recommendations. Coordinated rule-making would recognize both the broker-dealer best interest standard and the investment advisory fiduciary duty as each satisfying the requirements of the DOL Fiduciary Rule.

The benefits of coordination are immediate and apparent. If a retail investor selects a broker-dealer as their investment professional under a consistent regulatory approach, for example, the entire relationship will be governed by a single best interest standard applicable to all of the investor's accounts with that broker-dealer. While coordination between the Department and Commission is a critical first step, we also urge the Commission to reach out to state regulators through NASAA to ensure that states refrain from adopting individual fiduciary standards that are inconsistent with the federal standards applicable to broker-dealers, investment advisers and retirement advice providers. Coordinated federal principles obviate the need for state-level best interest standards. By coordinating efforts, the Commission can use its expertise to promote a best interest standard that protects investors, preserves investor choice and promotes consistency in investor experience across all accounts.

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Vanguard appreciates the opportunity to submit these comments and would welcome further discussion with the Commission. If you have any questions or wish to discuss in greater detail, please do not hesitate to contact Ann Combs at [REDACTED] or James Creel at [REDACTED].

Sincerely,



The Vanguard Group, Inc.

cc. The Honorable Michael S. Piwowar
The Honorable Kara M. Stein
Dalia Blass, Director, Division of Investment Management
Heather Seidel, Acting Director, Division of Trading and Markets

²⁵ See Vanguard's August 7, 2017 comment letter to the Department.