National Leadership for
Portfolio Diversifying Investments

IPA
Investment Program Association

February 15, 2018

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: *Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers (June 1, 2017)*

Dear Chairman Clayton:

The Investment Program Association ("IPA") submits the following comments in response to the request for public comments on standards of conduct for investment advisers and broker-dealers.[1] The IPA appreciates that the U.S. Securities and Exchange Commission (the "Commission") is analyzing and reviewing appropriate standards of conduct applicable to the investment professionals it regulates. As the Commission stated in its request for public comments, there have been significant marketplace developments since it last solicited information from the public in 2013, including regulatory developments, changes to business models and technological innovations in the form and delivery of information.

The IPA has an immediate interest in the applicable standards of conduct because the Commission regulates many IPA member firms and individuals. For over thirty years, the IPA has provided national leadership for the portfolio diversifying investment ("PDI") industry. The IPA supports investor access to a variety of asset classes with low correlation to the traded markets[2] and historically available only to institutional investors, including the following classes: real estate investment trusts (REITs), business development companies (BDCs), closed-end funds, interval funds, energy and equipment leasing programs and private equity offerings. Our members include sponsors and issuers, broker-dealers, registered investment advisers, banks and private equity funds, attorneys, accountants and other professionals. With over $135 billion in capital investments, PDIs remain a critical component of an effectively balanced investment portfolio and serve an essential capital formation function for national, state and local economies. The mission of the IPA is to advocate for PDIs through education and public awareness.

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

[2] Asset classes that are not correlated to the traded markets generally do not move in parallel with the traded markets. This results in a type of diversification that reduces the portfolio risk from traded market volatility.

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As the Commission undertakes its analysis of the appropriate standards of conduct applicable to investment advisers and broker-dealers, the IPA believes that it is critical to recognize that both business models serve investor needs, but are inherently different. An investment adviser typically provides ongoing investment advice and monitoring, and therefore has a corresponding duty to supervise the account regardless of trading activity. Many investment adviser relationships are "discretionary," allowing advisers to execute trades pursuant to an agreement without prior client authorization. Investment adviser fees are commonly level or flat fees, based on a percentage of assets under management. In contrast, a brokerage relationship is non-discretionary and largely commission-based. A broker-dealer provides episodic investment guidance only incidental to a specific transaction. For many investors, a brokerage account provides a more cost-effective alternative, especially for investors who trade infrequently or who do not want or need ongoing advisory services.[3]

The IPA supports a uniform, national best interest standard of care for broker-dealers when providing non-discretionary, personalized investment assistance to retail clients. However, the Commission should consider in its review the totality of the existing broker-dealer regulatory regime, including the "best interest" standard currently applicable to broker-dealers. As per the applicable FINRA rules, broker-dealers must deal fairly with their customers and "observe high standards of commercial honor and just and equitable principles of trade"; broker-dealers must have a reasonable basis for recommendations regarding securities in light of a customer's financial situation and needs; and a broker-dealer's recommendations must be consistent with its customer's "best interest," thus prohibiting a broker-dealer from placing its interests ahead of its customer's interest.[4] Broker-dealers have successfully operated under this framework and existing guidance for years. As many commenters have suggested, the practical differences between current investor-facing standards of conduct applicable to broker-dealers and investment advisers are not significant.[5]

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[3] *See* Deloitte, *infra* note 6, at 12 ("Typically, fee-based accounts offer a higher level of service than brokerage accounts and often include automatic rebalancing of accounts, comprehensive annual reviews, enhanced reporting to account holders, and access to third party money managers. The fees are generally an 'all-in' asset-based fee that is generally higher than the fees paid in an advised brokerage account (to compensate for the additional services). Out of the subset of study participants that provided their average advised brokerage and fee-based account fees, it was observed that annual fee-based account fees were 64 bps higher than advised brokerage fees, on average (110 bps versus 46 bps)."). Many fee-based account minimums can be as high as $100,000. Even high net worth investors may pursue a "buy and hold" strategy where transaction-based commissions are more cost-effective.

[4] *See* FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); FINRA Rule 2111 (Suitability); and FINRA Rule 2111 (Suitability), FAQ Question 7.1, "Acting in a Customer's Best Interests." Broker-dealers have a "special duty" to the public, i.e., an obligation to deal fairly with their customers, and actions that are not fair to the customer must be disclosed. *See, e.g.*, Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944)

[5] Investment advisers, for example, also use disclosure to manage conflicts of interest. *See, e.g.,* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

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As part of its consideration of appropriate standards of conduct, the Commission must also consider the impact of the U.S. Department of Labor's ("DOL") fiduciary rule. On June 7, 2016, the DOL fiduciary rule took effect, with the first compliance date moved from April 10, 2017 to June 9, 2017. The DOL has now delayed full compliance and enforcement until July 1, 2019. As numerous studies[6] and anecdotal evidence have shown, there has been a wide range of responses to the DOL rule by broker-dealers and financial advisors.[7] Due to a lack of clarity in its implementation and ambiguity in the rule's substantive provisions—including the litigation risk associated with the BICE private right of action—the rule has resulted in a shift away from commission-based brokerage services to fee-based and self-directed accounts.[8]

The DOL rule has resulted in changes even within available brokerage services, such as the elimination of certain products, and asset and share classes.[9] These changes have primarily impacted retirement accounts but they have also impacted other types of accounts. Moreover, firms are considering additional changes in response to the DOL rule that may impact service offerings, products, compensation structures and operational processes and controls. The DOL rule has resulted in costs to financial advisors, both in time and money, as well as to investors, who may not have sufficient account minimums to maintain fee-based accounts or who will not receive personalized advice on self-directed accounts, among other direct and indirect impacts.[10]

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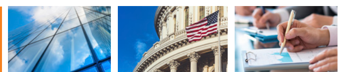
[6] *See, e.g.*, Deloitte, The DOL Fiduciary Rule: A study on how financial institutions have responded and the resulting impacts on retirement investors (Aug. 9, 2017), *available at* https://www.sifma.org/wp-content/uploads/2017/08/Deloitte-White-Paper-on-the-DOL-Fiduciary-Rule-August-2017.pdf; Harper Polling, Department of Labor Fiduciary Rule: National Survey of Financial Professionals (July 7-12, 2017), *available at* http://www.fsroundtable.org/wp-content/uploads/2017/08/17.07-FSR-Presentation-1.pdf; U.S. Chamber of Commerce, Fiduciary Rule: Initial Impact Analysis (Sept. 7, 2017), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2017/07/Fiduciary-RuleInitial-Impact-Analysis.pdf?x48633 (survey performed by FTI Consulting).

[7] For purposes of this section, the term "financial advisor" broadly includes broker-dealers and registered agents or representatives, investment adviser firms and their representatives, and dual registrants.

[8] "As of June 9th, 53% of study participants reported limiting or eliminating access to advised brokerage for retirement investors, impacting 10.2 million accounts and $900b AUM." Deloitte, *supra* note 6, at 11.

[9] "Products affected included, but were not limited to, mutual funds, annuities, structured products, fixed income, and private offerings. It was also noted that study participants had to limit asset classes for which a prohibited transaction exemption was not available (e.g., risk-based principal sales of non-investment grade debt, certain underwriting and new-issue activities)." Deloitte, *supra* note 6, at 13.

[10] A hearing before the House Financial Services Subcommittee on Capital Markets, Securities, and Investment on July 13, 2017 addressed the impact of the DOL fiduciary rule on clients and small accounts. For example, David Knoch, President of 1st Global in Dallas, Texas, testified that moving to a level fee method "will mean that clients who place trades less frequently will subsidize frequent traders" on a fee-based platform and that due to increased paperwork and operating burdens, "we have seen our affiliated financial advisors increasing the minimum account size to serve clients and even ending relationships with clients whose accounts are not cost effective to continue to service." *See* https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-dknoch-20170713.pdf. Similarly,



The IPA firmly supported delay of full implementation of the DOL fiduciary rule until July 1, 2019.[11] The delay allows the industry sufficient time to comply with those provisions currently in effect. The IPA has also supported regulatory coordination between the DOL and the Commission, but believes that the Commission is best suited to consider a balanced and appropriate standard for all investment professionals and to analyze the impact to date of the DOL fiduciary rule.

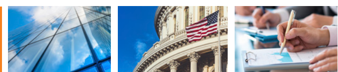
Many commenters have suggested that the Commission consider the current best interest standard applicable to broker-dealers along with enhanced up-front disclosures. The IPA believes that the appropriate approach is a flexible, principles-based approach rooted in the longstanding and widely accepted disclosure regime under the U.S. securities laws.[12] A complement to a disclosure-based approach is the Commission's and FINRA's strong examination and enforcement programs, which monitor and supervise firms and their agents, protect investors, and act as a deterrent for bad actors. The IPA encourages the Commission to consider the negative impact on capital raising as a result of significant rulemaking in recent years by federal and state regulatory agencies, as well as the cost and complexity of implementation and compliance in any new rulemaking.

The IPA also encourages the Commission to take note of the increasing trend toward fee-based brokerage services and a reduction in services for small or modest-sized accounts as a result of the DOL rule. The Commission should instead pursue a non-biased approach promoting investor choice in any account type, recognizing both the benefits and differences in services, products and compensation structures. The IPA supports one commenter's recommendation to provide a pre-proposal assessment or report to the public prior to any potential rulemaking. Finally, the IPA encourages a uniform, national standard to avoid duplicative or conflicting national and state fiduciary standards.

Jerry Lombard, President of the Private Client Group at Janney Montgomery Scott stated, "[u]pwards of 10,000 of our customer retirement accounts will be relegated to a 'no advice service' desk as they are too small for the risks imposed by the DOL or too costly to place in an advisory account." *See* https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-jlombard-20170713.pdf.

[11] *See* IPA Comment Letters to DOL, *available at* http://www.ipa.com/wp-content/uploads/2017/09/IPA-Comments-DOL-Fiduciary-Extension_09-15-17_FINAL.pdf (September 15, 2017); http://www.ipa.com/wp-content/uploads/2017/09/IPA-Comment-Letter-on-RIN-1210-AB82-7-21-17.pdf (July 21, 2017); http://www.ipa.com/wp-content/uploads/2017/04/Acosta-letter-of-support_FINAL.pdf (April 28, 2017).

[12] *See* Piwowar, Michael S., Comment Letter in Response to the Department of Labor's 'Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions'" (July 25, 2017), *available at* https://www.sec.gov/news/public-statement/piwowar-comment-dol-fiduciary-rule-prohibited-transaction-exemptions (discussing the Commission's eight decades of experience with conflict of interest disclosures).



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If the IPA may be of any assistance as the Commission conducts its review of this important issue, please do not hesitate to contact me or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel, at [redacted].

Sincerely,

Anthony Chereso
President & CEO, Investment Program Association