F E I N L A W O F F I C E S

[redacted]

Admitted in Virginia and
the District of Columbia

February 12, 2018

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

RE: Comment on Standards of Conduct for Investment Advisers and Broker-Dealers

Dear Chairman Clayton:

Attached for consideration by you and your fellow commissioners is a memorandum addressing how the Securities and Exchange Commission might formulate a “best interest” standard of conduct for broker-dealers and investment advisers under the Dodd-Frank Act that would be consistent with the DOL’s best interest contract exemption, the trust law standard in the Uniform Prudent Investor Act, and FINRA’s Suitability Rule.

This memorandum was prepared by me with helpful comments from Professor Robert H. Sitkoff of Harvard Law School, an expert in trust law and fiduciary administration. Please do not hesitate to contact me or Professor Sitkoff if you or your staff have any questions concerning the fiduciary principles discussed in the attached.

Sincerely,

Melanie L. Fein

Melanie L. Fein

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

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HARMONIZATION OF FIDUCIARY STANDARDS

About the Author

This document was prepared by Melanie L. Fein. Ms. Fein has been senior counsel to the Board of Governors of the Federal Reserve System, a member of the adjunct faculty of Yale Law School, and a partner in the law firms of Arnold & Porter and Goodwin Procter. She currently maintains her own practice and advises financial institutions on fiduciary and other matters. She is the author of treatises on *Securities Activities of Banks* (Wolters Kluwer), *Mutual Fund Activities of Banks* (Aspen Law & Business), and *Federal Bank Holding Company Law* (Law Journal Press).

I. INTRODUCTION

This memorandum discusses how the Securities and Exchange Commission ("SEC") might formulate a "best interest" standard of conduct for broker-dealers and investment advisers under the Dodd-Frank Act that would be consistent with the DOL's best interest contract (BIC) exemption (the "DOL Rule"), the trust law standard in the Uniform Prudent Investor Act ("UPIA"), and FINRA's Suitability Rule (Rule 2111).

As an initial matter, it is important to understand the basic fiduciary standards that apply across all fiduciary fields. A fiduciary standard generally is one that imposes on a person a duty to act in the interests of another who has reasonably reposed trust or confidence that the other person will do so without regard to self-interest. The person that owes the duty is referred to as a "fiduciary." In fiduciary law, there are two core fiduciary duties—the duty of loyalty and the duty of care—along with related subsidiary duties.

The <u>duty of loyalty</u> requires a fiduciary to refrain from placing his own interests ahead of his principal and to avoid unauthorized self-dealing or conflicts of interest. The duty of loyalty generally is not breached if the principal is informed of a conflict of interest and consents to it, or if the conflict of interest is authorized by law or court order, and the action is fair and reasonable. For example, the duty of loyalty generally is not breached if a fiduciary invests its principal's assets in proprietary products from which it receives a fee, if the conflict of interest is disclosed and the principal consents. This conflict typically is authorized in trust law by state statute.

The <u>duty of care</u>—also called <u>prudence</u>—generally requires a fiduciary to act with the care, skill and caution that a prudent person reasonably would employ in managing his own affairs.

In addition to the duty of loyalty and the duty of prudence, a "<u>best interest</u>" standard has been articulated under which a fiduciary owes a duty to act in the "best interest" of the customer. This duty is expressed as a duty to act in the customer's best interest without regard to the interests of the broker or adviser. Thus stated, the best interest standard incorporates both the duty of loyalty and the duty of prudence. The "best interest" standard appears in the Dodd-Frank Act, the DOL Rule, and SEC and FINRA interpretations of the suitability rule applicable to broker-dealers and investment advisers. The term "best interest" does not appear in the UPIA.[1]

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[1] Professor Langbein of Yale Law School has advocated a "best interest" standard as an alternative to the requirement that a trustee act in the "sole interest" of its beneficiary under the duty of loyalty in trust law. See Langbein, John H.,

The standards in the Dodd-Frank Act, DOL Rule, and Suitability Rule are substantively very similar and also correspond with trust fiduciary law as exemplified by the UPIA. However, the DOL, SEC, FINRA and Congress have used differing terminology to articulate the standards, leaving a false impression of incompatibility in the standards. Much of the confusion and stalemate in arriving at a uniform standard for broker-dealers stems from the diverse terminology used to apply the core fiduciary principles.

This memorandum suggests a way that the various articulations of the standards might be reconciled in a uniform standard applicable to broker-dealers and investment advisers.

II. SIMILAR STANDARDS OF CONDUCT

A. Dodd-Frank Act

Section 913 of the Dodd-Frank Act authorizes the SEC to adopt a "fiduciary duty" for broker-dealers.[2] Specifically, the Act authorizes the SEC to adopt a "best interest" standard of conduct under which:

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be 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. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer….[3]

The Dodd-Frank Act uses the term "standard of conduct" rather than "standard of care" or prudence in describing the fiduciary standard for brokers and investment advisers. Unlike the UPIA or the DOL Rule, discussed below, the Dodd-Frank Act does not require a broker or investment adviser to act with the "care, skill, prudence, and diligence" of a prudent person. However, the Dodd-

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Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, Yale Law Journal, Vol. 114, p. 929, 2005. In the articulation applied to broker-dealers and investment advisers, the best interest standard also incorporates the duty of prudence and is an overarching standard of conduct that combines both prudence and loyalty.

[2] Section 913(g) is entitled "Authority to Establish a Fiduciary Duty for Brokers and Dealers."

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act § 913.

Frank Act's "best interest" standard incorporates a standard of care, and brokers already are subject to a standard of care under FINRA's Suitability Rule that closely resembles the UPIA standard.

The Dodd-Frank Act's "best interest" standard of conduct does not specifically refer to the fiduciary duty of loyalty. However, it incorporates the duty of loyalty by requiring that a broker or investment adviser must act "without regard to" self-interest and requiring that any material conflicts of interest be disclosed and "may be consented to" by the customer.

Thus, it may be said that the Dodd-Frank Act standard of conduct incorporates both a fiduciary standard of care (or prudence) and the fiduciary duty loyalty.

B. UPIA Standard of Care

The UPIA is intended to impose "the obligation of prudence in the conduct of investment functions" and to "specify the attributes of prudent conduct."[4]

The UPIA sets forth a standard of care that provides as follows:

> Section 2. Standard of Care[5]...
>
> (a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
>
> (b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.
>
> (c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of

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[4] UPIA § 1, comment.

[5] The UPIA uses the term "standard of care" rather than "standard of prudence."

> investment decisions or strategies; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; (5) the expected total return from income and the appreciation of capital; (6) other resources of the beneficiaries; (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.
>
> (d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.
>
> (e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].
>
> (f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.[6]

The UPIA sets forth a diversification requirement in another section:

> A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.[7]

The UPIA sets forth the duty of loyalty in yet another section:

> A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.[8]

The UPIA standard of care may be viewed as a "suitability" standard, and indeed uses "suitability" language. For example, the standard of care requires that a trustee's decisions be evaluated as part of an overall investment strategy having risk and return objectives "reasonably suited" to the trust.[9] The duty to monitor requires the trustee to exercise continuing oversight of the "suitability of

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[6] UPIA § 2.
[7] UPIA § 3.
[8] UPIA § 5.
[9] UPIA § 2(b).

investments."[10] Furthermore, it is the trustee's responsibility to invest at a risk level that is "suitable" to the purposes of the trust.[11] The UPIA also states that mutual funds "are especially suitable" for small trusts[12] and that a trustee must dispose of "unsuitable" assets within a reasonable time.[13]

It should be noted that the UPIA applies when a trustee invests and manages assets of a trust—i.e., when the trustee holds title to the assets as trustee and exercises investment discretion with respect to the trust assets.[14]

The UPIA does not apply to fiduciaries who are not trustees. However, the UPIA may be viewed as setting a best practice standard for others acting in a fiduciary capacity, such as broker-dealers and investment advisers.

Finally, it should be remembered that the UPIA standard of care is a default standard that generally applies only when the trust instrument is silent.[15] In contrast, the DOL Rule and Suitability Rule generally create mandatory and not default standards.

C. DOL Rule

The BIC exemption in the DOL Rule requires that a broker-dealer, when giving investment advice to an IRA account, adhere to certain "impartial conduct standards." The core requirement of these standards is that the broker provide investment advice that, at the time of the recommendation, is in the "best interest" of the retirement investor. The DOL's rule provides that a broker's investment advice meets the "best interest" standard when the broker acts:

> with 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

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[10] UPIA § 2, comment (Duty to Monitor).

[11] UPIA § 2, comment on § 2(e).

[12] UPIA § 2, comment on § 2(f).

[13] UPIA § 4.

[14] The UPIA is not generally designed for applications when a fiduciary acts in a nondiscretionary capacity—i.e., when the fiduciary merely gives investment advice and the customer makes the ultimate investment decision.

[15] It should be noted, however, that trust law also imposes a basic standard of good faith that is non-waivable. For example, the Uniform Trust Code provides that, "Except as otherwise provided in the terms of the trust, this [Code] governs the duties and powers of a trustee" and "The terms of a trust prevail over any provision of this [Code] except: ….the duty of a trustee to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries…." Uniform Trust Code § 105(a) and (b).

> 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 without regard to the financial or other interests of the [broker or any other party].

This standard of conduct incorporates the general trust law duty of care, albeit less fulsomely stated than in the UPIA. The "without regard to" language also reflects the duty of loyalty. Unlike the UPIA standard of care, the DOL standard is not a default standard.

D. FINRA Suitability Rule for Brokers

Although broker-dealers traditionally have not been considered to be "fiduciaries," they are subject to a standard of conduct that closely resembles the fiduciary duties of care and loyalty in trust law and the DOL Rule. Specifically, FINRA Rule 2111—the Suitability Rule—provides in pertinent part:

> A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. 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.[16]

The Supplementary Material to the Rule states that "The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct."[17] The Supplementary Material further states:

> A member or associated person shall make a recommendation covered by this Rule only if, among other things, the member or associated person has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that

[16] FINRA Rule 2111.
[17] FINRA Rule 2111 Supplementary Material, .01 General Principles.

> customer. The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) unless the member or associated person has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case.[18]

In interpreting the suitability rule, FINRA has said the rule requires a broker-dealer to act in a customer's "best interest":

> <u>Acting in a Customer's Best Interests</u>. Q7.1. Regulatory Notice 11-02 and a recent SEC staff study on investment adviser and broker-dealer sales-practice obligations cite cases holding that brokers' recommendations must be consistent with their customers' "best interests." What does it mean to act in a customer's best interests?
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> A7.1. In interpreting FINRA's suitability rule, numerous cases explicitly state that "a broker's recommendations must be consistent with his customers' best interests." The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests. Examples of instances where FINRA and the SEC have found brokers in violation of the suitability rule by placing their interests ahead of customers' interests include the following:
>
> - A broker whose motivation for recommending one product over another was to receive larger commissions.
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> - A broker whose mutual fund recommendations were "designed 'to maximize his commissions rather than to establish an appropriate portfolio' for his customers."

[18] FINRA Rule 2111 Supplementary Material, .04 Customer's Investment Profile.

- A broker who recommended "that his customers purchase promissory notes to give him money to use in his business."
- A broker who sought to increase his commissions by recommending that customers use margin so that they could purchase larger numbers of securities.
- A broker who recommended new issues being pushed by his firm so that he could keep his job.
- A broker who recommended speculative securities that paid high commissions because he felt pressured by his firm to sell the securities.[19]

The requirement that a broker's recommendation must be consistent with the customer's best interests does not obligate a broker to recommend the "least expensive" security or investment strategy (however "least expensive" may be quantified), as long as the recommendation is suitable and the broker is not placing his or her interests ahead of the customer's interests. Some of the cases in which FINRA and the SEC have found that brokers placed their interests ahead of their customers' interests involved cost-related issues. The cost associated with a recommendation, however, ordinarily is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable.

The customer's investment profile, for example, is critical to the assessment, as are a host of product- or strategy-related factors in addition to cost, such as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. These are all important considerations in analyzing the suitability of a particular recommendation, which is why the suitability rule and the concept that a broker's recommendation must

[19] FINRA FAQ 7.1, http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.

> be consistent with the customer's best interests are inextricably intertwined.[20]

Accordingly, the Suitability Rule and the "best interest" standard therein as applied by FINRA are consistent with the UPIA standard of care and the "best interest" standard in the DOL rule.[21]

E. SEC Suitability Rule for Advisers

The SEC's staff has stated that investment advisers "owe their clients a duty to provide only suitable investment advice."[22] This duty is not written in the Advisers Act or the anti-fraud provisions thereof and the SEC never has officially adopted a suitability rule as a regulatory requirement for investment advisers. Nevertheless, the staff has said the duty exists and "generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client's situation, experience and objectives."[23]

In articulating this "suitability" duty, the SEC's staff has relied on a rule that was proposed by the SEC in 1994 but never was adopted.[24] The rule was proposed under the Adviser Act's anti-fraud provisions and would have required advisers to give clients only "suitable" advice.[25] Even though the rule never was promulgated, the SEC's staff has said the rule would have codified the suitability

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[20] FINRA FAQ 7.1, http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.

[21] The Suitability Rule applies with respect to recommendations by a broker to its existing customers as well as to a potential investor who then becomes a customer. See FINRA Rule 2111 (Suitability) FAQs, Q&A 2.2, http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq (Jan. 10, 2018).

[22] Securities and Exchange Commission, General Information on the Regulation of Investment Advisers, SEC website (August 17, 2017): https://www.sec.gov/divisions/investment/iaregulation/memoia.htm

[23] Staff of the Investment Adviser Regulation Office Division of Investment Management, U.S. Securities and Exchange Commission, Regulation of Investment Advisers by the U.S. Securities and Exchange Commission, March 2013 ("Staff Report") at 24.

[24] SEC Staff Report at 24.

[25] See Securities and Exchange Commission, Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994).

obligations of advisers and "reflects the current obligation of advisers under the Act."[26]

The proposed rule would have required an adviser "before providing any investment advice, and as appropriate thereafter" to make a "reasonable inquiry into the client's financial situation, investment experience, and investment objectives" and reasonably determine that the advice given is suitable for the client. The official release accompanying the 1994 proposal stated:

> Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice. This duty is enforceable under the antifraud provision of the Advisers Act, section 206, and the Commission has sanctioned advisers for violating this duty. The Commission now proposes to make explicit this duty in a new rule under section 206(4) of the Advisers Act.[27]

The rule would have explicitly prohibited an adviser from giving advice to a client unless the adviser reasonably determined the advice was "suitable" to the client's financial situation, investment experience, and investment objectives. The SEC stated that the suitability of advice would be evaluated "in the context of the client's portfolio." The SEC noted that a similar standard applies in determining the prudence of an investment made for a retirement plan under the Employee Retirement Income Security Act of 1974 and in determining the suitability of a trustee's investment decision under trust law. The extent of an adviser's suitability inquiry would be determined by what is "reasonable under the circumstances" and:

> [T]o formulate a comprehensive financial plan for a client, an adviser may be required to obtain extensive personal and

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[26] In its Staff Report, the staff noted that the SEC has instituted enforcement actions against advisers for providing unsuitable investment advice, citing In the Matter of George E. Brooks & Associates, Inc., Investment Advisers Act Release No. 1746 (Aug. 17, 1998) (adviser failed to appropriately diversify and effected unsuitable trades of speculative high risk stocks in the discretionary accounts of customers with conservative investment objectives, many of whom were elderly and had little investment experience); and In the Matter of Philip A. Lehman, Investment Advisers Act Release No. 1831 (Sept. 22, 1999) (alleging adviser recommended risky investment for customer's individual retirement account despite customer's conservative investment objective and age).

[27] Securities and Exchange Commission, Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406, at 2 (Mar. 22, 1994).

> financial information about the client, including current income, investments, assets and debts, marital status, insurance policies, and financial goals. This information must be updated periodically so that the adviser can adjust its advice to reflect changed circumstances.[28]

Even if a client refused to provide information needed to make a suitability determination, the SEC said an adviser's advice would need to be reasonable and be based on "trustworthy" information available from "other reliable sources."[29]

The 1994 proposed rule therefore articulated a suitability obligation similar to what we find in today's FINRA's Suitability Rule. Investment advisers, however, are not subject to FINRA's suitability rule (unless they are dual registrants), and the SEC has never said that FINRA's guidance on suitability is applicable to investment advisers.[30]

III. SELECTED ISSUES

A. Reasonableness of Compensation

Dodd-Frank Act. The Dodd-Frank Act provides that "The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard [i.e., the best interest standard] applied to a broker, dealer, or investment adviser." The Act also states that the receipt of commission-based compensation by a broker shall not be considered a violation of the best interest standard.

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[28] Id.

[29] Id. ("If a client refused to provide requested information, however, the adviser could not make assumptions about the client that were not reasonable. When no other information is available, the adviser may have to assume the client has no assets or source of income other than the assets the adviser manages. If the client refused to provide information upon which an adviser could base recommendations, the adviser would be permitted to rely upon trustworthy information about the client that it obtains from other reliable sources, such as a consultant to the client or other intermediary.").

[30] Moreover, investment advisers are not subject to the "know your customer" rule applicable to broker-dealers under FINRA Rule 2090. That rule requires every broker-dealer to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer."

DOL Rule. The DOL Rule requires that a fiduciary receive no more than reasonable compensation.[31] In addressing what is "reasonable" compensation, the DOL stated:

> The obligation to pay no more than reasonable compensation to service providers is long recognized under ERISA and the Code….At bottom, the standard simply requires that compensation not be excessive, as measured by the market value of the particular services, rights, and benefits the Adviser and Financial Institution are delivering to the Retirement Investor.[32]….Ultimately, the "reasonable compensation" standard is a market based standard.[33]
>
> ****
>
> The reasonableness of the fees depends on the particular facts and circumstances at the time of the recommendation. Several factors inform whether compensation is reasonable including, inter alia, the market pricing of service(s) provided and the underlying asset(s), the scope of monitoring, and the complexity of the product. No single factor is dispositive in determining whether compensation is reasonable; the essential question is whether the charges are reasonable in relation to what the investor receives.[34]

The DOL stated that these standards are "rooted in common law principles" applicable to fiduciaries "under the common law of agency and trusts."[35]

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[31] The DOL rule requires a broker to adhere to policies and procedures requiring that neither it nor any related entity use quotas, bonuses, contests, or differential compensation or incentives that would reasonably be expected to cause its representatives to make recommendations that are not in the best interest of a retirement investor. The DOL rule specifically does not foreclose a broker from providing differential compensation, including commissions, based on investment decisions by retirement investors to the extent that the broker's policies and procedures and incentive practices, when viewed as a whole, are "reasonably and prudently designed to avoid a misalignment" of the interests of the broker or its representatives and investors.

[32] 81 Federal Register 21002, 21029 (April 16, 2016).

[33] 81 Federal Register at 21031.

[34] 81 Federal Register 21030.

[35] Id. at 21026.

Trust Law. Trust law allows a trustee to receive only reasonable compensation for its services.[36]

Suitability Rule. The Suitability Rule does not address the reasonableness of a broker's compensation. However, FINRA Rule 2122 requires that charges for services performed by a broker (including miscellaneous services such as collection of monies due for principal, dividends, or interest; exchange or transfer of securities; appraisals, safe-keeping or custody of securities, and other services) "shall be reasonable and not unfairly discriminatory among customers."

B. Investment Costs

Dodd-Frank Act. The Dodd-Frank Act does not specifically address investment costs.

DOL Rule. The DOL Rule does not obligate an adviser to recommend the lowest cost product or the product that generates the lowest fees:

> Consistent with the Department's prior interpretations of this standard, the Department confirms that an Adviser and Financial Institution do not have to recommend the transaction that is the lowest cost or that generates the lowest fees without regard to other relevant factors.[37]

Trust Law. The UPIA provides that a trustee may incur reasonable investment costs:

> In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.[38]

Suitability Rule. As noted above, FINRA has said that the best interest standard in the Suitability Rule does not require a broker to recommend only the "least cost" investment and that cost is one of a number of relevant considerations.

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[36] See Restatement (Third) of Trusts § 38 (2003) (A trustee is entitled to reasonable compensation out of the trust estate for services as trustee, unless the terms of the trust provide otherwise or the trustee agrees to forgo compensation).
[37] Id. at 21030.
[38] UPIA § 7.

C. Proprietary Products and Third Party Payments

Dodd-Frank Act. The Dodd-Frank Act specifically provides that the sale of only proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation of the best interest standard.

DOL Rule. The DOL Rule provides that a broker that limits its recommendations to proprietary products (or products that generate third party payments) shall be deemed to satisfy the best interest standard if certain disclosures and other requirements are met.[39]

Trust Law. Trust law allows a trustee to invest in proprietary products and to receive third party payments for services performed in connection with the investment of trust assets if the investment or fees are authorized by the trust instrument, beneficiary consent, state law, or court order. Nearly all states have adopted statutes authorizing trustee investments in proprietary products and investments that pay service fees to the trustee, subject to disclosure requirements.[40]

Suitability Rule. The Suitability Rule does not prohibit a broker from recommending proprietary products or receiving fees from third parties in connection with customer investments. Brokers are subject to disclosure requirements.

D. Monitoring

Dodd-Frank Act. The Dodd-Frank Act provides that nothing in the law shall require a broker-dealer to have a "continuing duty of care or loyalty" to the

[39] Among other things, the broker must disclose material conflicts of interest associated with any arrangement for third party payments and document the services it will provide in exchange for third party payments. The broker also must document the limitations on its "universe of recommended investments" and reasonably conclude that the payments and conflicts of interest will not cause it to not receive unreasonable compensation or recommend imprudent investments. Under the DOL rule, a broker's compensation practices can include differential compensation based on neutral factors tied to differences in services provided to investors but cannot be based on differences in the amounts of third party payments received. The broker cannot use incentives that would cause the broker or its representatives to subordinate the interests of the investor or make recommendations based on the broker's consideration of factors other than the investment objectives, risk tolerance, financial circumstances, and needs of the investor.

[40] See Uniform Trust Code § 802.

customer (i.e., there is no duty to monitor) after providing personalized investment advice about securities.

DOL Rule. The DOL rule provides that a broker's contract with its customer must describe whether or not it will monitor the customer's investments and alert the customer to any recommended change to those investments. If the broker agrees to monitor, it must describe the frequency with which monitoring will occur and the reasons for which the customer will be alerted.

Trust Law. Trust law requires a trustee—that is, a trustee exercising discretion to invest and manage trust assets—to monitor the investments. The UPIA provides:

> [The standard of care] appl[ies] both to investing and managing trust assets. "Managing" embraces monitoring, that is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments.[41]

Suitability Rule. FINRA has stated that the focus of the Suitability Rule is on whether a recommendation was suitable when made and generally does not create an ongoing duty to monitor and make subsequent recommendations.[42]

IV. HARMONIZATION OF LANGUAGE

The above discussion demonstrates that the fiduciary standards under the Dodd-Frank Act, Uniform Prudent Investor Act, the DOL Rule, and FINRA's Suitability Rule are substantively very similar despite using varying terminology. The essential task for the SEC is to propose a rule that incorporates the essence of each standard without imposing undue compliance burdens on broker-dealers and investment advisers. Ideally, the SEC should be able to propound a rule that would satisfy the DOL's concerns and obviate the need for disparate rules by the two agencies.

The attachment hereto outlines a framework for an SEC "best interest" rule for broker-dealers and investment advisers. This language draws on the

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[41] UPIA § 2, comment (emphasis added).

[42] FINRA Regulatory Notice 12-55, Guidance on FINRA's Suitability Rule (Dec. 2012), FAQ #7: "It is important to emphasize, moreover, that the rule's focus is on whether the recommendation was suitable when it was made. A recommendation to hold securities, maintain an investment strategy involving securities or use another investment strategy involving securities—as with a recommendation to purchase, sell or exchange securities—normally would not create an ongoing duty to monitor and make subsequent recommendations."

Dodd-Frank Act, the DOL Rule, FINRA's Suitability Rule, and the Uniform Prudent Investor Act.

V. APPENDIX—OUTLINE OF RULE

Harmonization of Best Interest Standard of Conduct
For Broker-Dealers and Investment Advisers

Outline of Rule

The following is an outline of a possible "best interest" rule that could be adopted by the SEC to harmonize the fiduciary standards applicable to broker-dealers and investment advisers when they provide personalized investment advice to retail customers. This proposal incorporates elements of the Dodd-Frank Act, DOL best interest contract (BIC) exemption (referred to as "DOL Rule"), FINRA's Suitability Rule, and the trust law standards in the Uniform Prudent Investor Act ("UPIA"). This outline is not in standard regulatory format but is intended to provide the basis for a regulation. This outline does not include all of the detail of the DOL Rule or FINRA's Suitability Rule, which can be added to the extent appropriate.

A. Best Interest Standard of Conduct

The standard of conduct for all broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be 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 and in compliance with this rule. *NOTE: This reflects the Dodd-Frank Act language*.

B. Duty of Care

1. Prudence

A broker, dealer, or investment adviser shall be deemed to act in the best interest of the customer if it acts with 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 customer without regard to the financial or other interests of the broker, dealer, or investment adviser and in compliance with the provisions of this rule. *NOTE: This reflects the DOL Rule language and is similar to the trust law duty of care reflected in the UPIA.*

2. Reasonable Basis for Recommendations

A broker-dealer or investment adviser must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. *NOTE: This reflects FINRA's Suitability Rule language*.

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. The level of importance of each factor may vary depending on the facts and circumstances of the particular case. *NOTE: This reflects FINRA's Suitability Rule*.

Among the circumstances that a broker-dealer or investment adviser shall consider in making investment recommendations are such of the following as are relevant to the customer: general economic conditions; the possible effect of inflation or deflation; expected tax consequences of investments or strategies; the role that each investment or course of action plays within the overall portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; the expected total return from income and the appreciation of capital; other resources of the customer or account beneficiaries; the relevant time horizon; needs for liquidity, regularity of income, and preservation or appreciation of capital; and an asset's special relationship or special value, if any, to the purposes of the account or to one or more of the account beneficiaries. *NOTE: This language is taken from the UPIA.*

Recommendations respecting individual investments must be evaluated not in isolation but in the context of the customer's investment portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the customer's investment portfolio. *NOTE: This reflects the UPIA.*

Recommendations shall ensure that the investments in a customer's portfolio are diversified unless the broker or investment adviser reasonably determines that, because of special circumstances, the purposes of the customer's account are better served without diversifying. *NOTE: This reflects the UPIA.*

3. Diligence

A broker-dealer or investment adviser or employee or associated person thereof shall use reasonable diligence to obtain and analyze all of the relevant factors unless there is a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case. A broker-dealer or investment adviser shall make a recommendation covered by this rule only if the broker-dealer or investment adviser has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. *NOTE: This reflects FINRA's Suitability Rule.*

A broker-dealer or investment adviser shall make a reasonable effort to verify facts relevant to its investment recommendations for a customer's account. *NOTE: This language reflects the UPIA.*

4. Investment Costs

Recommendations by a broker-dealer or investment adviser shall cause the customer to incur only incur those costs that are appropriate and reasonable in relation to the assets, purposes of the account, and skills of the broker-dealer or investment adviser. *NOTE: This language reflects the UPIA.*

The best interest standard does not obligate a broker-dealer or investment adviser to recommend the lowest cost product or the product that generates the lowest fees without regard to other relevant factors. *NOTE: This language reflects the DOL Rule and is consistent with the UPIA.*

The requirement that a recommendation must be consistent with the customer's best interests shall not obligate a broker-dealer or investment adviser to recommend the "least expensive" security or investment strategy (however "least expensive" may be quantified), as long as the recommendation is suitable and the broker or investment adviser is not placing his or her interests ahead of the customer's interests. The cost associated with a recommendation ordinarily is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable. The customer's investment profile, for example, is critical to the assessment, as are a host of product- or strategy-related factors in addition to cost, such as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. *NOTE: This reflects FINRA's Suitability Rule and is consistent with the DOL Rule and UPIA.*

5. Monitoring Investments

A broker-dealer or investment adviser shall not have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities [*NOTE: This language is from the Dodd-Frank Act*] unless the broker-dealer or adviser agrees to do so [*NOTE: from the DOL Rule*]. The broker-dealer's or adviser's customer contract must describe whether or not it will monitor the customer's investments and alert the customer to any recommended change to those investments. If the broker-dealer or adviser agrees to monitor, it must describe the frequency with which monitoring will occur and the reasons for which the customer will be alerted. *NOTE: This language is from the DOL Rule and is consistent with FINRA's Suitability Rule*.

If a broker-dealer or investment adviser exercises discretion in investing and managing a customer's account, the broker or adviser shall have continuing responsibility for oversight of the suitability of its investments for the customer's account. *NOTE: This reflects the UPIA.*

C. Duty of Loyalty

1. Customer's Interests

In making recommendations that are consistent with the best interests of the customer, a broker-dealer or investment adviser must make recommendations without regard to his financial or other interests, unless authorized to do so by law or by customer consent in accordance with law. *NOTE: This reflects the Dodd-Frank Act, the DOL Rule, the UPIA, and the Suitability Rule*.

2. Examples of Violations

Examples of instances where a broker-dealer or investment adviser may be found to have placed its interests ahead of the customer's interests include the following:

- A broker whose motivation for recommending one product over another is to receive larger commissions.
- A broker whose mutual fund recommendations are "designed 'to maximize his commissions rather than to establish an appropriate portfolio' for his customers."
- A broker who recommends "that his customers purchase promissory notes to give him money to use in his business."
- A broker who seeks to increase his commissions by recommending that customers use margin so they can purchase larger numbers of securities.
- A broker who recommends new issues being pushed by his firm so that he can keep his job.
- A broker who recommends speculative securities that pay high commissions because he feels pressured by his firm to sell the securities.

NOTE: This reflects FINRA's Suitability Rule.

3. Reasonableness of Compensation

A broker-dealer or investment adviser shall charge no more than reasonable compensation for its investment recommendations and related services. *NOTE: This reflects the DOL Rule and UPIA.*

Compensation must not be excessive, as measured by the market value of the particular services, rights, and benefits the broker or investment adviser are delivering to the customer. The reasonableness of the fees depends on the particular facts and circumstances at the time of the recommendation. Several factors inform whether compensation is reasonable including, inter alia, the market pricing of service(s) provided and the underlying asset(s), the scope of monitoring, and the complexity of the product. No single factor is dispositive in determining whether compensation is reasonable; the essential question is whether the charges are reasonable in relation to what the investor receives. *NOTE: This language reflects the DOL Rule*.

Charges for services performed by a broker-dealer or investment adviser (including miscellaneous services such as collection of monies due for principal, dividends, or interest; exchange or transfer of securities; appraisals, safe-keeping or custody of securities, and other services) shall be reasonable and not unfairly discriminatory among customers. *NOTE: This reflects FINRA's Suitability Rule*.

The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of the best interest standard. *NOTE: This reflects the Dodd-Frank Act*.

4. Proprietary Products and Third Party Payments

The sale of only proprietary or other limited range of products by a broker-dealer or investment adviser shall not, in and of itself, be considered a violation of the best interest standard. *NOTE: This reflects the Dodd-Frank Act*.

A broker-dealer or investment adviser that limits its recommendations to proprietary products (or products that generate third party payments) shall be deemed to satisfy the best interest standard if required disclosures and other requirements are met and the products otherwise meet the standard of prudence. *NOTE: This reflects the DOL Rule*.

The customer contract shall disclose whether the broker-dealer or investment adviser offers proprietary products or whether they or their affiliates receive fees from third parties with respect to any recommended investments, and the extent to which the broker or adviser limits its investment recommendations, in whole or part, to such products or investments. The disclosure is insufficient if it merely states that the broker-dealer or adviser "may" limit investment recommendations based on whether the investments are proprietary products or products that generate third party fees without specific disclosure of the extent to which recommendations are, in fact, limited on that basis. *NOTE: This reflects the DOL Rule*.

D. Policies and Procedures

A broker-dealer or investment adviser subject to this regulation shall adopt and comply with written policies and procedures designed to ensure compliance with this regulation by itself and its employees or representatives.

In formulating such policies and procedures, the broker-dealer or adviser shall identify and document any material conflicts of interest and address how such conflicts of interest will be managed to avoid violation of the requirement that the broker-dealer or adviser act in the best interest of the customer without regard to its own interests. *NOTE: This generally reflects the DOL Rule and existing SEC and FINRA policies*.

E. Customer Contract

A broker-dealer or investment adviser that provides personalized investment advice about securities to retail customers shall enter into a written contract with its customer which shall set forth the services to be provided by the broker or adviser and the terms and conditions of such services. *NOTE: This generally reflects the DOL Rule and existing SEC and FINRA policies*.

The broker-dealer or investment adviser shall maintain an electronic copy of the customer's contract on its Web site that is accessible by the customer.

1. Agreement to Act in Customer's Best Interest

The contract shall state that the broker-dealer or investment adviser agrees 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. *NOTE: This generally reflects the DOL Rule.*

2. Agreement to Comply with Regulation

The contract shall state that the broker-dealer or investment adviser is required to comply with this regulation and that the broker or investment adviser agrees to so comply in rendering personalized investment advice to the customer.

The broker-dealer or investment adviser shall give the customer a copy of this regulation prior to rendering any personalized investment advice and shall maintain an electronic copy of this regulation on its Web site that is accessible by the customer.

NOTE: This generally reflects the DOL Rule but without requiring the contract to include the level of detail required by the DOL's BIC contract exemption.