

February 5, 2018

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

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

Dear Chairman Clayton:

Last August, the Investment Company Institute<sup>1</sup> submitted a letter to you recommending that the SEC take the lead in establishing and enforcing a best interest standard of conduct for broker-dealers providing recommendations to retail investors in non-discretionary accounts, across both retirement and non-retirement accounts.<sup>2</sup> We recommended that the SEC coordinate closely with the Department of Labor so that DOL explicitly recognizes the best interest standard of conduct in a new, streamlined prohibited transaction exemption for financial services providers that are subject to an SEC-governed standard of conduct. Finally, we urged the SEC to maintain the existing fiduciary duty standard for investment advisers that has served investors well for over seven decades. Our recommended approach would help ensure that investors are protected by a consistent, high standard

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<sup>1</sup> The [Investment Company Institute](http://www.ici.org) (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$21.7 trillion in the United States, serving more than 100 million US shareholders, and US\$7.1 trillion in assets in other jurisdictions. ICI carries out its international work through [ICI Global](http://www.ici.com), with offices in London, Hong Kong, and Washington, DC.

<sup>2</sup> Letter to the Honorable Jay Clayton, Chairman, Securities and Exchange Commission, from Dorothy M. Donohue, Acting General Counsel, dated Aug. 7, 2017, available at <https://www.sec.gov/comments/ia-bd-conduct-standards/cl4-2188873-160255.pdf>. For ease of reference, throughout this letter we refer to our recommended standard of conduct as the "best interest standard of conduct," and to the SEC-registered brokers and dealers to which it would apply simply as "broker-dealers."

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of conduct when they receive personalized recommendations from broker-dealers, regardless of whether they are investing for retirement or other important financial goals.

Today we are supplementing our August letter with a more detailed and somewhat revised best interest standard for you, the other commissioners, and the SEC staff to consider. Our goal in submitting this revised recommendation is to assist the SEC and staff by more clearly articulating a best interest standard of conduct for broker-dealers providing personalized recommendations to retail customers, and providing a framework that places the key elements of the best interest standard in the context of existing regulatory requirements. In particular, we place the standard in the context of existing broker-dealer obligations under the Securities Exchange Act of 1934 (“Exchange Act”) and FINRA rules, investment adviser duties under the Investment Advisers Act of 1940 (“Advisers Act”), and obligations of financial services providers under the Impartial Conduct Standards set forth in DOL’s Best Interest Contract exemption. Finally, we evaluate our recommended standard against the standards set forth in Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

We provide in an attachment to this letter our recommendation along with explanations. We summarize the most salient aspects below.

### **Revised Recommended Best Interest Standard of Conduct**

Our recommended best interest standard would require that a broker-dealer, when making a “personalized recommendation about securities”<sup>3</sup> to a “retail customer,”<sup>4</sup> satisfy explicit duties of loyalty and care. A broker-dealer also would be obligated, under FINRA rules, to adopt policies and procedures reasonably designed to prevent violations of the best interest standard of conduct.

#### *Duty of Loyalty*

Our recommended best interest duty of loyalty would have several components:

- 1. Retail Customer’s Interest First.** The standard would require that a broker-dealer, when making a personalized recommendation about securities to a retail customer, act in the retail

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<sup>3</sup> A “personalized recommendation about securities” would mean a customer-specific “recommendation” to a retail customer within the meaning of FINRA Rule 2111.

<sup>4</sup> A “retail customer” would mean a natural person, or the legal representative of such person, who receives a personalized recommendation about securities that is to be used primarily for personal, family, or household purposes.

customer's best interest and not put the broker-dealer's interests ahead of the customer's interests.

The best interest duty of loyalty also would broaden a broker-dealer's disclosure obligations. A broker-dealer would be prohibited from effecting a recommended transaction that raises a material conflict between the broker-dealer's interests and the customer's interests unless the broker-dealer discloses all material facts about the conflict and obtains the customer's consent.

2. **Disclosure.** The standard would require that the broker-dealer disclose to the retail customer (perhaps in a standard format) certain key aspects of its relationship with the retail customer—such as the type and scope of services provided, the applicable standard of conduct, the types of compensation it or its associated persons receive, and any material conflicts of interest.
3. **No False or Misleading Statements.** The standard would explicitly prohibit a broker-dealer from making false or misleading statements about a recommended transaction or its compensation or material conflicts of interest.
4. **Fair and Reasonable Compensation.** The standard would explicitly require a broker-dealer to receive no more than fair and reasonable compensation for a recommended transaction.

#### *Duty of Care*

**Diligence, Care, Skill, and Prudence.** Our recommended best interest standard would require that a personalized recommendation about securities made by a broker-dealer to a retail customer reflect reasonable diligence, care, skill, and prudence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the customer's investment profile.

#### **Placing the Best Interest Standard in Context**

Our recommended best interest standard would subject broker-dealers to additional, affirmative obligations. It would be consistent with the standard of conduct that applies to investment advisers, as interpreted under Section 206(1) and (2) of the Advisers Act, and would satisfy the requirement under Section 913 of the Dodd-Frank Act that any standard of conduct rule adopted pursuant to that section be “no less stringent than the standard of conduct applicable to investment advisers” under Section 206(1) and (2). The best interest standard, however, differs from the fiduciary duty applicable to investment advisers because it reflects certain key differences between the investment adviser and broker-dealer business models. Importantly, it would preserve investors' ability to obtain the guidance, products, and services they need to meet their retirement and other important financial goals.

*Comparing the Best Interest Standard to Existing Broker-Dealer Obligations*

Our recommended best interest standard would enhance existing obligations applicable to broker-dealers under current law when they make personalized recommendations to retail customers. As explained above, the best interest standard would add explicit duties of loyalty and care with specified obligations. Under the duty of loyalty, a broker-dealer would be required to act in the retail customer's best interest and not put its own interests ahead of the customer's interests. The best interest duty of loyalty would add a broad, affirmative obligation for a broker-dealer to disclose material conflicts, and would also add a requirement that the broker-dealer disclose to the retail customer (perhaps in a standard format) the key aspects of the broker-dealer customer relationship, including the type and scope of services provided, the applicable standard of conduct, the types of compensation the broker-dealer or its associated persons receive, and any material conflicts of interest.

The duty of care would require that a broker-dealer's personalized recommendation about securities to a retail customer reflect reasonable diligence, care, skill, and prudence. This standard is based on the suitability obligation that applies to broker-dealers, but would add the "prudent investment professional standard" from the DOL's Impartial Conduct Standards. We encourage the SEC, before explicitly incorporating this standard into the duty of care, to carefully consider the implications of adding such a standard to the federal securities laws, including how it would affect existing case law interpreting suitability obligations.

We emphasize that a broker-dealer would be required to satisfy *both* the duty of loyalty *and* the duty of care. This means that, even if a broker-dealer provides disclosure to a customer, and obtains the customer's consent, regarding a transaction that raises a conflict of interest, the broker-dealer would be prohibited from recommending that transaction (under the duty of care) if the recommendation did not reflect reasonable diligence, care, skill, and prudence based on the customer's investment profile.

*Comparing the Best Interest Standard to the Fiduciary Duty Applicable to Investment Advisers*

An investment adviser is subject to a fiduciary duty to act in the best interests of its clients, including a duty of loyalty and a duty of care. The duties of loyalty and care under our recommended best interest standard would be substantively consistent with the duties of loyalty and care applicable to investment advisers, except that:

- The duties under the best interest standard are intended to be defined by the specific conditions of the standard itself, and not with reference to the body of case law and SEC guidance that has developed over the years under the Advisers Act. That case law and guidance reflects the investment adviser business model and may not be readily applicable to broker-dealers. The best interest standard is intended to stand on its own, and provide sufficient guidance that broker-dealers can clearly understand their obligations, and customers can clearly understand the obligations owed to them.

- While the duties of loyalty and care typically apply to an investment adviser on an ongoing basis, the best interest duties of loyalty and care generally would apply on a transaction-by-transaction basis unless the parties agree otherwise. This approach is consistent with the transactional nature of a broker-dealer's business, including the transaction-based compensation broker-dealers typically receive.

*The Best Interest Standard is Consistent with Section 913 of the Dodd-Frank Act*

Our recommended best interest standard would be consistent with Section 913 of the Dodd-Frank Act because it would satisfy the requirement under Section 913 that any standard adopted under that section be “no less stringent than the standard of conduct applicable to investment advisers” under Section 206(1) and (2). Consistent with Section 913, and reflecting the traditional broker-dealer business model, a broker-dealer would not be prohibited from receiving transaction-based compensation or selling only proprietary or other “limited range of products,” or engaging in principal transactions, as long as the broker-dealer satisfies the duty of loyalty and duty of care. These elements of the standard would help preserve the ability of investors to choose the types of services and fee arrangements they prefer in meeting their retirement and other financial goals.

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We hope that our revised best interest recommendation will be helpful as you move forward in this area. We believe that only the SEC's development of a distinct best interest standard of conduct for broker-dealers providing recommendations to retail customers, in coordination with DOL's efforts to issue a streamlined exemption, will provide the clarity, consistency, and coordination you have recognized is necessary for successful reform in this area.

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We look forward to the opportunity to comment in more detail on a formal proposal on an enhanced standard of conduct for broker-dealers. We and our members are glad to assist in any way that would be helpful. If you or your staff have questions, or we may be of assistance, please contact me at ( [REDACTED] [REDACTED] or [REDACTED] ), Susan Olson at [REDACTED] or [REDACTED], or Dorothy Donohue at [REDACTED] or [REDACTED].

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens  
President & CEO  
Investment Company Institute

cc: The Honorable Michael S. Piwowar  
The Honorable Kara M. Stein  
The Honorable Robert J. Jackson, Jr.  
The Honorable Hester M. Peirce  
Dalia O. Blass, Director, Division of Investment Management  
Brett Redfearn, Director, Division of Trading and Markets  
Securities and Exchange Commission

The Honorable Preston Rutledge, Assistant Secretary of Labor  
Timothy D. Hauser, Deputy Assistant Secretary for Program Operations  
Joe Canary, Director, Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Department of Labor

## ICI Revised Recommendation on Best Interest Standard of Conduct<sup>1</sup>

**Best Interest Standard of Conduct.** Our recommended best interest standard would require that a broker-dealer, when making a “personalized recommendation about securities”<sup>2</sup> to a “retail customer,”<sup>3</sup> satisfy explicit duties of loyalty and care, as outlined below.

*Explanation:* There are several important aspects of this recommendation as described below.

The recommended standard would apply when a broker-dealer makes a “personalized recommendation about securities,” which is consistent with the approach under Section 913 of the Dodd-Frank Act and the Securities and Exchange Commission (SEC) staff’s recommendations in its 2011 Study on Investment Advisers and Broker-Dealers (“IA-BD Study”).<sup>4</sup> A “personalized recommendation about securities” would be defined to take place when a broker-dealer makes a customer-specific “recommendation” within the meaning of FINRA Rule 2111, consistent with established concepts of what constitutes a “recommendation.”

Our recommended best interest standard would (1) be consistent with the standard of conduct that applies to investment advisers, as interpreted under Section 206(1) and (2) of the Advisers Act, which includes duties of loyalty and care, and (2) satisfy the requirement under Section 913 of the Dodd-Frank Act that any standard of conduct rule adopted pursuant to that section be “no less stringent than the standard of conduct applicable to investment advisers” under Section 206(1) and (2).<sup>5</sup>

Our recommended best interest standard also reflects requirements of the Department of Labor’s (DOL) “Impartial Conduct Standards,” which generally obligate an intermediary to provide prudent advice that is in the retirement investor’s best interest, based on a duty of

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<sup>1</sup> ICI urges the SEC, when issuing a best interest standard of conduct, to explicitly clarify that the new standard shall be the exclusive standard of conduct for Federally-registered broker-dealers and investment advisers. In particular, we recommend that the SEC affirm, consistent with Sections 15(i) of the Securities Exchange Act of 1934 (“Exchange Act”) and Section 203A of the Investment Advisers Act of 1940 (“Advisers Act”), that the SEC standard of conduct shall preempt any standards enacted under state law that are inconsistent with the states’ authority under Federal law.

<sup>2</sup> As described further below, a “personalized recommendation about securities” would mean a customer-specific “recommendation” to a retail customer within the meaning of FINRA Rule 2111.

<sup>3</sup> As described further below, a “retail customer” would mean a natural person, or the legal representative of such person, who receives a personalized recommendation about securities that is to be used primarily for personal, family, or household purposes.

<sup>4</sup> Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers* (Jan. 2011), available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

<sup>5</sup> Consistent with the standard applicable to advisers, our recommended best interest standard would not require a broker-dealer to recommend “the best” or the “lowest cost” security available in the marketplace at the time of the recommendation, provided that the broker-dealer otherwise satisfies the duties of loyalty and care.

loyalty and a duty of care, require the intermediary to charge no more than reasonable compensation, and prohibit misleading statements.

In proposing this best interest standard, the SEC *should not* change (nor does it need to change) the standard of conduct that currently applies to investment advisers. This high standard of conduct, with its well-developed body of law, has served investors well, including those in registered investment companies, for nearly eight decades. The SEC comprehensively regulates registered investment advisers under the Advisers Act, and registered funds under the Investment Company Act of 1940. These laws, the rules thereunder, and the robust body of formal and informal staff guidance and case law that has developed around them, create a comprehensive framework governing all aspects of the registered fund advisory business.

### **Duty of Loyalty**

- 1. Retail Customer's Interest First.** The standard would require that a broker-dealer, when making a personalized recommendation about securities to a retail customer, act in the retail customer's best interest and not put the broker-dealer's interests ahead of the customer's interests.

*Explanation:* The proposed approach would be consistent with the duty of loyalty applicable to investment advisers, and would enhance existing broker-dealer obligations by imposing an explicit duty of loyalty on a broker-dealer making personalized recommendations to retail customers. Our recommended best interest duty of loyalty also would broaden a broker-dealer's disclosure obligations. A broker-dealer would be prohibited from effecting a recommended transaction that raises a material conflict between the broker-dealer's interests and the customer's interests unless the broker-dealer discloses all material facts about the conflict and obtains the customer's consent. Such disclosure and consent, however, would not relieve a broker-dealer from its obligations under the duty of care, as described below.

The proposed approach is consistent with an investment adviser's duty of loyalty as interpreted by the SEC under Section 206(1) and (2) of the Advisers Act and, as a result, satisfies the requirements of Section 913 of the Dodd-Frank Act that the best interest standard be no less stringent than that applicable to an investment adviser under Section 206(1) and (2).

Under the duty of loyalty that applies to investment advisers, an adviser is obligated to act in the best interest of its clients, which includes an obligation not to subrogate its clients' interests to its own interests. The duty of loyalty requires an adviser to "deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict."<sup>6</sup> The Advisers Act, however, does not prohibit investment advisers from having conflicts of interest; rather, recognizing that conflicts of interest are always present, the Advisers Act imposes obligations designed to ensure that

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<sup>6</sup> See Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010), 75 Fed. Reg. 49234 (Aug. 12, 2010).



clients receive meaningful disclosure about such conflicts.<sup>7</sup> The Supreme Court has recognized the fundamental obligation of investment advisers under Section 206(1) and (2) to disclose all material facts about conflicts of interest:

An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving “two masters” or only one, “especially . . . if one of the masters happens to be economic self-interest.”<sup>8</sup>

Thus, an investment adviser may only engage in a transaction with a client that raises a material conflict of interest with the adviser’s interests if the investment adviser provides appropriate disclosure of the conflict of interest related to the transaction and receives the client’s consent.

In contrast with an investment adviser’s duty of loyalty, which typically applies on an ongoing basis, the proposed approach would apply on a transaction-by-transaction basis, unless the broker-dealer and customer agree otherwise. This is designed to reflect the transactional nature of a broker-dealer’s business, including the transaction-based compensation that a broker-dealer typically receives.

A broker-dealer is prohibited “from placing his or her interests ahead of the customer’s interests” when making a recommendation.<sup>9</sup> The courts have interpreted the antifraud provisions of the Exchange Act to require a broker-dealer that recommends a security to “give honest and complete information” and to disclose “material adverse facts of which it is aware.”<sup>10</sup> The SEC and the courts also have interpreted the antifraud provisions as requiring a broker-

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<sup>7</sup> See Tamar Frankel & Arthur B. Laby, *The Regulation of Money Managers: Mutual Funds and Advisers* § 14.01 (3d ed. 2017) (“[F]iduciaries are exposed to conflict of interest. After all, they are entitled to gain a livelihood, and their promises and performance of their service may drive them to seek higher compensation and lower service efforts. Some of the most serious conflicts of interest relate to these two areas: higher compensation and lower service efforts. In light of the fact that these two aspects of the relationship cannot be controlled by the entrustors without undermining the very usefulness of the services, the law implicitly and explicitly aims at reducing situations in which temptations will increase the benefits to fiduciaries at the expense of the entrustors.”).

<sup>8</sup> *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 196 (1963) (quoting *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520, 549 (1961)).

<sup>9</sup> See FINRA Regulatory Notice 12-25 at 3 (May 2012). The SEC and FINRA have interpreted a broker-dealer’s suitability obligation as requiring that “[a] broker’s recommendations . . . be consistent with his customer’s *best interests*, and he or she . . . abstain from making recommendations that are inconsistent with the customer’s financial situation.” See *In re Dane S. Faber*, Securities Exchange Act Release No. 49216 (Feb. 10, 2004) (emphasis added).

<sup>10</sup> See *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 459-61 (9th Cir. 1986); *In re Richmark Capital Corp.*, Securities Exchange Act Release No. 48758 (Nov. 7, 2003).

dealer to disclose information about conflicts of interest in certain situations, including where the broker-dealer may receive compensation from the providers of securities it recommends.<sup>11</sup>

In addition to incorporating an investment adviser's obligations under the Advisers Act, the proposed duty of loyalty also is consistent with Section 913 of the Dodd-Frank Act. First, it requires that "any material conflicts of interest shall be disclosed and may be consented to by the customer." Second, it recognizes that, due to the transactional nature of a broker-dealer's business, a broker-dealer typically does not have a continuing duty of loyalty to the customer after making a recommendation. Third, it does not prohibit a broker-dealer from receiving transaction-based compensation or selling only proprietary or other "limited range of products."

We note that the DOL's Impartial Conduct Standards similarly incorporate a duty of loyalty that requires the intermediary to put the interests of plan participants and beneficiaries ahead of its own or any other party (affiliated or otherwise).<sup>12</sup> The Impartial Conduct Standards do not directly prohibit an intermediary from receiving transaction-based compensation, recommending only proprietary or a limited range of products, or engaging in transactions that generate payments from third parties or compensation for itself or its affiliates, provided it satisfies the duty of care, charges reasonable fees, does not make misleading statements, discloses material conflicts, and manages those conflicts through appropriate policies and procedures.

Finally, while Section 913 of the Dodd-Frank Act gives the SEC authority to "prohibit[] or restrict[] certain sales practices, conflicts of interest, and compensation schemes," we do not believe doing so is necessary to protect retail customers in light of the robust duty of loyalty we propose. Section 206(1) and (2) of the Advisers Act does not specifically prohibit any particular conflicts of interest but instead focuses on full and fair disclosure about material conflicts. Our recommended standard also would recognize that the Financial Industry Regulatory Authority ("FINRA") can address security- or conflict-specific concerns that it identifies in the course of examining broker-dealers, or otherwise, through rulemaking or guidance specific to broker-dealers.<sup>13</sup> For example, FINRA has, in the past, taken action to

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<sup>11</sup> See, e.g., IA-BD Study at 55–56.

<sup>12</sup> The best interest standard incorporated into DOL's Impartial Conduct Standards also specifies that the advice must be "without regard to the financial or other interests" of the advice provider. The "without regard to" language has resulted in confusion in using the DOL's Best Interest Contract exemption and should not be incorporated into the best interest standard for broker-dealers. Such language is unnecessary for purposes of obligating an intermediary to put its client's interests before its own.

<sup>13</sup> See Financial Industry Regulatory Authority, Report on Conflicts of Interest (Oct. 2013), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf>.

address concerns about practices in the retirement area,<sup>14</sup> securities that can create unique risks or conflicts of interest,<sup>15</sup> and for other special situations applicable to retail customers.<sup>16</sup>

- 2. Disclosure.** Our recommended best interest standard would require that the broker-dealer disclose to the retail customer certain key aspects of its relationship with the retail customer—such as the type and scope of services provided, the applicable standard of conduct, the types of compensation it or its associated persons receive, and any material conflicts of interest.

*Explanation:* To help facilitate the ability of retail customers to understand and compare the business practices and material conflicts of interest of different financial professionals, the SEC might consider requiring broker-dealers to disclose this information in a standard format, such as a form similar to an investment adviser’s Form ADV, Part 2A, a relationship guide of the sort FINRA proposed for comment in 2010,<sup>17</sup> or another way.

- 3. No False or Misleading Statements.** Our recommended best interest standard would explicitly prohibit a broker-dealer from making false or misleading statements about a recommended transaction or its compensation or material conflicts of interest.

*Explanation:* This prohibition is consistent with Section 206(1) and (2) of the Advisers Act, which prohibits an investment adviser from committing fraud on any client or prospective client, and with the antifraud provisions of the Exchange Act, which prohibit fraud by broker-dealers in connection with the purchase or sale of securities. This prohibition also would be consistent with the requirement under DOL’s Impartial Conduct Standards that statements by an intermediary about the recommended transaction, fees and compensation, material conflicts of interest, and any other matters relevant to a retirement investor’s investment decision, must not be materially misleading at the time they are made.

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<sup>14</sup> See Rollovers to Individual Retirement Accounts: FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers, FINRA Regulatory Notice 13-45 (Dec. 2013), <http://www.finra.org/sites/default/files/NoticeDocument/p418695.pdf>; Brokerage and Individual Retirement Account Fees: FINRA Provides Guidance on Disclosure of Fees in Communications Concerning Retail Brokerage Accounts and Individual Retirement Accounts, FINRA Regulatory Notice 13-23 (July 2013), <http://www.finra.org/sites/default/files/NoticeDocument/p304670.pdf>.

<sup>15</sup> See FINRA Rule 2114 (Recommendations to Customers in OTC Equity Securities); FINRA Rule 2211 (Communications with the Public About Variable Life Insurance and Variable Annuities); FINRA Rule 2310 (Direct Participation Programs); FINRA Rule 2320 (Variable Contracts of an Insurance Company); FINRA Rule 2330 (Members’ Responsibilities Regarding Deferred Variable Annuities); FINRA Rule 2342 (“Breakpoint” Sales); FINRA Rule 2353 (Suitability) (regarding trading in index warrants, currency index warrants, and currency warrants); FINRA Rule 2360 (Options); FINRA Rule 2370 (Security Futures); FINRA Rule 5123 (Private Placements of Securities).

<sup>16</sup> See FINRA Rule 2272 (Sales and Offers of Sales of Securities on Military Installations).

<sup>17</sup> See Disclosure of Services, Conflicts and Duties, Regulatory Notice 10-54 (Oct. 2010), [http://finra.complinet.com/net\\_file\\_store/new\\_rulebooks/f/i/finra\\_10-54.pdf](http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_10-54.pdf).

- 4. Fair and Reasonable Compensation.** The standard would explicitly require a broker-dealer to receive no more than fair and reasonable compensation for a recommended transaction.

**Explanation:** Consistent with the SEC staff's interpretation of Section 206(1) and (2) of the Advisers Act, a broker-dealer would be required to receive fees that are fair and reasonable, and would have to disclose to customers if it charged fees that substantially exceeded fees charged by other investment advisers providing similar services.<sup>18</sup> This requirement also would recognize the requirement under DOL's Impartial Conduct Standards that an intermediary may not receive in excess of reasonable compensation for its services to a retirement investor.

### **Duty of Care**

**Diligence, Care, Skill, and Prudence.** Our recommended best interest standard would require that a personalized recommendation about securities made by a broker-dealer to a retail customer reflect reasonable diligence, care, skill, and prudence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the customer's "investment profile" (as that term is defined in FINRA Rule 2111, or any subsequent rule).<sup>19</sup>

**Explanation:** This recommended standard would be consistent with the duty of care applicable to investment advisers, and the duty of care under the Impartial Conduct Standards. It also generally is consistent with existing broker-dealer suitability obligations, but would add a "prudence" requirement, as discussed below.

The duty of care applicable to investment advisers requires an adviser to make only suitable recommendations to its clients, after making a reasonable inquiry into a client's financial situation, investment experience and investment objectives.<sup>20</sup> Under existing broker-dealer

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<sup>18</sup> See, e.g., David Gracer Company, Inc., SEC Staff No-Action Letter (pub. avail. Apr. 28, 1975) (stating adviser should disclose that advisory fee of 3.5% may exceed those charged by other advisers providing similar services); Hartzman & Co., Inc., SEC Staff No-Action Letter (pub. avail. Oct. 13, 1973) (stating that a potential fee of 4% may violate Section 206 of the Advisers Act unless adequate disclosure is made to potential clients). This requirement also is consistent with the antifraud provisions of the Exchange Act and FINRA rules, which require broker-dealers to charge fair prices and commissions. See FINRA Rule 2121 (Fair Prices and Commissions); FINRA Rule 2122 (Charges for Services Performed).

<sup>19</sup> "A customer's investment profile includes, but is not limited to, the customer'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 to the member or associated person in connection with such recommendation." FINRA Rule 2111(a).

<sup>20</sup> See Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997); Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406 (Mar. 16, 1994), 59 Fed. Reg. 13464 (Mar 22, 1994) (proposing a suitability rule for investment advisers that was based in large part on existing broker-dealer suitability obligations); see also IA-BD Study, at 27. As discussed, our recommended standard would apply on a transaction-by-transaction basis, consistent with the transactional nature of a broker-dealer's business and Section 913 of the Dodd-Frank Act.

regulation, broker-dealers are subject to suitability obligations based on both the suitability of a recommended security or strategy generally and its suitability for a particular customer.<sup>21</sup>

The Impartial Conduct Standards require that advice provided to a retirement investor reflect the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor. The DOL has described this as the “prudent investment professional standard.”

We have added this “prudent investment professional” standard to our recommended best interest duty of care. The proposed approach would provide a way for the SEC to develop a duty of care that reflects the DOL’s Impartial Conduct Standards. As discussed above, the federal securities laws require broker-dealers and investment advisers to provide suitable investment advice, and have not to date explicitly incorporated a “prudent investment professional” standard. Before proposing to introduce a “prudent investment professional” standard into the federal securities laws, the SEC should carefully consider the implications of doing so, including how it would affect existing case law interpreting suitability obligations.

Under our recommended best interest standard, a broker-dealer would be required to satisfy *both* the duty of loyalty *and* the duty of care when making a personalized recommendation about securities to a retail customer. This means that, even if a broker-dealer provides adequate disclosure to a customer, and obtains the customer’s consent, regarding a recommended transaction that raises a conflict of interest, the broker-dealer would be prohibited from recommending that transaction (under the duty of care) if the recommendation did not reflect reasonable diligence, care, skill, and prudence based on the customer’s investment profile.

### **Elements of the Best Interest Standard that Relate to Both the Duty of Loyalty and the Duty of Care**

- 1. Policies and Procedures.** Under existing regulation, broker-dealers are required to adopt policies and procedures reasonably designed to prevent violations of the federal securities laws. FINRA already requires a broker-dealer’s written procedures and supervisory system to be reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules. If the SEC adopts a best interest standard for broker-dealers, this FINRA requirement would therefore obligate broker-dealers to adopt policies and procedures reasonably designed to prevent violations of the new best interest standard of conduct.

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<sup>21</sup> *Reasonable-basis* suitability obligations effectively require a broker-dealer to exercise diligence, care, and skill, as they require a broker-dealer “to have a reasonable basis to believe, based on reasonable diligence, that a recommendation is suitable for at least *some* investors.” *Customer-specific* suitability obligations require a broker-dealer to find that a recommendation is suitable for the customer to whom it is made based on the customer’s investment profile (e.g., taking into account the customer’s investment objectives and risk tolerance).

2. **Personalized Recommendation About Securities.** Our recommended best interest standard would be triggered whenever a broker-dealer makes a customer-specific “recommendation” to a retail customer within the meaning of FINRA Rule 2111.<sup>22</sup> Such a recommendation would be defined as a “personalized recommendation about securities.”

*Explanation:* While Section 15(k) of the Exchange Act refers to “personalized investment advice about securities,” the statute does not define the phrase. For clarity, we believe it is better to instead use the phrase “personalized recommendations about securities.” The SEC staff recognized in the IA-BD Study that the making of recommendations could be read as consistent with the scope and interpretive history of both statutes. The use of the phrase “personalized recommendation about securities” is intended to define clearly when a broker-dealer would be subject to the best interest standard by using established concepts under the existing broker-dealer regulatory regime outlining when a communication constitutes a recommendation, including FINRA Rule 2111.

The proposed approach also seeks to avoid confusion as to when the best interest standard applies, and to facilitate compliance, by focusing on when a recommendation is sufficiently personalized such that it triggers customer-specific obligations under the duty of care. Moreover, as contemplated by Section 913 of the Dodd-Frank Act and discussed below, the proposed approach recognizes that broker-dealers have various relationships with retail customers, the frequency of recommendations (e.g., one time, episodic, continuous) varies from customer to customer, and broker-dealers do not have an obligation to give continuing recommendations to retail customers, or to monitor or update past recommendations, unless otherwise agreed.

*Explanation:* Certain common activities should not be deemed a recommendation triggering the best interest standard, including, but not limited to:

- Offering the use of financial calculators or similar investment tools for general informational purposes (although the use of these types of tools may, in some circumstances, entail a recommendation that would subject the broker-dealer to the best interest standard);
- Making generally available, or providing at a retail customer’s request, information about securities derived from third-party sources, such as prospectuses, fund fact sheets, and independent third-party ratings information;
- Marketing, selling, or promoting one’s own services, including describing an investment professional’s capabilities, prior to the establishment of a relationship with the customer;
- Providing administrative services including, for example, to orphaned accounts, such as a limited purpose broker-dealer (i.e., fund distributor) responding to a retail customer’s

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<sup>22</sup> See FINRA Regulatory Notice 12-25 (May 2012) (describing when a recommendation is made for purposes of FINRA Rule 2111).

inquiry about options where no recommendation is made, when the account is held directly with the fund and no intermediary relationship exists; and

- Executing unsolicited trades.

This list is meant only to highlight examples of the types of activities that should *not* be deemed a recommendation. The SEC staff identified various other activities in the IA-BD Study that were raised by commenters, and we understand that additional activities have been identified since that time. We urge the SEC to consider carefully and provide explicit guidance as to the types of activities that would and would not be deemed a recommendation to provide clarity as to when the best interest standard applies.

- 3. Retail Customer.** For purposes of the best interest standard of conduct, the term “retail customer” would mean a natural person, or the legal representative of such person, who receives a personalized recommendation about securities that is to be used primarily for personal, family, or household purposes.

*Explanation:* This is similar to the approach taken in defining “consumer” for purposes of Regulation S-P, and consistent with the definition of “retail customer” in Section 211(g)(2) of the Advisers Act.<sup>23</sup> The proposed approach, however, is tailored to reflect that the proposed best interest standard would apply to broker-dealers only when making personalized *recommendations* about securities (as compared to providing personalized *investment advice* about securities, as is used in the Advisers Act). The definition is intended to include all natural persons, regardless of net worth or sophistication, as well as “legal representatives,” such as parents and guardians for minors. A “legal representative” would not include a bank, registered broker-dealer, registered investment adviser, or insurance company that is responsible for exercising independent judgment in evaluating the recommendation.

- 4. Scope of Standard.** A best interest standard of conduct for broker-dealers would permit the broker-dealer to limit the scope, nature, and anticipated duration of the relationship with the customer. The best interest standard of conduct would not require a broker-dealer to have a continuing duty of loyalty or care to the retail customer after making a personalized recommendation about securities.

*Explanation:* Under current law, broker-dealers are permitted to define the scope of their relationship with their customers, including the types of securities and services they will make available, provided that they comply with the federal securities laws and applicable FINRA and other self-regulatory organization rules.

Unlike the duties of loyalty and care applicable to investment advisers, which typically apply on an ongoing basis, reflecting the ongoing nature of the advisory relationship (and the asset-based

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<sup>23</sup> Section 211(g)(2) defines “retail customer” to mean “a natural person, or the legal representative of such natural person, who—(A) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and (B) uses such advice primarily for personal, family, or household purposes.”

compensation advisers typically receive), the duties of loyalty and care under the proposed best interest standard should apply on a transaction-by-transaction basis, unless the broker-dealer and customer agree otherwise. This approach is consistent with the transactional nature of a broker-dealer's business, including the transaction-based compensation broker-dealers typically receive. It also is consistent with Section 913 of the Dodd-Frank Act, which explicitly provides that a broker-dealer is not required to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities. Section 913 further reflects a broker-dealer's ability to define the scope of the client relationship by also addressing receipt of transaction-based compensation, and sale of proprietary or other limited range of products, as discussed below.

- 5. Receipt of Transaction-Based Compensation.** The receipt of compensation based on commission or other standard compensation for the sale of securities would not, in and of itself, be considered a violation of the best interest standard of conduct, provided that the broker-dealer otherwise satisfies the duties of loyalty and care.

*Explanation:* This approach is consistent with Section 913 of the Dodd-Frank Act, and recognizes that the duties of loyalty and care still apply. For these purposes, standard compensation for the sale of securities would include, but is not limited to, commissions, compensation such as markups, markdowns, spreads, commission equivalents, loads, Rule 12b-1 fees, and other concessions or payments received by a broker-dealer in connection with effecting transactions in securities. As noted above, the Impartial Conduct Standards also do not directly prohibit a broker-dealer from receiving transaction-based compensation, provided it satisfies the duty of care and meets certain other conditions.

- 6. Sale of Proprietary or Other Limited Range of Products.** A broker-dealer's making recommendations from only among proprietary or other limited range of products would not, in and of itself, be considered a violation of the best interest standard of conduct, provided that the broker-dealer otherwise satisfies the duties of loyalty and care.

*Explanation:* This approach is consistent with Section 913 of the Dodd-Frank Act, and recognizes that the duties of loyalty and care still apply. The Impartial Conduct Standards also do not directly prohibit a broker-dealer from recommending only proprietary or a limited range of products, or engaging in transactions that generate payments from third parties or compensation for itself or its affiliates, provided it satisfies the duty of care and meets certain other conditions.

- 7. Principal Trading.** Under our recommended standard of conduct, a broker-dealer would be required to satisfy the duties of loyalty and care when acting in a principal capacity in executing a transaction with a retail customer, including disclosing to the retail customer prior to the transaction that it may act as principal in transactions and the associated conflicts of interest, and obtaining the retail customer's consent.



**Explanation:** We recognize that principal trading is one of the more difficult areas that the SEC will need to address through any rulemaking articulating a standard of conduct. A broker-dealer acting as principal in transactions with customers raises the potential for self-dealing. The SEC must address this potential conflict, but also must recognize that dealer activities such as trading as principal have the potential to benefit customers through enhanced liquidity, expanded investment choices, and better trade execution.

We believe that certain aspects of Section 206(3) of the Advisers Act could serve as a model to address the potential conflicts that principal trading raises for broker-dealers, without imposing all the requirements of the section, including trade-by-trade disclosure and customer consent. The proposed approach could be supplemented by existing broker-dealer obligations, which require broker-dealers to disclose when they are trading as principal in a recommended security<sup>24</sup> and, under Exchange Act Rule 10b-10, to disclose on a confirmation whether they acted as agent or principal in a transaction. In considering the appropriate restrictions and disclosures that should apply to broker-dealers' principal trading, however, we recommend that the SEC also revisit its interpretations under Section 206(3) of the Advisers Act for registered investment advisers.

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<sup>24</sup> See *Arleen W. Hughes*, Securities Exchange Act Release No. 4048 (Feb. 18, 1948) (Commission Opinion), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949).