



CENTER FOR CAPITAL MARKETS  
C O M P E T I T I V E N E S S

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August 7, 2018

Mr. Brent J. Fields  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Re: Regulation Best Interest (Securities Exchange Act Release No. 83062 (Apr. 18, 2018)) (File No. S7-07-18); Form CRS Relationship Summary (Securities Exchange Act Release No. 83063 (Apr. 18, 2018)) (File No. S7-08-18); Proposed Commission Interpretation Regarding Standard of Conduct of Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation (Investment Advisers Act Release No. 4889 (Apr. 18, 2018)) (File No. S7-09-18)

Dear Mr. Fields:

The U.S. Chamber of Commerce<sup>1</sup> (“Chamber”) created the Center for Capital Markets Competitiveness (“CCMC”) to advance the United States’ global leadership in capital formation.

CCMC appreciates the opportunity to comment on the U.S. Securities and Exchange Commission’s (“SEC” or “Commission”) proposals regarding the standards of conduct for investment advisers and broker-dealers. The proposals were published in three releases: *Regulation Best Interest* (“Reg. BI Proposal”);<sup>2</sup> *Form CRS Relationship Summary* (“Form CRS Proposal”);<sup>3</sup> and *Proposed Commission Interpretation*

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<sup>1</sup> The Chamber is the world’s largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions.

<sup>2</sup> Securities Exchange Act Release No. 83062 (Apr. 18, 2018), 83 Fed. Reg. 21574 (May 9, 2018).

<sup>3</sup> Securities Exchange Act Release No. 83063 (Apr. 18, 2018), 83 Fed. Reg. 21416 (May 9, 2018).

*Regarding Standard of Conduct of Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation* (“IA Proposal”) (collectively, the “Proposals”).<sup>4</sup>

The CCMC believes that the SEC’s proposals must:

- develop a focused, principles-based best interest standard applicable to broker-dealers rather than impose a uniform fiduciary standard across diverse business models;
- leverage existing broker-dealer suitability obligations including a focus on recommendations as the basis for proposed Reg. BI, rather than impose a new duty on broker-dealers to monitor the performance in an account;
- enhance retail investors’ understanding of the choices available to them under the investment advisory and brokerage service models; and
- preserve investors’ access to a diverse range of valuable products, services, service providers, and payment options.

CCMC believes the Proposals are fundamentally sound. However, there are important aspects of each Proposal that we believe should be improved to ensure effective implementation and reduce potential adverse consequences for retail investors.

## **Executive Summary**

### ***Reg. BI***

CCMC believes that proposed Reg. BI reflects the proper approach to rulemaking concerning broker-dealers. Reg. BI establishes principles-based standards that build upon and enhance the existing regulatory regime for broker-dealers, rather than attempt to define the term “best interest” or simply label broker-dealers “fiduciaries.”

There are essential elements of proposed Reg. BI that could be improved. Most fundamentally, the SEC should reconsider the distinctions regarding conflicts of

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<sup>4</sup> Investment Advisers Act Release No. 4889 (Apr. 18, 2018), 83 Fed. Reg. 21203 (May 9, 2018).

interest: which conflicts are “material” and which conflicts “arise from financial interests.” The Commission has not provided sufficient guidance or clarity in the Reg. BI Proposal regarding how broker-dealers should make these determinations and what steps they need to take to appropriately mitigate conflicts.

CCMC also believes SEC should provide more clarity on its expectations on how they will apply the best interest standard when assessing costs of and remuneration for recommended investments and how broker-dealers can meet the Commission’s expectations when they offer limited investment choices.

Additionally, SEC should conform its definition of “retail customer” for purposes of Reg. BI to align with existing definitions rather than introduce a new broader definition.

Finally, we respectfully request that the SEC provide further clarification regarding the disclosure and recordkeeping requirements under the proposed regulation.

### ***Form CRS***

CCMC generally supports the concept of layered disclosure. However, as proposed, Form CRS unduly constrains broker-dealer disclosures, such as by requiring broker-dealers to attempt to explain complex concepts in a concise way when these concepts do not lend themselves to simple description. Moreover, the strict formatting and length limitations combined with the required disclosures present a substantial risk that firms may be left with a choice of omitting key information or violating the formatting requirements of the rule. We believe Form CRS should be shorter, more focused, less prescriptive, and allow firms more flexibility in how to approach the disclosure obligations. We also urge the Commission to make clear that the questions in Form CRS are designed to be prompts for conversations and that they are not, in effect, mandatory disclosures. Finally, we request that the Commission reconsider the recordkeeping obligations in light of the burdens these requirements could place on firms.

### ***Investment Adviser Interpretation***

CCMC believes that a thorough and accurate restatement of an investment adviser’s fiduciary duty would ensure that advisers share a common understanding of their legal obligations. However, the Commission should ensure that its “restatement” does not create new obligations or change existing ones. CCMC

believes the Commission should clarify some aspects of its proposed interpretation to ensure that the SEC is not introducing new interpretive issues or creating new legal obligations. We believe that, if the SEC interpretation is adopted as proposed, particularly since disclosure can address conflicts of interest, firms may need to review and revise their existing policies, procedures, and controls in light of the guidance. The questions the SEC raises on the efficacy of disclosure could introduce confusion among investment advisers as it could be read to be in conflict with existing legal standards, including those set forth in Supreme Court decisions. Additionally, because the SEC effectively created a higher standard in proposed Reg. BI for broker-dealers with respect to managing certain conflicts, the SEC should clarify that it will not judge investment adviser conduct against proposed Reg. BI's requirements given that Reg. BI does not apply to investment advisers. Finally, the Commission requested comment on three proposed additions to the current investment adviser regulatory regime. CCMC believes the Commission should carefully weigh the costs and benefits of these proposals to ensure they are necessary to enhance investor protection.

### **Discussion**

CCMC welcomes the leadership role taken by the SEC to enhance the standards of conduct for broker-dealers and investment advisers to foster a regulatory system that best serves the interests of retail investors. Broker-dealers are already subject to many regulators and regulations, and, as the principal federal regulator of broker-dealers, the SEC is the proper agency to update the regulatory framework that has served the investing public over many decades. The SEC's proposed Reg. BI would apply to a broad array of broker-dealers servicing retirement and taxable accounts. CCMC encourages the SEC to work with other regulators such as state regulators, the Financial Industry Regulatory Authority ("FINRA"), and the Department of Labor ("DOL") to ensure a workable approach that provides consistency and avoids duplicative or contradictory standards.

CCMC generally supports the Proposals and commends the SEC for proposing a new best interest standard for broker-dealers under the Securities Exchange Act of 1934 ("Exchange Act"). Proposed Reg. BI constitutes a notable expansion of the obligations facing broker-dealers when compared to the current suitability standards under FINRA rules and the general antifraud provisions of the Exchange Act. If adopted, it would establish an approach that acknowledges that the unique and important role played by registered broker-dealers benefits retail investors. CCMC commends the SEC's objectives of preserving retail investor choice and access to the

brokerage “pay as you go” advice model and providing flexibility for broker-dealers to develop and implement reasonable policies and procedures using a principles-based approach. Consistent with these objectives, CCMC specifically endorses the SEC’s proposals to:

- develop a focused, principles-based best interest standard applicable to broker-dealers rather than impose a uniform fiduciary standard across diverse business models;
- leverage existing broker-dealer suitability obligations as the basis for proposed Reg. BI<sup>5</sup>, including a focus on recommendations, rather than impose a new duty on broker-dealers to monitor the performance in an account;
- enhance retail investors’ understanding of the choices available to them under the investment advisory and brokerage service models; and
- preserve investors’ choice and access to valuable products, services, service providers, and payment options.

Although CCMC generally supports the Proposals, there are a number of concerns the Commission should address, as discussed below, to make the Proposals more effective and manageable to implement for firms and to prevent potential adverse consequences that could negatively affect retail customers. CCMC believes that, with these improvements, the Proposals would achieve the Commission’s goals and could be implemented by firms in a timely and efficient manner; however, CCMC believes firms would need at least 18 months to fully and effectively implement the changes in the Proposals.

CCMC commissioned a survey of 15 financial services companies that, collectively, are responsible for managing more than 78.5 million investment accounts and approximately \$23 trillion in assets. The majority view of these firms is that the Proposals will result in improved investor protection, but most firms saw an

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<sup>5</sup> The SEC uses the same language as FINRA suitability rules in some places throughout proposed Reg BI, such as references to “likely performance” when incorporating a broker-dealer’s existing obligations. When it comes to the word “performance,” it is worth noting that references to “performance” appear in both FINRA Rule 2210 and FINRA Regulatory Notice 12-25. FINRA Rule 2210 states that, “Communications may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast.” When relevant, especially when discussing “likely performance,” the SEC should cite to FINRA Reg Notice 12-25 to prevent an inconsistencies or confusion.

opportunity to improve Reg. BI and Form CRS. Specifically, many firms concluded that the proposed standard set forth in the Reg. BI Proposal resulted in a higher standard of conduct for broker-dealers than investment advisers and that Form CRS, as proposed, would prove to be cumbersome and unwieldy.

If Reg. BI ultimately imposes a higher standard of conduct on broker-dealers, on top of the regulatory requirements to which broker-dealers are already subject, some companies expressed concern that firms may move away from a broker-dealer model and offer only advisory services to retail customers. Such a result would undercut investor choice and could most impact small investors who are less likely to be able to afford advisory services.

With appropriate modifications more than 60% of firms indicated it would be unlikely that they would reassess the products they offer to retail customers or to rethink the services they offer.

Finally, most firms expressed the view that the Commission's cost estimates were too low and underestimated the costs associated with implementing Form CRS. More than 40% of firms anticipated having to spend a moderate amount to implement the requirements in Reg. BI and Form CRS. The anticipated costs to implement the IA Proposal were less severe, however the firms responding were dual-registered firms. To implement the IA Proposal, more than half of the firms surveyed anticipate spending only a small amount. Many firms believed that the potential benefits of all the Proposals would outweigh the costs, which firms believe are likely to decrease over time.

#### **A. CCMC Comment Letter on Chairman Clayton's Request**

On June 1, 2017, Chairman Clayton invited public views on the current regulatory framework of investment advisers and broker-dealers and the different standards under which they operate.<sup>6</sup> CCMC provided its views to the Commission on December 13, 2017, and reiterates those views here.<sup>7</sup> We believe there are four essential criteria that should serve as guideposts to assess the Proposals: (i) performing a sound cost-benefit analysis that is informed by existing standards of

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<sup>6</sup> See 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>.

<sup>7</sup> See Letter from Tom Quadman, Executive Vice President, CCMC to Hon. Jay Clayton, Chairman, SEC, dated Dec. 13, 2017 ("CCMC Letter").

conduct; (ii) protecting investor choice by maintaining multiple business models; (iii) promoting investor protection by requiring effective disclosure; and (iv) providing clarity on new requirements to ensure that regulated entities can effectively comply with their obligations.

1. **Cost-Benefit Analysis.** CCMC strongly believes the SEC should properly account for existing standards of conduct in the context of the broader regulatory environment to ensure its cost-benefit analysis of the Proposals is sound. A narrow view of applicable regulatory regimes focusing on the fact that investment advisers are subject to a fiduciary duty while broker-dealers have a suitability obligation ignores the litany of specific regulatory requirements to which broker-dealers are subject that are specifically designed to protect investors, which include detailed requirements regarding registration and qualification, licensing, continuing education, communications with the public, order handling, financial responsibility, and supervision.<sup>8</sup> To that end, CCMC credits the SEC for acknowledging the existing regulatory environment in which investment advisers and broker-dealers operate and building off existing regulations to reduce potentially costly, redundant requirements in the Proposals.
2. **Investor Choice.** The option to hire a professional to assist with financial investments and the ability to choose from varying advice models significantly benefits retail investors. As the SEC noted, “[t]here is broad acknowledgement of the benefits of, and support for, the continuing existence of the broker-dealer model as an option for retail customers seeking investment advice, notwithstanding the concerns regarding broker-dealer conflicts (including the transaction-based compensation model) and retail customer confusion regarding these conflicts and the limits of the applicable regulations.”<sup>9</sup> When Congress adopted the Dodd-Frank Act authorizing the SEC to adopt a new standard of conduct for broker-dealers, it acknowledged the viability and benefits of the broker-dealer model. As CCMC has previously noted, multiple business models lead to diverse fee structures, products, services, and activities,

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<sup>8</sup> Indeed, referring to “a suitability obligation” itself ignores numerous additional product-specific heightened suitability obligations FINRA has adopted to address recommendations of variable annuities, day trading, direct participation programs, index warrants, options, and security futures. *See* FINRA Rules 2330 (variable annuities), 2130 (day trading), 2310 (direct participation programs), 2350 Series (index and currency warrants), 2360 (options), 2370 (security futures).

<sup>9</sup> Reg. BI Proposal, at 21.

which provides more choices for investors, but the data indicate that the trend-line for investor choice is distressing. Although there are over 12,500 SEC-registered investment advisers, there are fewer than 4,000 broker-dealers, down from over 6,000 in 2005.<sup>10</sup> In part, this trend has been made worse through DOL rulemaking. The Commission should ensure that its final rules do not exacerbate the current decline in investor choice that may leave retail investors with no choice but to invest in a fee-based account.<sup>11</sup>

3. **Investor Protection.** Federal securities laws empower investors to protect themselves by ensuring that firms provide their customers with accurate and complete disclosure. As CCMC has stressed in the past, this disclosure does not argue for a passive role for regulators, and disclosure obligations should be a prominent part of SEC rulemaking in this area. Disclosure, however, must be effective, understandable, truthful, and accessible. CCMC applauds the Commission for focusing the Proposals on this aspect of investor protection, which it believes is the proper focus of rulemaking in this area; however, as discussed more fully below, the Commission's views on the sufficiency of disclosure in particular circumstances should be clarified to ensure consistent understanding.
4. **Clarity.** Investment advisers and broker-dealers perform different functions under different circumstances. Tailoring the regulatory requirements for each is essential, even when they may be engaged in similar conduct such as providing advice or recommendations on securities investments. The SEC should establish specific expectations under any final rule. Without such a refined understanding, regulated entities will be challenged to comply, and it will be difficult, if not impossible, for the SEC to conduct an informed and complete cost-benefit analysis.

## **B. Regulation Best Interest (Reg. BI)**

Some have criticized Reg. BI on the basis that it does not define the term "best interest" or that it does not label broker-dealers as "fiduciaries." This criticism is

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<sup>10</sup> Reg. BI Proposal, at 231-35.

<sup>11</sup> See CCMC Letter, at 6 (noting and discussing recent evidence demonstrating that the DOL fiduciary rule "has sharply limited the ability of investors to receive advice in brokerage accounts and that investor access to certain investment and income-oriented products (e.g., mutual funds and variable annuities) has been curtailed").

unfounded for multiple reasons. Broker-dealers and investment advisers are different business models, so having different standards is appropriate and necessary.<sup>12</sup>

Criticisms generally ignore the overall regulatory regime to which investment advisers and broker-dealers are subject and focus only on a single, albeit important, aspect of the retail customer/firm relationship. Attention should focus not on the fact that the SEC's proposal does not use the word "fiduciary" (and instead employs the phrase "best interest," under proposed Reg. BI), but rather on the substance of the entire regulatory regime, of which Reg. BI and Form CRS would be a significant part, but not the totality.

The term "best interest" refers to a general standard with specific obligations which are set forth in proposed Reg. BI. Proposed Reg. BI is explicit in stating that the best interest standard is satisfied by meeting the enumerated "Disclosure Obligation," "Care Obligation," and "Conflict of Interest Obligations." These obligations address the underlying principles associated with the fiduciary duty under the Advisers Act but appropriately contextualize them for broker-dealers. The proposed best interest standard is intended to be a principles-based, facts-and-circumstances approach, and not simply a defined term. This approach is in line with the fiduciary standard applicable to investment advisers today and with existing regulatory obligations of broker-dealers, both of which recognize that the relevant obligation for each kind of professional is necessarily fact-based.

Recommendations by broker-dealers do not occur in a vacuum, and a proper appreciation of the particular recommendation and the individual investor to whom it is provided is essential in making a meaningful determination of whether a recommendation is consistent with best interest principles.

**1. Proposed Reg. BI enhances the existing suitability standard, particularly when paired with the new disclosure requirements in proposed Form CRS.**

Although, as discussed in detail below, we believe particular aspects of proposed Reg. BI should be clarified or amended, the proposed regulation will result

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<sup>12</sup> See Reg. BI Proposal, at 43 ("Proposed Regulation Best Interest focuses on specific enhancements to the broker-dealer regulatory regime, in light of the unique characteristics of the brokerage advice relationship and associated services that may be provided, and therefore would be separate and distinct from the fiduciary duty that has developed under the Advisers Act.").

in a more enhanced standard than under FINRA's current suitability rule and the antifraud provisions of the federal securities laws. The improvements include:

- The proposed standard clearly requires that a broker-dealer's recommendations be in a retail customer's "best interest." This means, among other things, that broker-dealers cannot put their own interests ahead of those of their retail customers. Although the FINRA suitability rule has been interpreted to impose such a requirement, the codification of this standard makes the fundamental requirement clear and unambiguous. However, further guidance from the SEC is needed to adequately determine the contours of the requirement and its application to specific scenarios.
- The SEC has clearly articulated an expectation that broker-dealers carefully consider the cost of the security or strategy as a factor when making recommendations without making the obligation a cost-only analysis.
- The proposed standard improves disclosure of the scope and terms of the broker-dealer's relationship with its retail customers, which should help address potential customer confusion – particularly when combined with proposed Form CRS.
- The proposed standard mandates policies and procedures to identify and manage material conflicts of interest through disclosure, mitigation, or elimination. This requirement should assist broker-dealers in managing the potential impact of these conflicts on their recommendations and help retail customers evaluate recommendations; however, the SEC must further clarify the duty to mitigate financial conflicts of interest or proposed Reg. BI may run the risk of a loss of investor choice and access.
- The SEC's guidance makes clear that broker-dealers cannot reduce their legal obligations through contract (as they may with institutional accounts under FINRA Rule 2111).

## **2. There are areas where proposed Reg. BI can be improved.**

There are certain components of the proposed regulation that CCMC believes should be enhanced or clarified. The changes would assist broker-dealers in implementing the heightened new standard as intended and will help prevent any negative unintended consequences. Our concerns focus primarily on the scope of

certain terms in proposed Reg. BI. In many instances, these concerns not only raise practical implementation issues for the proposed disclosure, care, and conflicts of interest obligations and recordkeeping requirements but could result in adverse effects on retail investors. Below, we discuss the following areas, which we believe merit additional consideration by the Commission.

**a. Application of the “best interest” standard**

The Commission has clearly indicated that the Care Obligation under proposed Reg. BI is not a “lowest cost” obligation nor is it a “least remunerative” obligation. These factors are important in determining whether a given recommendation is in the retail customer’s “best interest.” Under the guidance provided in the Reg. BI Proposal, broker-dealers can recommend securities or investment strategies that are more expensive to a retail customer or more remunerative to the broker-dealer if they are in the client’s best interest.

Notwithstanding the Commission’s guidance, it is difficult to determine how a broker-dealer must weigh these financial factors when applying the Care Obligation and what would not be considered to be in the client’s best interest. It is particularly important as disclosure alone may not discharge this obligation (since certain remuneration could be deemed to constitute financial incentives).

Additionally, since a broker-dealer is not required to scour the investing universe in developing a recommendation, we are concerned that the lack of clarity on this point could expose broker-dealers to claims regarding cheaper or less remunerative options that were available in hindsight. We ask that the SEC provide additional guidance on how to weigh financial factors and confirm that if a broker-dealer determines that a particular security or investment strategy is in the particular customer’s best interest, then the fact that it may be more expensive to the customer and/or more remunerative to the broker-dealer would not violate the Broker-Dealer’s obligations under Reg. BI.

Proposed Reg. BI would require that broker-dealers exercise reasonable “diligence, care, skill, and prudence” when making a recommendation. The term “prudence,” borrowed from ERISA, embodies a fiduciary standard. Importing a term from the ERISA context into the federal securities laws could result in confusion and an unintended incorporation of ERISA into federal securities regulation. We believe the use of this term is unnecessary.

The SEC has rightfully and thoughtfully considered existing obligations and regulations in this area, including the DOL’s fiduciary rule, and opted for its own approach, which we believe is correct and reflects that the SEC is drawing from the long tradition and effectiveness of the federal securities laws that the Commission administers and enforces. Incorporating language from other approaches or regulatory regimes grounded in statutes outside the federal securities law—such as “prudence” from the ERISA context—increases the likelihood that the SEC’s rulemaking will be seen to embrace these approaches and the corresponding interpretations and jurisprudence when the SEC has, instead, set forth its own unique requirements that are meant to work within the long-established constructs of the securities industry and the federal securities laws. Therefore, we strongly urge the Commission to omit the term “prudence” from the final rule.

The Commission also proposes to include a “Retail Customer Investment Profile” as a means of helping retail customers receive investment advice that is in their best interest. In its proposal, the Commission lists several factors that should be included in the customer’s investment profile such as age, financial situation and needs, tax status, investment time horizon, and other factors. The fear of outliving one’s assets is often cited as a primary concern among consumers seeking a financially secure retirement. Therefore we support firms maintaining the flexibility to take into account longevity and market risk and other important considerations if they deem them appropriate.

Finally, we request that the SEC confirm that the Care Obligation does not require firms to exhaust all possible investment options when making recommendations and that recommendations can be limited to the products that are offered by the broker-dealer. Although the Commission stated that the regulation “would not require a broker-dealer to analyze all possible securities, all other products, or all investment strategies to recommend the single ‘best’ security or investment strategy” nor would it “prohibit . . . recommendations from a limited range of products,” other part of the Reg. BI Proposal indicates that the SEC has, in effect, done precisely this.<sup>13</sup> Specifically, because the Care Obligation requires firms to consider reasonably available alternatives, and the Care Obligation cannot be altered or satisfied by contract or disclosure, the Commission should provide specific, practical guidance on how a firm can limit the universe of options it considers in making recommendations. If the net effect is that broker-dealers have to select the best option from a seemingly endless number of options (i.e., every available option in

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<sup>13</sup> Reg. BI Proposal, at 135.

the marketplace), broker-dealers will face a task that is practically impossible. Moreover, we believe retail customers would be better served by broker-dealers that are expert on a more discrete set of products than broker-dealers that have only a superficial understanding of hundreds or thousands of options.

Finally, we think it is critical that the SEC add specific language into the regulation (and not just the preamble) providing that no private right of action is created under the regulation.

**b. Scope of the proposed definition of “retail customer”**

Proposed Reg. BI defines a “retail customer” as “a person, or the legal representative of such person, who: (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (2) uses the recommendation primarily for personal, family, or household purposes.” Proposed Reg. BI’s definition of “retail customer” would create significant compliance challenges and burdens for firms because it is inconsistent with related definitions in Exchange Act Rule 17a-3(a)(17), Proposed Form CRS, and FINRA rules. Complying with yet another definition – and one that is significantly broader – would impose substantial compliance burdens and would risk inconsistent but overlapping internal compliance protocols. These logistical difficulties are particularly notable with respect to FINRA’s rules because certain of proposed Reg. BI’s requirements, particularly the Care Obligation, are based on FINRA suitability requirements.

This proposed definition is broader than other definitions of “customer” or “retail investor” in the following ways: (1) Exchange Act Rule 17a-3(a)(17) and Section 913(a) of the Dodd-Frank Act limit the definition of “customer” to natural persons; and (2) the definition of “retail investor” in FINRA Rule 2210 excludes registered investment advisers and partnerships, corporations, trusts, or natural persons with assets of \$50 million or more.<sup>14</sup> Proposed Form CRS’s definition of

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<sup>14</sup> FINRA Rule 2210(a)(6) defines a “retail investor” as “any person other than an institutional investor.” An “institutional investor” is defined in Rule 2210(a)(4) to include, among others, any “institutional account.” The term “institutional account” is defined in Rule 4512(c) as “the account of: (1) a bank, savings and loan association, insurance company or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.”

“retail investor” is limited to natural persons and a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust.

By extending the best interest obligation to “legal representatives” of retail customers, the proposed definition would capture scenarios that should not be in scope because the recommendation is provided to a professional fiduciary (e.g., a registered investment adviser, family office, bank trust department) that does not need the distinct protections that proposed Reg. BI is intended to provide.

The definition of “retail customer” should be narrowed so that it is appropriately focused on natural persons or trusts or other entities established by natural persons for the purpose of investing in securities, and legal representatives of such persons who are not professional fiduciaries. Such a definition would provide greater precision and would be consistent with the SEC’s objectives of capturing certain non-natural persons that represent the assets of a natural person, such as trusts, that would benefit from the protections of Reg. BI while avoiding a definition that could sweep in institutional accounts that generally should not be in scope.<sup>15</sup> The definition should also exclude investors with more than \$50 million in total assets to conform to the FINRA definition, which would ensure consistency with existing requirements, and exclude sophisticated investors who function more closely to institutional investors than traditional retail customers.

If the SEC disagrees with these proposed modifications, at a minimum, the definition of “retail customer” should be harmonized with the proposed definition of “retail investor” in the Form CRS Proposal and be limited to natural persons. Having Reg. BI potentially apply to a much broader scope of non-natural persons and legal representatives would be burdensome and confusing with little or no investor protection benefit.

We also believe the SEC should clarify the application of Reg. BI to potential retail customers. The SEC clearly stated in the Reg. BI Proposal that “[t]he Commission believes that the determination of whether a recommendation has been made to a retail customer that triggers the best interest obligation should be interpreted consistent with existing broker-dealer regulation under the federal securities laws and SRO rules, which would provide clarity to broker-dealers and maintain efficiencies for broker-dealers with established infrastructures that already

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<sup>15</sup> Reg. BI Proposal, at 85.

rely on this term.”<sup>16</sup> FINRA guidance on the suitability rule provides that the obligations apply to potential customers only when customers act on the advice and executes the trade through the firm making the recommendation.<sup>17</sup> CCMC believes the SEC should either acknowledge that Reg. BI would be interpreted in the same way and would apply to recommendations made to prospective retail customers only when it results in compensation to the firm or include such a provision in Reg. BI itself.

**c. The identification and mitigation of “material conflicts of interest”**

Proposed Reg. BI places significant emphasis, in both the Disclosure Obligation and the Conflicts of Interest Obligations, on “material conflicts of interest.” The Reg. BI Proposal states that the SEC will interpret the phrase “material conflicts of interest” as “a conflict of interest that a reasonable person would expect might incline a broker-dealer – consciously or unconsciously – to make a recommendation that is not disinterested.”<sup>18</sup>

Although this interpretation originates from federal case law as a standard for investment advisers under the Investment Advisers Act of 1940,<sup>19</sup> this standard is not one that has been applied to broker-dealers under the Exchange Act or FINRA rules and should not be incorporated into Reg. BI. While the “consciously or unconsciously . . . not disinterested” interpretation may be workable in the context of investment adviser disclosure obligations when relying on disclosure to manage conflicts of interest, it is not appropriate and not practical in the context of proposed

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<sup>16</sup> Reg. BI Proposal, at 74.

<sup>17</sup> FINRA Rule 2111 (suitability) FAQ 2.2 (“The suitability rule would apply when a broker-dealer or registered representative makes a recommendation to a potential investor who then becomes a customer. Where, for example, a registered representative makes a recommendation to purchase a security to a potential investor, the suitability rule would apply to the recommendation if that individual executes the transaction through the broker-dealer with which the registered representative is associated or the broker-dealer receives or will receive, directly or indirectly, compensation as a result of the recommended transaction. In contrast, the suitability rule would not apply to the recommendation in the example above if the potential investor does not act on the recommendation or executes the recommended transaction away from the broker-dealer with which the registered representative is associated without the broker-dealer receiving compensation for the transaction.”)

<sup>18</sup> Reg. BI Proposal, at 110.

<sup>19</sup> See, e.g., *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

Reg. BI. Broker-dealers must identify and disclose material conflicts of interest of each associate of the broker-dealer “associated with the recommendation.”

The SEC is also proposing to take a term—“material”—that is generally understood and define it in a new way that raises a host of interpretive questions and provides little clarity. For example, the SEC would need to clarify the following:

- What does it mean to be “not disinterested?” This would, on its face, seem to encompass any conflicts of interest, which was clearly not the Commission’s intent.
- Is the “not disinterested” standard the same thing as “material” as that term is generally understood? If so, why is the interpretation necessary? If not, how are they different? Although broker-dealers have experience identifying and managing conflicts of interest, the focus is typically on actual conflicts, not just possible unconscious conflicts.<sup>20</sup>
- Is it possible for a broker-dealer or associated person to have a conflict that makes him or her “not disinterested” and at the same time does not rise to the level of a “material conflict of interest?”

We understand that the SEC’s intent is to capture only those conflicts that are “material” as opposed to “any conflicts of interest” that a broker-dealer may have with a retail customer.<sup>21</sup> Consistent with this objective, we urge the SEC to use the well-established definition of “material” as it has been understood and interpreted by the courts for purposes of the securities laws, rather than adopting a new standard that raises a host of interpretive questions.<sup>22</sup> Should the SEC decide to impose a new standard for assessing conflicts under Reg. BI, it should avoid using the term “material” to prevent confusion.

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<sup>20</sup> See, e.g., FINRA Rules 2241, 2242.

<sup>21</sup> As the Reg. BI Proposal states: “[l]imiting the obligation to ‘material’ conflicts is consistent with case law under the antifraud provisions, which limit disclosure obligations to ‘material facts,’ even when a broker-dealer is in a relationship of trust and confidence with its customer. We believe that expanding the scope of the obligation more broadly to cover any conflicts a broker-dealer may have would inappropriately require broker-dealers to provide information regarding conflicts that would not ultimately affect a retail customer’s decision about a recommended transaction or strategy and might obscure the more important disclosures.” Reg. BI Proposal, at 111.

<sup>22</sup> See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

This broad interpretation of what constitutes a “material conflict of interest” is also inconsistent with the Commission’s statement that “expanding the scope of the obligation more broadly to cover *any* conflicts a broker-dealer may have would inappropriately require broker-dealers to provide information regarding conflicts that would not ultimately affect a retail customer’s decision about a recommended transaction or strategy and might obscure the more important disclosures.” Indeed, we believe this interpretation would result in precisely the “lengthy disclosures that do not meaningfully convey the material facts and material conflicts of interest and may undermine the Commission’s goal of facilitating disclosure to assist retail customers in making informed investment decisions.”

In addition to the distinction the Commission draws between conflicts of interest and material conflicts of interest, proposed Reg. BI also distinguishes between conflicts that “arise from financial incentives” and those that do not. We believe that, as described in the Reg. BI Proposal, the majority of material conflicts of interest are likely to be financial in nature. Consequently, the SEC should either (a) provide more guidance on this topic, including examples of non-financial conflicts, to help firms implement policies and procedures under the Conflicts of Interest Obligation or (b) reconsider whether this distinction between financial and non-financial conflicts is appropriate.

At a minimum, we believe the SEC needs to provide examples of the types of financial conflicts it presumably does not intend to capture, such as bonuses for representatives who meet overall assets under management or revenue targets that are not tied to particular investment products.

If the Commission does not provide more clarity on this point, there is a significant risk that broker-dealers will treat all material conflicts of interest as financial in nature because it will be extremely challenging for firms to identify and mitigate material conflicts of interest. However, if all conflicts are treated as financial in nature, they are subject to the mitigation/elimination obligation. This is not what we understand the SEC to have intended.

In connection with the requirements of policies and procedures, we agree with the Commission’s approach of allowing firms to rely on a “risk-based compliance and supervisory system” instead of “a detailed review of each recommendation of a securities transaction or security-related investment strategy to a retail customer.”

Given the strong criticism of certain types of financial incentives in the Reg. BI Proposal and the Commission's conclusion that disclosure is not sufficient, it is not clear how some financial conflicts could be mitigated without eliminating them altogether. Rather than leaving broker-dealers vulnerable to second-guessing, we ask that the SEC either provide more guidance on how such conflicts may be mitigated or clearly identify a set of financial incentives, such as single-product sales contests, that are prohibited. If such a set is not identified, it is likely that the mitigation/elimination requirement will, in practice, be interpreted to sweep in much more than the Commission intends.

With regard to specific financial incentives, we understand the concerns the SEC has with product-based sales contests. The same concerns do not exist with programs that reward overall asset or revenue growth, or recruitment bonuses tied to assets under management. The Commission has indicated that it may treat these distinct incentives similarly under proposed Reg. BI. The Commission stated that "certain material conflicts of interest arising from financial incentives may be more difficult to mitigate" and noted that "[t]hese practices may include . . . similar bonuses that are based on sales of certain securities *or accumulation of assets under management.*"<sup>23</sup>

Incentives to grow assets or revenue are fundamentally different from sales contests that are based on a particular product. Bonuses tied to an increase in assets under management do not give an incentive to recommend securities that may not be consistent with a customer's best interest, and they are a routine component of a well-rounded compensation package. Moreover, increasing assets under management is a natural outgrowth of serving clients well, and an indicator that clients have benefitted from working with a financial advisor. The unfortunate reality is that many Americans are un- or underprepared for retirement and should be advised about the benefits of increasing their investment assets.<sup>24</sup>

Numerous studies, including *The Role of Financial Advisors in the U.S. Retirement Market*, demonstrate that advised investors, segmented by age and income, have a minimum of 25% more assets than non-advised individuals; and advised individuals

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<sup>23</sup> Reg. BI Proposal, at 183 (emphasis added).

<sup>24</sup> For example, a 2017 report by the Board of Governors of the Federal Reserve System found that 28% of non-retired adults have no retirement savings or pension, including approximately 20% of individuals over 44 years old. See Board of Governors of the Federal Reserve System, *Report on the Economic Well-Being of U.S. Households in 2016*, at 57-58 (May 2017), available at [www.federalreserve.gov/publications/files/2016-report-economic-well-being-us-households-201705.pdf](http://www.federalreserve.gov/publications/files/2016-report-economic-well-being-us-households-201705.pdf).

65 or older with \$100,000 or less of annual income have an average of 113% more assets than non-advised investors.<sup>25</sup> Similarly, a study by Vanguard concluded that financial advisors that adopt the best practices in wealth management could add around 3% in net returns for an investor over the long term.<sup>26</sup> The SEC should not disincentivize the growth of assets under management by conflating related compensation with product-specific sales contests and we request that the SEC confirm that programs that reward asset or revenue growth generally do not raise the same concerns as programs tied to the sale of specific products.

In some circumstances, one product that generates more compensation for the firm than another product may still be in the best interest of the customer.<sup>27</sup> When a product that is more remunerative to the firm or associated person is recommended, a conflict of interest “arising from financial incentives” is present; however, we believe the conflicts in this scenario may be adequately addressed with disclosure. We ask that the SEC clarify if it expects broker-dealers to take additional specific steps to mitigate the conflict and, if so, what types of steps it would expect firms to undertake.

Although the Commission provided some examples of possible ways to mitigate material conflicts of interest that arise from financial incentives, we believe the SEC should provide further guidance on how firms are to determine how much mitigation is sufficient since, as is evident in the Reg. BI Proposal, the Commission has concluded that disclosure is not sufficient. Moreover, some of the potential mitigation actions the SEC listed, such as basing product compensation on “neutral factors” or “time and complexity” are not feasible and, instead, are likely to result in a reduction of products that are offered to retail customers and could introduce new conflicts of interest. Although the Commission has determined that disclosure appears not to be sufficient, we believe disclosure does mitigate material conflicts of interest, and we request that the Commission explicitly acknowledge disclosure’s place in mitigating conflicts. Failure to provide clarity on the mitigation of financial

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<sup>25</sup> *The role of financial advisors in the US retirement market*, July 10, 2015, available at <http://www.fsroundtable.org/wp-content/uploads/2015/07/The-role-of-financial-advisors-in-the-US-retirement-market-Oliver-Wyman.pdf>.

<sup>26</sup> *Putting a Value on Your Value*, Sept. 2016, available at <https://www.vanguard.com/pdf/ISGQVAA.pdf>.

<sup>27</sup> “[T]his does not mean that a broker-dealer could not recommend the more remunerative of two reasonably available alternatives, if the broker-dealer determines the products are otherwise both in the best interest of— and there is no material difference between them from the perspective of— the retail customer, in light of the retail customer’s investment profile.” Reg. BI Proposal, at 56.

conflicts, including which financial conflicts firms must mitigate and how firms can achieve mitigation, could lead to the same consequences as the DOL fiduciary rule in terms of limiting investor choice with respect to the types of accounts available and the products and services made available to brokerage accounts.

The requirement to mitigate or eliminate material conflicts of interest arising from financial incentives in proposed Reg. BI effectively subjects broker-dealers to a higher standard than investment advisers, who are generally able to disclose conflicts of interest. Imposing a standard on broker-dealers with respect to managing conflicts of interest that is greater than that imposed on investment advisers, on top of the additional regulatory obligations to which broker-dealers are subject that are not imposed on investment advisers, threatens to undermine the SEC's objective of preserving retail customer choice and access to the brokerage advice model and may introduce a new source of confusion when it comes to investors' understanding of the duties they are owed..

#### **d. Disclosure Obligations**

Proposed Reg. BI requires broker-dealers to “reasonably disclose” material facts and material conflicts of interest. The SEC has indicated that this standard would require a broker-dealer “to give sufficient information to enable a retail customer to make an informed decision with regard to the recommendation” and that this standard would be measured against a negligence standard, not against a standard of strict liability.<sup>28</sup> The SEC should clarify whether such an interpretation, requiring “sufficient information . . . to make an informed decision” broadens the disclosure obligation beyond “material facts” and “material conflicts” mandated by the proposed regulation.

Although intentional omissions or misstatements would clearly and rightfully be in violation of the provision, it is unclear what would constitute “negligence” under these circumstances.

In addition, we believe the Commission should provide additional insight into what a broker-dealer is required to deliver to a retail customer in order to permit the customer to make an “informed decision.”<sup>29</sup>

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<sup>28</sup> Reg. BI Proposal, at 115.

<sup>29</sup> We note that these same concerns are present with respect to the Commission's use of “informed consent” in the IA Proposal. *See, e.g.*, IA Proposal, at 16 (“The disclosure should be

We request that the SEC confirm that this provision does not require a case-by-case analysis of what is reasonable disclosure to permit the customer to make an “informed” decision. Rather, disclosure that is clear, accurate and detailed enough to inform a reasonable client should be the standard; not an individualized, subjective standard.

CCMC is concerned that broad interpretations would result in lengthy disclosure that could obscure the material information, which is precisely the outcome the SEC indicated it hoped to avoid. The Commission also indicated that “a broker-dealer would not be able to waive compliance with the rule’s obligation to act in the best interest of the retail customer at the time a recommendation is made and the specific obligations thereunder” pursuant to Section 29(a) of the Exchange Act.<sup>30</sup> We request that the Commission confirm that it does not intend to imply that disclosure and client consent constitute an impermissible waiver under the federal securities laws.

#### **e. Proposed Recordkeeping Obligations**

We request the SEC confirm that, except with respect to the specific recordkeeping requirements set forth in the proposed rule text, Reg. BI does not require any additional set of records to demonstrate best interest determinations. We believe that the type of documentation generally maintained by broker-dealers for suitability purposes should be sufficient for documenting Reg. BI determinations and disclosures and that the current recordkeeping obligations in Rule 17a-4 are sufficient.

We also request that SEC confirm that Reg. BI does not contemplate that broker-dealers would create and maintain detailed narratives of why certain products were recommended over others, as the DOL fiduciary rule could have required.

#### **f. Specificity of Disclosure**

We appreciate the notion of a “layered disclosure regime” that is encapsulated in both the Reg. BI Proposal and the Form CRS Proposal. This involves general

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sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest.”).

<sup>30</sup> Reg. BI Proposal, at 80; *see also* IA Proposal, at 8 n.21 (“As an adviser’s federal fiduciary obligations are enforceable through section 206 of the [Investment Advisers] Act, we would view a waiver of enforcement of section 206 as implicating section 215(a) of the Act, which provides that ‘any condition, stipulation or provision binding any person to waive compliance with any provisions of this title . . . shall be void.’”).

disclosures up front, followed by more specific disclosures before or at the time of a recommendation. The Commission clearly indicated that, as proposed, Reg. BI does not impose a strict point of sale or point of recommendation disclosure obligation. We support that position because a mandatory point of sale disclosure requirement would result in significant costs and burdens. We believe that, as described above, addressing the scope of the interpretation of material conflicts of interest will make the Disclosure Obligation manageable. However, clarification and guidance are still needed for certain aspects of the Proposals. In particular, we ask the SEC to provide clarity in the following areas.

The Reg. BI proposal states that written disclosure is not always required, as long as there is at least one initial written disclosure that explains how and when other disclosures may be provided to the retail customer. For example, the SEC indicated that it is acceptable for a broker-dealer to provide a retail customer with a written disclosure explaining the different types of conflicts that may arise in different scenarios and how the broker-dealer intends to disclose such conflicts at a later point in time, including by disclosure in the trade confirmation, assuming there is not a significant time gap between the two events. The SEC provided one example of a situation (i.e., capacity) when it would be permissible to provide a disclosure on a post-trade basis.

We ask the SEC to provide more guidance regarding the specificity of disclosures that must be provided under Reg. BI. For example, what level of disclosure is required when several products meet the same investment objective but have different cost structures, terms, or conditions? We believe the Commission should confirm that it is sufficient to disclose that different products are available with different features rather than require firms to also document why the firm recommended one product over another.

#### **g. Dual Registrant Challenges**

Several aspects of proposed Reg. BI present particular challenges for firms that are registered as both investment advisers and broker-dealers. Perhaps most fundamentally is the recommendation for a customer to move from a brokerage to an advisory account or vice versa. Both the Reg. BI Proposal and the IA Proposal indicate that the recommendation of account type, when it involves securities, is a covered recommendation, but that the applicable standard depends on the capacity in which the firm is acting (e.g., if acting as broker then subject to Reg. BI, if acting as adviser then subject to the Advisers Act). However, it is not clear whether, in this

specific situation, the substantive standards governing the recommendation are different in any material respects. Moreover, to the extent there are any financial conflicts of interest involved in the recommendation, it is difficult to see how such conflicts in this case could be “mitigated” in addition to being fully disclosed, including through provision of Form CRS.

We also ask the SEC to provide clarity regarding the application of the Disclosure Obligation to dually registered broker-dealers and investment advisers and dual-hatted personnel when disclosing the capacity in which they are acting. For example, it is not clear what and how frequently disclosure is required to put a customer on notice of the capacity in which a dually-registered broker-dealer and investment adviser is acting. Although the Commission stated that, with respect to dual-registrants, “delivery of the Relationship Summary and compliance with the Regulatory Status Disclosure would not be considered reasonable disclosure of the capacity in which a dually-registered broker-dealer or dually-registered individual is acting at the time of the recommendation” and that it “would expect a broker-dealer that is a dual-registrant to do more to meet the Disclosure Obligation,” it did not provide sufficient guidance on what “doing more” would entail. Dual-registrants should not have to make an oral disclosure of the capacity the financial advisor is operating in for each and every conversation they are having with their retail customers. Clients may be confused by such redundant communication, and significantly, it may cause them to miss more important disclosures. Such a requirement would not only be redundant, but could adversely impact the conversations between retail customers and their financial professionals and would be challenging for firms to adequately monitor and supervise.

### **C. Proposed Form CRS**

CCMC generally supports the concept and idea of layered disclosure; however, Form CRS as proposed needs some enhancements. According to a poll commissioned by CCMC, 96% of U.S. investors report that they trust their financial professional and 97% believe their financial professional has their best interest in mind.<sup>31</sup> However, the poll also found that investors are interested in additional disclosures. When the SEC’s proposed Form CRS was described, 72% of investors

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<sup>31</sup> CCMC commissioned an online poll of over 800 U.S. investors who had investments outside of a work-sponsored 401(k) plan, pension, or personal real estate. A report of the results is available on CCMC’s website at [https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/CCMC\\_InvestorPolling\\_v5-1.pdf](https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/CCMC_InvestorPolling_v5-1.pdf).

said they believe the form will improve transparency. CCMC agrees that Form CRS has the potential to benefit investors; however, some aspects must first be changed.

We believe the Form CRS should be less prescriptive and allow firms more flexibility in how to approach the disclosure obligations, particularly regarding page and length limitations. The proposed Form CRS is attempting to explain the differences between technical, nuanced concepts (e.g., “best interest,” “fiduciary,” “recommendations”) in a concise, simple way; however, these are concepts that do not lend themselves to simple description. The page and length limitations imposed by the proposed regulation, coupled with the required disclosure that is mandated by the proposed rules, present a substantial risk of liability for omissions that may be necessary only to ensure the disclosure meets the Commission’s strict formatting requirements. The SEC should account for the fact that any disclosure it requires, when coupled with the formatting and length limitations, necessarily reduces the amount of space individual firms are able to provide their individualized disclosure. The SEC must ensure that it does not force firms to choose between omitting key information and violating the formatting requirements of the rule. Thus, as a general matter, we believe the Form CRS should be less prescriptive and allow firms more flexibility in how to approach the disclosure obligations.

CCMC supports the Commission’s efforts to encourage retail investors to discuss important aspects of their relationship with their financial services provider. However, there is a significant difference between encouraging conversations and requiring specific disclosure, and recordkeeping requirements. Creating supervisory and compliance policies and procedures relating to how financial professionals respond to “key questions” would be extremely burdensome. As a general matter, we urge the Commission to make clear that the questions in Form CRS are designed to be prompts for conversations and that they are not mandatory disclosures.

For example, one of the proposed mandatory questions requires firms to include the following: “Do the math for me. How much would I pay per year for an advisory account? How much for a typical brokerage account?” We believe that answering these questions accurately and completely in practice will prove very difficult for firms, particularly at the outset of a relationship with a retail investor, and could potentially provide retail investors with information that may not prove to be accurate. Although CCMC recognizes and agrees with the importance of accurately disclosing fees and commissions, these particular questions could be extremely challenging for firms to answer in a meaningful way and could create an inaccurate impression for investors. Thus, the Commission should focus on ensuring firms

disclose how fees are calculated and assessed rather than attempt to force firms to quantify fees when numerous variables could affect the calculation.

We also encourage the Commission to resolve the inconsistencies between proposed Reg. BI and some Form CRS disclosures. For example, proposed Form CRS requires broker-dealers that offer recommendations to disclose that “Our interests can conflict with your interests. When we provide recommendations, we must eliminate these conflicts or tell you about them and in some cases reduce them.” Proposed Reg. BI, however, imposes these requirements on “material conflicts of interest” and specifically does not apply to all conflicts. We also question whether such general disclosure provides retail investors with helpful information or whether it merely raises additional questions, such as which conflicts must be reduced. Form CRS should be amended to more clearly reflect the standards imposed by Reg. BI.

We urge the Commission to reconsider the overly broad recordkeeping obligations in the Form CRS Proposal. Because the proposed definition of “retail investor” for purposes of Form CRS and the related recordkeeping obligations include “prospective customers,” the rule essentially requires records of every delivery since every individual is a “prospective customer.” This requirement would impose enormous burdens on firms, which we also believe was not adequately considered in the Commission’s cost estimates to implement Form CRS. We suggest that recordkeeping obligations extend only to those prospective customers that become actual customers. To the extent the obligations extend to recording when a specific document or disclosure was delivered to a customer before he or she opens an account, it is permissible to record only the most recent delivery, not the first one.

## **D. Investment Adviser Fiduciary Guidance**

### **1. Current state**

Investment advisers are fiduciaries. The fiduciary duty of investment advisers is not defined in the Investment Advisers Act of 1940 (“Advisers Act”), but rather has been implied by case law based on the antifraud provisions of Section 206 and the general principles of the law of agency and of trusts. The core principle of the Advisers Act is that an adviser must seek to avoid conflicts, or at least fully disclose them to clients, and put the clients’ interests ahead of its own. As the Supreme Court emphasized when addressing an investment adviser’s obligation to disclose conflicts of interest as a fiduciary: “The [Adviser Act], in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested. To insure this, it

empowers the courts to require disclosure of material facts.”<sup>32</sup> Put simply, disclosure is—and has long been—a key component of the Advisers Act fiduciary duty, and CCMC believes that effective and accurate disclosure should remain central to an investment adviser’s fiduciary obligation.

## 2. Proposed Interpretation

Unlike the situation with proposed Reg. BI, where SEC seeks to raise the bar by establishing a new federal standard of conduct for broker-dealers, here the SEC states that it is merely restating the current state of the law. CCMC believes that a thorough and accurate restatement of the law in this area would improve investor protection by ensuring that all investment advisers are operating with a common understanding of their legal obligations. The Commission should ensure that its “restatement” is precisely that and does not create new obligations or change existing ones.

CCMC believes some aspects of the Commission’s proposed interpretation should be clarified to ensure that the SEC is not introducing new interpretive issues or creating new legal obligations, which is especially critical given the brief and conclusory economic analysis in the IA Proposal concluding that the Commission “expect[s] there to be no significant economic impacts from the interpretation” on the basis that the proposed interpretation “generally reaffirms the current practices of investment advisers.”<sup>33</sup>

We believe that, if the SEC interpretation of the insufficiency of disclosures is adopted as proposed, particularly given the indications that disclosure is not sufficient in some instances, many firms may need to review and revise their existing policies, procedures, and controls in light of the guidance, since disclosure has become a well-established and acceptable means of managing conflicts under the Supreme Court’s *Capital Gains* decision.<sup>34</sup> Specifically, in the discussion of conflicts of interest, the SEC suggests that there may be circumstances when it is not enough for investment

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<sup>32</sup> *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 201 (1963). In that case, the Supreme Court held that “the Investment Advisers Act of 1940 empowers the courts . . . to require an adviser to make full and frank disclosure of his practice of trading on the effect of his recommendations.” *Id.* at 197.

<sup>33</sup> IA Proposal, at 22.

<sup>34</sup> *See Capital Gains*, *supra* note 33, at 186 (“A fundamental purpose, common to these statutes [(i.e., the federal securities laws)], was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*, and thus to achieve a high standard of business ethics in the securities industry.”)

advisers to disclose the existence of a conflict. The questions the SEC raises on the efficacy of disclosure could introduce confusion among investment advisers to the extent it could be read to be in conflict with the Supreme Court's decision in *Capital Gains*.

To avoid introducing new obligations through its interpretation, the SEC should explain more fully when disclosure and consent are insufficient, an investment adviser is expected to eliminate or mitigate the conflict so it can be more readily disclosed. The IA Proposal states that disclosure is not adequate where (i) facts and circumstances indicate that the client "did not understand the nature and import of the conflict" or (ii) the material facts concerning the conflict could not be "fully and fairly" disclosed. The SEC should clarify these statements, explain the difference between eliminating and mitigating a conflict, and provide parameters for advisers to know when a conflict has been adequately mitigated. The SEC stated that it is not changing existing obligations. However, the guidance in the IA Proposal does not articulate the standard as investment advisers and others have understood it, the guidance does not place emphasis on disclosure of conflicts as the means to manage them.<sup>35</sup>

The Proposals, taken as a whole, also raise the question whether the proposed new standards for broker-dealers under Reg. BI, particularly the proposed requirement to mitigate or eliminate certain conflicts that cannot be "fully and fairly" disclosed, are going to be presumed applicable to investment advisers because of their status as fiduciaries. In particular, because the Commission has opted to issue the IA Proposal at the same time as the other Proposals, the IA Proposal must be viewed within the broader context, rather than as a stand-alone document. The SEC should clarify that the new requirements under proposed Reg. BI, for example, will not be a baseline against which investment adviser conduct could be judged given that the regulation, by its terms, does not apply to investment advisers. If so, it would seem that the IA Proposal would be creating new obligations rather than simply providing a textbook summary of an investment adviser's current obligations.

The SEC's discussion of an investment adviser's ability to define the scope of its services and duties by contract also could result in unintended confusion. For example, it is hard to reconcile the SEC's statement that an investment adviser can define the scope of its responsibilities by contract with another statement that an

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<sup>35</sup> See, e.g., *Capital Gains*, *supra* note 33, at 191-92 (noting the intent of Congress to "eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice that was not disinterested").

investment adviser cannot rely on the efficacy of disclosure, which, as we noted above, is the central philosophy animating the federal securities laws more broadly and, in particular, an investment adviser's fiduciary obligation, at least since *Capital Gains*. Some of the issues of concern arise because, unlike the other Proposals, the SEC does not distinguish in the IA Proposal between retail and institutional or other sophisticated advisory clients.<sup>36</sup> Statements about the adequacy of disclosure and the ability to negotiate the scope of duties may be better understood in the context of a retail client.

## **E. Proposals on Enhancing Investment Adviser Regulation**

In the IA Proposal, the SEC discussed three areas in which it is considering new regulatory requirements for investment advisers. The SEC framed this discussion as intended to further the harmonization of regulation between investment advisers and broker-dealers and to enhance the investor protections provided to investment advisory clients. The SEC must carefully weigh the costs and benefits.

While there is the potential for the additional requirements to enhance investor protections, they would also increase the cost of doing business for investment advisers and create a barrier to entry for new firms, particularly for smaller firms. The SEC must ensure that a thoughtful cost-benefit analysis fully supports and demonstrates the need for any additional rulemaking.

### **1. Licensing and Continuing Education**

SEC asked whether investment adviser personnel should be subject to licensing and continuing education requirements under the Advisers Act. Most states require investment adviser representatives who have a place of business in the state to be registered, licensed and/or meet certain other qualifications, and FINRA requires that associated persons of broker-dealers register and meet qualification requirements.

Before developing a single, national continuing education standard, the SEC should elucidate how imposing federal licensing and continuing education requirements on investment adviser personnel will enhance investor protection. As part of its cost-benefit analysis, it should also assess whether any such enhancements would outweigh the costs it could have on smaller firms or on the ability of new advisers to enter the marketplace.

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<sup>36</sup> See IA Proposal, at n.4 (“An investment adviser has a fiduciary duty to all of its clients, whether or not the client is a retail investor.”).

Because the SEC's main purpose in the Proposals is to enhance the protections afforded to retail investors, the SEC should consider limiting any eventual requirements to advisers and employees who deal with retail clients, as the SEC did when it adopted the definition of investment adviser representative.

## **2. Advisory Account Statements**

The SEC is also considering whether registered investment advisers should be required to provide clients with periodic account statements, either directly or through the client's custodian, regardless of whether the adviser is deemed to have custody of client assets under Advisers Act Rule 206(4)-2 or is a sponsor of a managed account program relying on the safe harbor in Rule 3a-4 of the Investment Company Act of 1940. Many investment advisory firms already provide account statements. The Commission should examine existing regulatory requirements and determine whether there are gaps in information that would merit additional rulemaking.

## **3. Financial Responsibility**

The SEC asks whether registered investment advisers should be subject to financial responsibility requirements, including requirements to maintain minimum capital, obtain a fidelity bond, conduct an annual audit, or file audited financial statements with the SEC as part of Form ADV.

As is always the case, the Commission here too must carefully consider the costs and benefits of these proposals including, for example, the fact that investment advisers provide advice and do not hold client assets, which are held at a custodian. Many broker-dealers, on the other hand, do hold client assets. The Commission should therefore consider the risks of an adviser or its personnel misappropriating client assets in light of the requirements of the custody rule and the requirement to disclose on Form ADV Part 2A (Item 18) any financial condition that is reasonably likely to impair an adviser's ability to meet contractual commitments to clients. The SEC should evaluate this issue further to ensure investors are adequately protected.

Mr. Brent Fields  
August 7, 2018  
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### **Conclusion**

We are happy to discuss these issues with you further to help achieve these goals.

Sincerely,

A handwritten signature in black ink, appearing to read 'T. Quadman', with a long, sweeping horizontal stroke extending to the right.

Tom Quadman