

July 30, 2018

**VIA EMAIL to rule-comments@sec.gov**

Brent Fields, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-0609

**Re: Comments on --**

**Regulation Best Interest, Release No. 34-83062; File No. S7-07-18 (April 18, 2018);**

**Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Release Nos. 34-83063; IA-4888; File No. S7-08-18 (April 18, 2018); and**

**Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889; File No. S7-09-18 (April 18, 2018)**

To the Securities and Exchange Commission:

I appreciate this opportunity to comment on the SEC's proposals (referred to together in this letter as the "Proposal") described in the above-referenced package of releases (together, the "Proposing Release").<sup>1</sup> I offer my comments on the Proposal both from my personal perspective as a long-time investor and user of both brokerage and investment advisory services, as well as from my professional perspective as an investment management attorney with over 25 years of experience assisting investment adviser and fund clients in meeting SEC regulatory requirements, including those implicated in the Proposal. However, the comments I offer are my own and do not necessarily reflect the views of any of my clients.

Before I address my specific comments on the Proposal, please note that I believe it would be far better from an investor protection, industry compliance and regulatory oversight/enforcement perspective – as well as accord more closely with reality – if the BD and IA 'silos' embedded in the US securities laws were finally broken down and if BDs and IAs were regulated instead under a broader umbrella as "financial professionals," in a generally more coherent, integrated and uniform fashion.<sup>2</sup> However, I will not focus on that point in this letter, since that approach would require fundamental changes in

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<sup>1</sup> Numerous other self-explanatory abbreviations and shortened references are used throughout this letter for convenience, including references to BDs (broker-dealers) and IAs (investment advisers).

<sup>2</sup> Indeed, but for historical entrenchment, it would make sense to include financial professionals of all stripes under that umbrella, whether they were handling securities, investment advice, commodities, insurance, banking or something else of a financial nature, similar to the approach taken in the UK, where a broad range of financial firms are drawn under a regulatory umbrella overseen by the relevant authorities in place there. See generally <https://www.fca.org.uk/about/the-fca>.

legislation, demanding more significant attention and action than I believe could be achieved by Congress in the current political climate.

Short of implementing a comprehensive “financial professionals” solution as just mentioned, I would alternatively favor eliminating the “broker-dealer exception” (incidental advice/no special compensation) from the Advisers Act. In my view, this would resolve many of the fundamental issues being discussed in the Proposal about whether a particular advisor is a “fiduciary,” as well as eliminate the virtually impossible task of determining, in today’s marketplace, when advice is “solely incidental.”<sup>3</sup> Of course, eliminating the broker-dealer exception would also require federal legislation and may therefore be difficult to achieve as well, although it might be more likely to get passed by Congress than the comprehensive “financial professionals” solution I would prefer.

That said, and recognizing the advantages of not requiring any legislation to address the important issues currently under discussion, I will direct my comments below to the Proposal and focus on how BDs and IAs should be distinguished and regulated at the regulatory level under the current statutory framework.

#### MAJOR POINTS ADDRESSED

1. [WHY SHOULD A UNIFORM FEDERAL FIDUCIARY STANDARD APPLY TO BDs AND IAs?](#)
2. [WHY SHOULD THE “RETAIL CUSTOMER” DEFINITION BE NARROWED TO EXCEPT OR EXEMPT SOPHISTICATED CUSTOMERS?](#)
3. [WHAT KIND OF UNIFORM “LAYERED” DISCLOSURE SHOULD BE REQUIRED FROM BOTH BDs AND IAs?](#)
4. [SHOULD THE RELATIONSHIP SUMMARY BE REQUIRED TO BE FILED IN A STRUCTURED DATA FORMAT?](#)
5. [WHY SHOULD THE COMMISSION AVOID REQUIRING DOCUMENTS BE FILED ON EDGAR?](#)
6. [SHOULD BDs BE PROHIBITED FROM HOLDING THEMSELVES OUT AS “ADVISORS/ADVISERS”?](#)
7. [WHY SHOULD THE PROPOSED IA INTERPRETIVE GUIDANCE NOT BE ISSUED IN FINAL FORM, OR AT LEAST NOT WITHOUT SUBSTANTIAL REWRITING OR RESHAPING?](#)
8. [SHOULD FEDERAL REQUIREMENTS FOR LICENSING, ACCOUNT STATEMENTS AND/OR FINANCIAL RESPONSIBILITY BE IMPOSED ON IAs?](#)

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<sup>3</sup> The broker-dealer exception might have made sense decades ago when advisers and brokers were more distinct in their clientele and operations, but in today’s marketplace, the exception seems anachronistic and unmanageable as a practical matter. For the same reason, the Commission should also eliminate the possibility of BDs acting with discretion over retail customer accounts unless registered as IAs and should pursue that as part of this rulemaking to the extent possible.

## 1. WHY SHOULD A UNIFORM FEDERAL FIDUCIARY STANDARD APPLY TO BDs AND IAs?

### A. BDs are already fiduciaries under state common law and they should have under federal law a fiduciary duty uniform with that applicable to IAs.

- In my view, it is inaccurate and unhelpful to characterize the current debate as whether BDs should be held to a “fiduciary” standard with respect to their customers, or whether instead they should be held only to a “suitability” or “best interest” standard. Characterizing the debate in this fashion misses the critical point that BDs are already fiduciaries to their customers according to general legal principles applicable under state common law.<sup>4</sup> Without using the word “fiduciary,” the Proposing Release reflects this point when it acknowledges that BDs are in a principal-agent relationship with their customers.<sup>5</sup> Under general principles of agency law, of course, agents are fiduciaries to their principals.<sup>6</sup>
- It is no surprise, then, that BDs are already subject to claims against them for breach of fiduciary duty. In fact, according to FINRA statistics, breach of fiduciary duty is the most frequent type of claim brought against brokers in customer arbitrations.<sup>7</sup> Typically, those claims are grounded in the common law of fiduciary duty as in effect at the state level.<sup>8</sup>

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<sup>4</sup> Certainly, the issue of whether and when a BD is a “fiduciary” under the common law of any given state can vary by state and can even vary within a state depending, for example, on whether the BD has discretion. See Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 Villanova Law Review 701, at 712-714 (2010) (Villanova Law Review Article) discussing brokers’ fiduciary obligations under state law. However, a variation in state law does not undercut the main point made here, that BDs -- at least a significant segment of them in a significant number of cases -- are already fiduciaries under state common law, especially when unsophisticated customers are relying on them for advice, and it is therefore not helpful to frame the current debate in a way that ignores, denies or glosses over this point.

<sup>5</sup> See, e.g., Release No. 34-83062 at 15 (April 18, 2018). See also the discussion on the “principal-agent relationship” in that begins at 215 in that Release; and Robert A. Kutcher, *Breach of Fiduciary Duties* (Kutcher) at 7: “The most common basis for imposing fiduciary duties on stockbrokers is the common law agency status they occupy in relation to their customers.”

<sup>6</sup> See Restatement (Third) of Agency §1.01 Agency Defined, which says: “Agency is the **fiduciary** relationship that arises when one person (a ‘principal’) manifests asset to another person (an ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents to so act.” (emphasis added) In addition to agency law, other areas of the common law serve as a source for concepts applied in fiduciary law. See Villanova Law Review Article, *supra* note 4, at 712: “State law in areas such as agency, trust, guardianship, business organizations, and attorney-client relationships is where fiduciary law developed and matured.”

<sup>7</sup> See “Top 15 Controversy Types in Customer Arbitrations” at <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics> showing “breach of fiduciary duty” claims as outpacing all other types of claims listed each year from 2014 through 2018 (to date). Also note that this list includes suitability, fraud, unauthorized trading and many other types of claims that are listed separately but which could be viewed as essentially different types of “breach of fiduciary duty” claims, albeit linked more directly to specific FINRA rules.

<sup>8</sup> See Mark J. Astarita, Esq., Typical Customer Arbitration Claims, at <http://www.seclaw.com/securities-dispute/>.

- So why are a BD’s existing fiduciary duties not more widely acknowledged or talked about today? I suspect this is because state common law duties are not enforced by regulators (SEC, FINRA or state securities agencies) and private plaintiffs (customers) attempting to enforce state common law fiduciary duties are subject to the near universal use of mandatory arbitration clauses in BD-customer agreements that require BD-customer disputes to be resolved through FINRA arbitration rather than pursued in court.<sup>9</sup> As a result, even if customers are successful in stating and proving a common law breach of fiduciary duty claim against a BD, there is a dearth of information available about the details of the claim asserted, which law is applied to the claim, the rationale used to reach the decision, and other key elements that would typically be available if the dispute were heard in court rather than handled in FINRA arbitration.<sup>10</sup>
- In the end, though, no matter what state common law fiduciary duties BDs may already owe to their customers, the real debate under the Proposal boils down to whether a BD should have a clear federal fiduciary duty imposed under federal law, by reading it into or imposing it under the federal securities laws governing BDs, the way a federal fiduciary standard has been read into Section 206 of the Advisers Act governing IAs.<sup>11</sup> In my view, to the extent BDs are not already fiduciaries under the federal securities laws, a BD’s fiduciary duty should be “federalized” in that way and the federal fiduciary duty should be applied uniformly between IAs and BDs, for the reasons explained more fully below.

B. Holding BDs to a uniform federal fiduciary standard offers many needed benefits.

- Interpreting the ’34 Act anti-fraud and other provisions applicable to BDs as embodying a federal fiduciary standard uniform with that applicable to IAs under the Advisers Act would be a proverbial “home run” for accomplishing the SEC’s goals in this rulemaking:<sup>12</sup>

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<sup>9</sup> See Villanova Law Review Article, *supra* note 4, at 704-716, for a detailed discussion of other sources of ambiguity about a BD’s fiduciary obligations. The fact that customers are relegated to state common law claims and FINRA arbitration for enforcing BDs’ existing fiduciary duties should not get lost in this process, since the Proposing Release says that Reg BI is not intended to create any new private rights of action. If that is the case, whatever protection is afforded customers under a new federal “best interest” or other standard might not be enforceable by the customers themselves.

<sup>10</sup> See Villanova Law Review Article, *supra* note 4, at 706-708, for a more complete discussion of the poorly developed legal record created by FINRA arbitrations against BDs.

<sup>11</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (*Capital Gains*) and progeny, in particular *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), and *Transamerica Mtg. Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (*Transamerica*).

<sup>12</sup> Chairman Clayton laid out three key issues with respect to the provision of investment advice to retail investors: first, the longstanding confusion about the different types of financial professionals; second, the legal obligations that investment professionals owe to their customers and clients should be clarified and brought in line with what a reasonable investor would expect; and third, better coordination among regulators. See “The Evolving Market for Retail Investment Services and Forward-Looking Regulation — Adding Clarity and Investor Protection while Ensuring Access and Choice,” Remarks of SEC Chairman Jay Clayton (May 2, 2018) at <https://www.sec.gov/news/speech/speech-clayton-2018-05-02>.

- It would completely eliminate the chance that retail investors would be confused about what standard applies to a BD versus an IA because the standards would be the same for both. Indeed, this is the most logical way to “harmonize” the standard of conduct between BDs and IAs, instead of introducing a new “best interest” standard that has no substantive definition and is not accompanied by a clear explanation of how it differs from an IA’s fiduciary standard.
- Entirely aside from whether investors are confused about applicable standards of conduct, BDs and IAs would be held, as a federal matter, to the highest standard under the law – a fiduciary standard – eliminating the chance that either would be held to a “watered down” standard when providing advice to the most vulnerable investors in the country, retail investors who are trying to secure their financial future, whether for their retirement, their children’s education, covering uninsured medical costs or just trying to make ends meet.
- A uniform federal fiduciary standard would enhance the ability for federal regulators to develop, interpret and ultimately enforce the standard, the way they currently do for IAs under the Advisers Act.<sup>13</sup> While it is unclear whether proposed Reg BI would create new private rights of action against BDs,<sup>14</sup> imposing a uniform federal fiduciary duty on BDs would not be any different than the Commission’s proposed Reg BI in this regard.<sup>15</sup>
- A standard of conduct for BDs commensurate with that applicable to IAs is what Congress contemplated in the Dodd-Frank Act when it authorized the SEC to promulgate BD standard of

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<sup>13</sup> The Commission remains the main driver behind development of the federal fiduciary standard applicable to IAs because there is generally no private right of action under the Advisers Act, in particular Section 206. See *Transamerica*, *supra* note 11, holding that there is no private right of action under the Advisers Act, except a limited right under Section 215 to void or rescind certain advisory contracts and to seek an injunction against continued operation of the contract and restitution. As a consequence, breach of fiduciary duty claims under Section 206 of the Act tend to be brought by the Commission, not advisory clients. Clients wishing to bring fiduciary claims against their adviser must generally pursue avenues other than the Advisers Act.

<sup>14</sup> Although the Proposing Release states that Reg BI would not create new private rights of action, it is unclear whether this would be the case to the extent the “best interest” standard (or a federal fiduciary standard, for that matter) is based on or becomes enforceable through the anti-fraud provisions in Section 10(b) of the ‘34 Act and/or rules such as Rule 10b-5, where private rights of action have been recognized. This contrasts with an IA’s federal fiduciary obligation emanating from the anti-fraud provisions of Section 206 of the Advisers Act because, as previously mentioned, the Supreme Court has already held there is generally no private right of action under the Advisers Act.

<sup>15</sup> Aside from the role of private plaintiffs in enforcing Reg BI (or in enforcing a uniform federal fiduciary standard), the question remains what role FINRA would play and, more specifically, whether FINRA would be expected to be inspecting for compliance with the applicable standard and/or bringing enforcement actions against firms that are violating it. News reports suggest it would. See, for example, “Finra anticipates oversight role for SEC advice rule” at <http://www.investmentnews.com/article/20180521/FREE/180529991/finra-anticipates-oversight-role-for-sec-advice-rule> (“[Finra chief executive Robert Cook] said that although [Reg BI] would be an SEC regulation, the agency would lean on Finra to ensure that brokers are following it.....’It’s not our rule,’ Mr. Cook told reporters.... ‘Exactly what the rule means and how it gets overseen is obviously something that we would be working closely with the SEC on.’”)

conduct rules.<sup>16</sup> Moreover, it is what the SEC’s own staff recommended in the 913 Study issued in 2011, for sound reasons explained there.<sup>17</sup>

- Imposing a uniform federal fiduciary standard on both BDs and IAs could also help to forestall further DOL and/or state efforts aimed at imposing their own fiduciary standard on financial professionals, and thereby avoid an even more burdensome and confusing patchwork of regulation at the federal and state levels.<sup>18</sup> If, in the end, the DOL or states are nonetheless permitted to and in fact do impose their own fiduciary standard on financial professionals, at least BDs would already be conducting business according to both a common law and federal fiduciary standard and would not therefore have to reconcile an entirely new federal “best interest” standard with any other regulator’s fiduciary standard.

C. A uniform federal fiduciary standard should not result in undue negative impacts on BDs.

- Importantly, a uniform federal fiduciary standard should not result – or not have to result -- in a cut-back on products and services that BDs make available to retail investors. It would be perplexing if it did, given that BDs are already fiduciaries to their customers under common law, as noted above.
- Significantly, a uniform fiduciary standard would not *per se* prohibit a BD from engaging in all of the transactions involving conflicts of interest that the Proposing Release lists as permissible

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<sup>16</sup> Although the Dodd-Frank Act makes reference to IAs and BDs acting in the “best interest” of their customers, Section 913(g)(2) of Dodd-Frank expressly states that such conduct rules as the SEC may promulgate for BDs “shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2)” of the Advisers Act. (emphasis added) While it is unclear whether the “best interest” standard in Reg BI is “more stringent” than the “suitability” standard imposed by FINRA rules, it is even less clear that it is “as stringent as” (or “no less stringent than”) the fiduciary standard applicable to IAs. This is addressed in more detail later in this letter.

<sup>17</sup> See Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011) (“913 Study”), available at [www.sec.gov/news/studies/2011/913studyfinal.pdf](http://www.sec.gov/news/studies/2011/913studyfinal.pdf). The Proposing Release says that the proposed “best interest” standard in Reg BI “draws from” or “reflects” (Release No. 34-83062 at 66) the uniform standard discussed in the 913 Study, but also that it is not the “same” as (Id. at 64) – indeed is “separate and distinct” from (Id. at 43) -- the fiduciary duties interpreted under the Advisers Act. However, other than pointing out differences in wording, nowhere does the Proposing Release make clear *how, in what ways or to what degree* the standards are different or, more importantly, it does not clearly articulate whether those differences make the “best interest” standard “less stringent” than the standard applicable to IAs.

<sup>18</sup> A uniform federal fiduciary standard would also serve as a more robust basis for preempting state action entirely, at least in the area of regulating the standard of conduct of SEC-registered firms, should preemption be pursued. With respect to IAs, I would note Advisers Act Sections 203A(b) and 222 that already have the effect of preempting certain state laws impacting SEC-registered IAs. The SEC’s interpretation of Section 203A(b) is that it preempts not only a state’s specific registration, licensing or qualification requirements, but all regulatory requirements imposed by state law on SEC-registered IAs relating to their advisory activities or services, except those provisions that are specifically preserved by NSMIA (generally relating to fraud). See Advisers Act Release No. 1633 (May 15, 1997) at 69-73. However, the SEC simultaneously takes the position that NSMIA did not preempt state private civil liability laws. Id. at 73, footnote 152. With respect to BDs, Section 15(i) of the Securities Exchange Act of 1934 also limits state law impacting BDs in certain operational areas.

under proposed Reg BI, such as principal transactions, commission-based compensation, third party compensation, etc.<sup>19</sup> Indeed, IAs under a federal fiduciary standard are already permitted to do all those things, subject to appropriate safeguards such as disclosure and consent.

- Despite this, we have all read or heard about BDs that are, for example, “dropping” commission-based IRAs from their offerings or “pushing” investors (particularly smaller investors) into fee-based accounts, in the context of the BDs becoming “fiduciaries” for the first time under the DOL’s Fiduciary Rule.<sup>20</sup> In my view, the Commission should look particularly carefully and critically upon arguments made that BDs would have to cut back on products or services they offer if they were held to a federal fiduciary standard similar to that for IAs. To the extent BD cut-backs were or are in fact happening as a result of the now invalidated DOL Fiduciary Rule, the Commission should question whether that was for reasons particular to that rule,<sup>21</sup> which would not apply in the same way if the IA federal fiduciary standard were made uniformly applicable to BDs.<sup>22</sup>

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<sup>19</sup> Release No. 34-83062 at 53-54.

<sup>20</sup> See, for example, <http://time.com/money/5011799/fiduciary-rule-obama-wall-street-payday/>. For all the talk about “preserving choice” in the Proposing Release, the release does not clarify (for me anyway) why, in what way or to what degree investors’ choice would be any narrower if the IA fiduciary standard were made uniformly applicable to BDs than it would be if BDs were made subject to Reg BI. Unfortunately, there simply seems to be a lot of deference given to assertions from the BD industry that choices would be narrowed, and in large measure due to increased compliance costs that would be necessary if BDs were fiduciaries. That sounds odd, given that BDs (or a significant swath of them) are already fiduciaries under state common law as previously discussed. Nonetheless, if certain customers find that their BDs decide to quit serving smaller accounts when subjected to a fiduciary standard, I would hope and expect that those customers could find many other firms standing ready to provide service for even the smallest accounts, and in an affordable fiduciary arrangement for those customers who desire advice. Moreover, given the speed with which new firms and resources are becoming available to investors who need advice, it appears that new “pay-as-you-go” fee arrangements already exist or may be in the offing without having to continue to rely on the old “commission” model. See Simon-Kucher & Partners Report Explores Eight Innovative Fee Models for Wealth Management (March 14, 2018) at <http://www.simon-kucher.com/en-us/about/media-center/simon-kucher-partners-report-explores-eight-innovative-fee-models-wealth>.

<sup>21</sup> Perhaps most notably this would include the DOL’s rigid and burdensome approach to the “exclusive benefit” (or “sole benefit”) requirement under the fiduciary regime contemplated by the DOL Fiduciary Rule. Importantly, a similar issue should not arise if the federal fiduciary standard applicable to IAs is made applicable to BDs because the “exclusive benefit” aspect of fiduciary duty is approached differently there than under the DOL Fiduciary Rule. For example, IAs rely on making disclosure and obtaining client consent to discharge their fiduciary duty under the Advisers Act in circumstances where the benefit of their advice is not exclusive to the client, meaning where benefits would also flow to the adviser or its affiliates as a result of the IA’s advice. A disclosure-and-consent approach is a much more straightforward and manageable approach than the DOL “exclusive benefit”/PTE approach to conflicts that arise when the benefits of advice are not exclusive, and thus applying over the IA fiduciary standard should not hinder BDs from offering the same products and services they have offered customers historically. To the extent BDs argue that cut-backs would be necessary if they were subject to the federal fiduciary standard applicable to IAs, one would have to wonder if regulatory change were merely being used as an excuse to place BD customers into more profitable fee-based advisory arrangements, furthering a trend that has been happening for decades for economic reasons unrelated to fiduciary status.

<sup>22</sup> Aside from concerns about being held to a fiduciary standard, BDs might also be concerned about being made fiduciaries not only to existing customers but also to prospective customers, such as a 401(k) participant who has not yet done business with a particular BD, but who the BD is ‘advising’ to roll over retirement assets from the

- It is also important to emphasize that having BDs and IAs under a uniform fiduciary standard does not mean that the standard would apply identically to all BDs and IAs alike, any more than it means that the federal fiduciary standard currently applies identically to all IAs. The scope and contours of the fiduciary duty owed by any financial professional depends on the scope and contours of the relationship and agreement between the professional and their customer/client.<sup>23</sup>
  - As you know, there are many types of IA firms today, some of which offer only financial planning, some that offer non-discretionary advice, some that offer full discretionary portfolio management, and so on. Some charge flat fees, some hourly fees, some subscription fees, some asset-based fees, some receive shareholder servicing fees, some receive “commissions” (often in the form of 12b-1 fees, with appropriate BD licensing), and so on. All of these highly variable IA relationships today fit under the “fiduciary” umbrella emanating from the Advisers Act. Similarly, the types of services offered and compensation received by BDs also varies widely but can be accommodated within a fiduciary framework. Indeed, they already are being accommodated within the fiduciary framework under state common law. Moreover, as previously discussed, various common BD arrangements, such as commission-based fees and principal transactions, would not be precluded *per se* even by a federal fiduciary standard.
  - Accordingly, it is not a compelling argument against imposing a federal fiduciary standard on BDs to simply say BDs are different than IAs or that their business models have developed differently over the years. Of course BDs can be different than IAs, even though today they can also be indistinguishable from IAs, at least to a retail investor. By the same token, IAs can be different with respect to one another as well. The point remains that all of those differences can be accommodated in appropriate ways under the fiduciary umbrella and result in a framework that both protects retail investors at the level they expect and deserve and avoids unfairly restricting financial firms.

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participant’s 401(k) into investments in an IRA held at the BD, given that BDs at least arguably are not currently fiduciaries to prospective customers under state common law. Either way, the Commission should hold BDs to a federal fiduciary standard with respect to advice given to the BD’s prospective customers as well as its existing customers, the way prospective clients of IAs are included in Section 206 of the Advisers Act. It seems axiomatic that BDs should not be able to put their interests ahead of those of either an existing or prospective customer, just as they couldn’t if they were IAs under Section 206, or for that matter, if they were BDs covered by proposed Reg BI. Accordingly, subjecting BDs to a uniform federal fiduciary standard should not result in any more cutbacks in products/services than Reg BI, at least as a consequence of including both existing and prospective customers within the protection of the rule.

<sup>23</sup> See *SEC v. Chenery Corp.*, 318 U.S. 80 at 85-86 (1943): “But to say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?” Similarly, see Kutcher, *supra* note 5, at 15-16: “Regardless of the source, it is clear that a stockbroker is burdened with the fiduciary duty to act in the best interest of the customer. The question thus becomes one of scope.” With respect to the related question of whether and to what degree a fiduciary relationship can be shaped by contract between a fiduciary and beneficiary, see generally the discussion at Lorna A. Schnase, “An Investment Adviser’s Fiduciary Duty,” Chapter 8 in Practising Law Institute’s Investment Adviser Regulation Treatise, Third Edition (October 2016) (IA Fiduciary Chapter) at 8-16 to 8-19, available at <http://www.40actlawyer.com/wp-content/uploads/2017/01/1-fid-duty-pli10-2016.pdf>.



- In the same vein, it is misplaced to argue that BDs do not (or should not) have a fiduciary duty to their customers because the BD-customer relationship tends to be ‘transactional’ in nature or because a BD does not have a duty to monitor customer accounts. To the contrary, transactional or limited-scope (including non-monitoring) relationships can be – and already are -- accommodated perfectly well within the fiduciary framework.
  - Witness the many fiduciary IAs that have one-time, ‘transactional’ or client-driven relationships with their clients that do not encompass a duty to monitor or even to follow up. One example is an IA that creates a forward-looking financial plan for its client but agrees with the client that the client will seek out the IA if assistance is needed in implementation or updating the plan. Another example is a client that initiates contact with an IA online and makes one-time or periodic use of the IA’s online asset allocation advice tool. A third example is a client who seeks assistance from an IA for the limited purpose of seeking advice on a particular issue, such as how to divvy up a recent inheritance among asset classes, or how to approach spending down from accounts in retirement, or how to organize and reconcile an investor’s existing securities accounts held at various institutions. Any one of these relationships might include a client that has an “account” with the IA (or the IA’s affiliate) but may well not include a duty to monitor that account. In the course of entering into those types of arrangements, an IA would be expected to disclose any duty to monitor or follow-up (or not), typically in the IA’s Form ADV Firm Brochure,<sup>24</sup> to avoid any misunderstanding on that point.
  - There are undoubtedly cases where customers have misunderstood their BD’s duty or intention to monitor an account, or perhaps even pressed claims against their BD for failing to monitor. However, that misunderstanding will not be cured by watering down the BD’s standard of conduct. That misunderstanding is a communication problem,<sup>25</sup> not a standard of conduct problem. Clearly communicating whether the BD will monitor the account should be addressed in communications between the BD and the customer, most importantly at the time the relationship is formed.<sup>26</sup>
  
- D. Reg BI falls short of a fiduciary standard and short of what retail investors deserve.
  - While Reg BI incorporates a requirement for BDs to act in a customer’s “best interest,” there are key aspects missing from the regulation that would apply if BDs were held to a “fiduciary” standard, as they should be when providing advice to retail investors.<sup>27</sup> While acting in a client’s

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<sup>24</sup> Form ADV, Part 2A, Item 13, specifically calls for disclosure about the IA’s review of accounts or financial plans.

<sup>25</sup> Which one could envision being exacerbated, for example, if the BD rep uses the title “financial advisor,” “wealth manager” or the like, adding to the customer’s confusion about exactly what the BD will be doing.

<sup>26</sup> As such, this problem would be most logically addressed in the context of a disclosure like the Relationship Summary under Form CRS contemplated by the Proposal and/or the BD’s Firm Brochure that I am suggesting below.

<sup>27</sup> Here, I am in part aiming to respond to the question about how Reg BI and a “fiduciary” standard are different. See Remarks of Brett Redfearn, Director, Division of Trading and Markets (May 22, 2018), at <https://www.sec.gov/news/speech/redfearn-remarks-finra-annual-conference-052218>: “To those who think that

“best interest” is certainly a fundamental feature of being a fiduciary, a fiduciary’s obligations go beyond “best interest” and beyond the 3-prong care, disclosure and conflicts obligations laid out in proposed Reg BI. Some of these fiduciary obligations are discussed below and are among the ways that the standard set by proposed Reg BI could be viewed as “less stringent” than the standard to which IAs are held under Section 206, contrary to what Congress had in mind under Section 913(g)(2) of Dodd-Frank.

- First and foremost missing from Reg BI are what might be called qualitative, state of mind aspects that support a fiduciary relationship being one of “trust and confidence,” a bedrock concept in fiduciary law. These are aspects that would foster trust between investors and their BDs and give investors good reason to be confident that their BDs are on “their side” aiming to “do the right thing.” Together, these aspects infuse the fiduciary relationship with a sense of fidelity and trust, which could benefit not only a BD’s individual customers, but also help shore up public confidence in the financial services industry as a whole.<sup>28</sup> These aspects make being a fiduciary a status<sup>29</sup> and not just a 3-box checklist (of disclosure, care and conflicts).<sup>30</sup> More than just a thing to be done, being a “fiduciary” is a mindset and an attitude – in an organization, this might be called a “culture” -- that informs the fiduciary’s way of thinking and going, including its motives and priorities.<sup>31</sup> A fiduciary attitude fills the

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[fiduciary] is the key missing standard, please let the Commission know by commenting—and be specific—what is missing from this proposal apart from the word ‘fiduciary.’”

<sup>28</sup> The Supreme Court highlighted the importance of public confidence in *Capital Gains*, *supra* note 11, at 201, where it said about an IA’s fiduciary duty to disclose: “Experience has shown that disclosure in such situations, while not onerous to the adviser, *is needed to preserve the climate of fair dealing which is so essential to maintain public confidence in the securities industry and to preserve the economic health of the country.*” (emphasis added)

<sup>29</sup> By “status,” I do not mean that holding a BD to a fiduciary standard would necessarily have to be applied to any portion of the BD-customer relationship other than that contemplated by Reg BI, that is, when a BD is making a recommendation. While I believe it would be preferable if the federal fiduciary standard were applied to the whole of the BD’s relationship with its retail customer, I believe it is possible for a BD’s fiduciary status to be limited to only portions of the relationship, just as the conduct standards under Reg BI are proposed to be limited, and just as dual-registered BD-IAs today can switch from acting as an IA to acting as a BD (and therefore switch regulatory standards) at different points during a relationship with their customer-client. As such, I do not believe that the main difference between Reg BI and a fiduciary standard is that a fiduciary standard would apply to the “whole of the relationship,” whereas Reg BI’s “best interest” standard does not. In my view, the differences between a fiduciary standard and Reg BI are deeper and more significant than that.

<sup>30</sup> Some may take the viewpoint (see, for example, the remarks *supra* note 27) that Reg BI is not a check-the-box compliance exercise because the “facts and circumstances” approach embodied in Reg BI will require analyzing whether the best interest of a particular customer has been met, which may be different than the best interest of another customer. However, in the end, Section (a)(2) of proposed Reg BI still says that a BD’s best interest obligation shall be satisfied (emphasis added) if the BD meets the three-prong care, disclosure and conflicts obligations laid out in the regulation. To many, that will look like a 3-box checklist.

<sup>31</sup> The futility of trying to capture cultural concepts in a checklist is illustrated perfectly by this story: “Reducing culture to ‘tick box’ compliance won’t help either. Dealing with my late husband’s finances, one bank treated me with callous indifference: ‘We don’t have anyone who deals with bereavement today, come back tomorrow’. Three months later I was still chasing the money. The other gave me tea and sympathy in a private room and paid up almost instantly. Both ticked the ‘bereavement process in place’ box but the experience suggested very different

- gaps between prescriptive requirements,<sup>32</sup> keeping the beneficiary's interest front and center.<sup>33</sup> Looking through the eyes of the beneficiary, the fiduciary asks "how would my beneficiary handle this for themselves if they had my knowledge, skill and experience?"<sup>34</sup> One might say the lodestar that guides a fiduciary is "doing right" by their beneficiary.<sup>35</sup>
- One specific element missing from Reg BI that would reflect this type of qualitative, state of mind being described is the requirement for BDs to act in "good faith."<sup>36</sup> Indeed, this is one of the three fiduciary duties specifically mentioned by the Supreme Court in the *Capital Gains* case.<sup>37</sup> According to the case, courts have imposed on fiduciaries not only a duty to act with good faith, but with "utmost" good faith. It is striking that good faith – or any state of mind for that matter -- is not even mentioned in Reg BI.

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cultures..." Sue Lewis, "Treating Customers Fairly?," Chapter 1:6 in Financial Conduct Authority, *Transforming Culture in Financial Services* (Mar. 2018) at 36.

<sup>32</sup> Chairman Clayton recently addressed gap-filling at financial institutions: "There are many reasons why having a clear mission is beneficial to culture and improving culture. I'll cite one in particular. It fills in the gaps. Organizations with the most comprehensive compliance programs and policies and procedures will inevitably encounter circumstances not contemplated by their policies and procedures. In those situations, what drives how people will act? The law and regulations? What if those also do not contemplate the situation? Or, more significantly, what if the law permits a range of actions with some that, while legal, can cause significant harm. In these circumstances, those on the front lines, those making decisions, need a touchstone." See Observations on Culture at Financial Institutions and the SEC, Remarks of Chairman Jay Clayton (June 18, 2018) at <https://www.sec.gov/news/speech/speech-clayton-061818>.

<sup>33</sup> I note in this regard that proposed Reg BI does not require the BD to place the investor's interest first, as is required of IAs as fiduciaries. Rather it merely requires that the BD act without placing the BD's interest ahead of the customer's interest. Although I did not see in the Proposing Release a clear explanation for this difference (BD's interest cannot be "ahead" of customer's interest versus IA client's interest must be "first"), that seemingly small wording difference could potentially allow BDs to engage in conduct under proposed Reg BI that they could not if they were subject to a fiduciary standard. Since it was not explained in the Proposing Release, I would urge the Commission to illuminate the purpose for that difference in this notice and comment process.

<sup>34</sup> Similarly, see Arthur B. Laby, *The Fiduciary Obligations as the Adoption of Ends*, 56 Buffalo Law Review 99, 134-135 (2008) (Buffalo Law Review Article): "Some courts formulate the fiduciary obligation as a duty to treat the principal as the fiduciary would treat himself." (citations omitted)

<sup>35</sup> See Buffalo Law Review Article, *supra* note 34, at 146: "Although the fiduciary may have discretion in the methods used to further the principal's objectives, the fiduciary cannot lose sight of the principal's goals."

<sup>36</sup> It is not a valid objection to imposing a "good faith" requirement on BDs that it is too difficult to enforce a requirement that supposes we can know or prove what is in a broker's mind. To the contrary, many aspects of the securities laws hinge on state of mind elements, such as scienter, willfulness and *mens rea*, to name just a few.

<sup>37</sup> The three fiduciary duties specifically mentioned by the Court were a duty to act in the utmost good faith, a duty to make full and fair disclosure of all material facts, and an affirmative obligation to employ reasonable care to avoid misleading clients. *Capital Gains*, *supra* note 11, at 194.

- Some might argue that adding a good faith requirement in Reg BI would be redundant<sup>38</sup> because if a BD is not acting in good faith, it must be violating its “best interest” obligation or one of the disclosure, care or conflicts obligations contemplated under the proposed regulation. However, I do not believe that is the case, especially given the way that the “best interest” obligation is satisfied under Section (a)(2) of the proposed regulation. Sadly, one could envision at least some BDs who will work hard to check the three “boxes” laid out in Reg BI<sup>39</sup> but who will still engage in practices that violate the spirit of what it means to be acting in a customer’s best interest<sup>40</sup> or, more to the point, do not live up to the very high “fiduciary” standard that justifies the trust and confidence placed in the BD by customers when receiving advice. Adding to Reg BI the requirement for BDs to act in “good faith” would help to fill this gap. On the other hand, imposing on BDs a federal fiduciary duty uniform with that imposed on IAs would do more than help to fill the gap<sup>41</sup>...it would hit the nail on the head.<sup>42</sup>

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<sup>38</sup> Certainly, some authorities do not treat a fiduciary’s duty to act in good faith as a separate duty, but rather treat it as a subset of the duty of loyalty or describe it as the mindset required of a loyal fiduciary. For example, compare Ron A. Rhoades, *What Are the Specific Fiduciary Duties of Those Who Provide Investment Advice to Retail Consumers?* (April 12, 2011) (outline referring to, among others, the duties of care, loyalty and good faith as a “triad” of duties) with *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (explaining that the duty of good faith is essentially a subset or element of the duty of loyalty). However, treating good faith as a subset of loyalty would be less problematic if Reg BI actually imposed on BDs an explicit duty of loyalty. But it does not. Rather, it picks up only certain elements of the duty of loyalty in the “best interest” standard and related disclosure and conflicts obligations. Despite that, a major piece of what Reg BI misses by not simply requiring that BDs adhere to an express “duty of loyalty” (or a fiduciary duty that includes a duty of loyalty) is the less tangible, state of mind aspect of what it means to be “loyal.”

<sup>39</sup> These BDs might reason that they have:

- delivered the Relationship Summary and other required disclosures;
- done the due diligence to establish care;
- implemented all the required conflict policies and procedures;

and, therefore, “by definition” they have acted in the customer’s best interest, according to Section (a)(2) of proposed Reg BI. This line of reasoning illustrates why Reg BI could be viewed as creating a “safe harbor” for BDs that satisfy the three-prong care, disclosure and conflicts obligations, to the extent they are deemed to have acted in the customer’s “best interest” without more.

<sup>40</sup> Recall the bereavement story recounted *supra* note 31.

<sup>41</sup> Even if a full fiduciary standard is not adopted under Reg BI, BDs should at a minimum be required to act in the customer’s “best interest” in addition to fulfilling to the disclosure, care and conflicts obligations referenced in the proposed regulation. That way, BDs would have to meet some substantive standard aside from the three-prong obligations laid out in Section (a)(2). Of course, that might heighten the already significant concern that, outside of the three prongs in Section (a)(2), the proposed regulation does not define what it means to be acting in a customer’s “best interest.”

<sup>42</sup> In response to those who argue that “fiduciary” would need its own definition if adopted as the federal standard for BDs, I would point out how unnecessary that would be given that IAs have been subject to a federal fiduciary duty for decades without a specific definition. See Arthur B. Laby, *Current Issues in Fiduciary Law, SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940*, 91 Boston University Law Review 1051 (2011) (BU Law Review Article) at 1089-1100, for a discussion of the source and content of fiduciary law under the federal fiduciary standard. Along the same lines, if the Commission intends Reg BI to be tantamount to a fiduciary duty, I

- Also missing from Reg BI are the ‘qualitative’ requirements that BDs must deal with their customers fairly and honorably, two more elements reflected in *Capital Gains* and essential to creating a relationship of trust and confidence between financial professionals and their retail customers, in addition to building public confidence in the industry as a whole.<sup>43</sup>
  - One might be tempted to fill this “gap” by pointing to FINRA rules. However, it should be noted that BDs have no explicit FINRA requirement to deal fairly with customers as a general matter. The fundamental responsibility for BDs to deal fairly used to appear only in Interpretive Material (IM-2310-2) under old NASD Rule 2310. Now, it appears only in the Supplementary Material to FINRA Rule 2111 (the Suitability Rule), which says: “Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing.” (emphasis added)<sup>44</sup>
    - Contrast this with the approach taken in the UK, which treats fairness as a bedrock principle impacting every aspect of the financial firms regulated there: “Fair Treatment of Customers > All firms must be able to show consistently that fair treatment of customers is at the heart of their business model.” (emphasis added)<sup>45</sup>
  - Equally concerning is that, while FINRA rules make reference to honor and fairness (worded as “just and equitable”) of a sort, they do so in a manner that is at odds with the concept of a fiduciary. For example, the requirements under FINRA Rule 2010 call for BDs to observe high standards of “commercial” honor and just and equitable principles of “trade,” emphasizing the arm’s-length, business nature of the BD-customer relationship, rather than aligning with the personal – even intimate and confidential<sup>46</sup> -- nature of the typical “fiduciary” relationship where one party, like a retail investor, has reposed trust and confidence in another, like their financial professional.
  - In my view, requiring a BD to deal with its customers fairly and honorably is too important to leave FINRA as the primary – if not the sole – definer and enforcer of those standards.<sup>47</sup>

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would urge the Commission to just use the term “fiduciary” as the operative standard for BDs and allow the term as fleshed out by decades of history to simply do its job.

<sup>43</sup> As the Supreme Court referenced is so critical. See *supra* note 28.

<sup>44</sup> While there are other requirements under FINRA rules for BDs to act fairly relative to particular matters (see, for example, FINRA Rule 2121 Fair Prices and Commissions), the general requirement for fair dealing, as noted, appears only in supplemental material stated as an implicit responsibility.

<sup>45</sup> See Fair Treatment of Customers at <https://www.fca.org.uk/firms/fair-treatment-customers>, which also states: “Firms are responsible for making sure customers are treated fairly. Our principles (PRIN) include explicit and implicit guidance on the fair treatment of customers. Principle 6 says: ‘A firm must pay due regard to the interests of its customers and treat them fairly’, but other principles also apply to this area of business behaviour.”

<sup>46</sup> *In the Matter of Arleen W. Hughes doing business as E.W. Hughes & Co.*, Securities Exchange Act Release No. 4048 (Feb. 18, 1948), *aff’d*, *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949) (*Arleen Hughes*) (Commission Opinion): “The very function of furnishing investment counsel on a fee basis -- learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities -- cultivates a *confidential and intimate relationship*....” (emphasis added)

<sup>47</sup> I would similarly urge the Commission not to rely on the so-called “shingle theory” for grounding a BD’s obligation to treat customers fairly. There, too, the obligation is implicit, not explicit, is largely based on

Instead, BDs should be subject to this requirement as part of a uniform federal fiduciary duty enforceable by the SEC.

- Other authorities have used similar ‘qualitative’ terms to define how IAs as fiduciaries must act – aside from the loyalty, good faith, fairness and honor already mentioned -- that reflect the fiduciary relationship being one of trust and confidence. These include, for example, treating clients with “utmost candor” and “rectitude,”<sup>48</sup> and being “honest” or “frank” in disclosure or ensuring that disclosure is “full and frank.”<sup>49</sup> While these specific terms are not used in every case involving an IA, they illustrate the qualitative, state of mind aspects of being a “fiduciary” that go beyond merely taking specific steps such as those called for by Reg BI.
- No doubt, some who read the points made here about being a “fiduciary” will find these qualitative, state of mind concepts just too foreign to match what they believe BDs do and the type of relationship BDs have with their customers. Indeed, some might believe that BDs are merely self-interested sales reps, motivated more by earning commissions and meeting sales targets than enhancing the financial well-being of their customers, or that a BD’s customers do not (or should not) place trust and confidence in them.<sup>50</sup> To the extent those beliefs are true, those BDs in my view should simply not be in the business of giving advice – even incidental advice -- at least not to retail investors. And it seems unassailable that those BDs should not be able to call themselves “advisers” – or otherwise hold themselves out as advisers – when they are not subject to the federal fiduciary standard and, to the contrary, are actually acting in an arms-length “sales” capacity. Retail investors are too vulnerable to be left trying to protect themselves in light of the disparities in power, knowledge and experience that will likely exist between the investors and their BDs. Even if it is disclosed that their BD is not a fiduciary, retail investors may well not understand that disclosure, or equally concerning, they may not understand the significance of the disclosure to them. Even the few investors who understand the disclosure are unlikely to know what their options are for protecting themselves in light of that disclosure, or to know how to pursue other options as a practical matter.
- For all these reasons, I urge the Commission to impose on BDs a federal fiduciary duty uniform with that applicable to IAs under the Advisers Act when BDs are making recommendations to retail customers.

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commercial standards, not fiduciary standards, and has an unclear legal underpinning. See Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 Wash. & Lee L. Rev. 1271 (1995) for a more detailed discussion of the shingle theory.

<sup>48</sup> See, e.g., *Patricia Burdett v. Robert S. Miller*, 957 F.2d 1375 (USCA 7th Cir. 1992) (holding that an investment adviser is a fiduciary under Illinois common law and stating that a fiduciary duty is the duty of an agent to treat his principal with the utmost candor, rectitude, care, loyalty, and good faith).

<sup>49</sup> *Capital Gains*, *supra* note 11, at 195–197.

<sup>50</sup> See, for example, Luke Landes, Investing, “Brokers are Salespeople, Not Financial Advisers,” at <https://www.consumerismcommentary.com/brokers-are-salespeople-not-financial-advisers/>; and Bob Clark, “When Is a Salesperson Not a Salesperson? Brokers and Fiduciary,” at <https://www.thinkadvisor.com/2011/03/08/when-is-a-salesperson-not-a-salesperson-brokers-an/?slreturn=20180512150003>.

## 2. WHY SHOULD THE “RETAIL CUSTOMER” DEFINITION BE NARROWED TO EXCEPT OR EXEMPT SOPHISTICATED CUSTOMERS?

If the Commission decides to adopt Reg BI to define a BD’s standard of conduct when providing advice to retail customers, a narrower definition of “retail customer” should be used when crafting that standard.<sup>51</sup> Sophisticated, less vulnerable investors do not need the protections envisioned by the Proposal at a level that would justify the added burden and cost to financial firms of compliance.

- The concept of retail client built into Section 203A of the Advisers Act and related Rule 203A-3 offers a springboard for the definition of “retail customer” under the Proposal. Rule 203A-3 includes all natural persons other than “excepted persons” and uses wealth and knowledge standards typical under the securities laws as a proxy for determining which persons should be “excepted,” as essentially not needing the protections offered.
- As such, I would urge the Commission to define “retail customer” in the Proposal following the definition effectively woven into Advisers Act Rule 203A-3. This would serve to narrow the definition and would adopt a known regulatory definition that is consistent with that applicable in the regulation of IAs and used for similar purposes.<sup>52</sup>
- Following the lead of Rule 203A-3, “retail customer” would include all natural persons except “qualified clients” as described in Rule 205-3(d)(1). The “qualified clients” exception would take out of the definition of “retail customer,” in essence, natural persons: (1) who have with more than \$1,000,000 in their account with the BD; (2) who have more than \$2,000,000 in net worth (as defined), or who are “qualified purchasers” as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940 (which covers wealthy investors using different measures); or (3) who are certain high-level or knowledgeable officers, directors or employees of the BD.<sup>53</sup>
- It would also appear appropriate for the definition of “retail customer” to include the legal representatives of a retail customer (such as the trustee of a retail customer’s personal trust), so

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<sup>51</sup> This is particularly the case if the Commission decides to impose a prescriptive regulation-based “best interest” standard on BDs with specific disclosure, care and conflict obligations as proposed. It would arguably be less important to narrow the definition of “retail customer” for purposes of defining a BD’s standard of conduct if the Commission decides to impose on BDs a principles-based federal fiduciary duty uniform to that applicable to IAs, assuming the federal fiduciary standard were allowed to operate for BDs as it does for IAs, giving them the flexibility to shape the contours and terms of their relationships with their clients, and the disclosures they provide them, depending on the client’s level of sophistication and investment acumen. See *Heitman Capital Management, LLC* (SEC No-Action Letter, publicly available February 12, 2007) at <https://www.sec.gov/divisions/investment/noaction/2007/heitman021207.pdf>.

<sup>52</sup> For the sake of consistency with other rules already applicable to BDs, there is some appeal in narrowing the “retail customer” definition by following the “institutional accounts” exception applicable under the FINRA customer-specific suitability obligation, instead of following Advisers Act Rule 203A-3. However, the FINRA rule creates less of a “bright line” for BDs to follow than the Advisers Act rule. The FINRA rule would also not be familiar to IAs, diminishing the benefit of harmonizing the definition of “retail customer” under Reg BI and the definition of “retail investor” under Form CRS, as I am also urging.

<sup>53</sup> Note that the proposed requirement that the recommendation be used “primarily for personal, family or household purposes” would not need to change.

long as the legal representative were also a “retail customer.” Using that approach, the definition would *include*, for example, the “retail” surviving spouse serving as the trustee of the deceased spouse’s personal trust, but would *exclude* a bank serving as the trustee of that trust.

- For similar reasons, the definition of “retail customer” should include entities/non-natural persons beneficially owned by retail customers (such as a family limited partnership), so long as the ultimate decision maker(s) acting on behalf of that entity with respect to the BD relationship are themselves “retail customers.”
- Furthermore, the definition of “retail customer” for purposes of Reg BI should also be harmonized with the definition of “retail investor” for purposes of determining who should receive a Relationship Summary on Form CRS.
  - Just as sophisticated customers do not need the protection of Reg BI, sophisticated investors do not need to receive a Relationship Summary summarizing information they will likely already know (like what is the difference between a broker and an adviser) or would likely ask for in detail anyway (for example, how is the BD paid and what key conflicts exist).
  - Harmonizing the two definitions will help, in particular, BDs that are required to comply with both Reg BI and rules requiring a Relationship Summary, so they can target their compliance efforts at the correct group of customers without confusion about who is in the group, depending on whether a particular requirement or procedure emanates from Reg BI or from Form CRS.
  - Using Rule 203A-3 as a guide for a harmonized definition of “retail customer”/“retail investor” will also help to make the definition fit with IAs that have retail clients, who will be subject to Form CRS requirements and are likely already familiar with Rule 203A-3 and have the concepts already built into their compliance systems.
- For all these reasons, the proposed definition of “retail customer”/“retail investor” should be narrowed and harmonized as described.

### 3. **WHAT KIND OF UNIFORM “LAYERED” DISCLOSURE SHOULD BE REQUIRED FROM BOTH BDs AND IAs?**

The Commission should require “layered” disclosure from both BDs and IAs but should require an approach different than that laid out in the Proposal. SEC rules should require 3 types of disclosure documents from both IAs and BDs to retail investors: (1) an Educational Comparison Piece; (2) a Relationship Summary; and (3) a Firm Brochure. Each is discussed more below.

- (1) Educational Comparison Piece. This one-page document should be produced by the SEC<sup>54</sup> and should compare typical IAs and BDs<sup>55</sup> side-by-side on key components of the relationship

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<sup>54</sup> While the SEC has not historically produced documents required to be delivered to investors by financial firms, it has certainly produced hundreds, if not thousands, of documents intended to educate the public on matters relating to investments. Moreover, the SEC is already largely dictating the IA versus BD comparison language for the Form CRS Relationship Summary proposed in the Proposing Release and it would therefore not have to draft from scratch the comparison information for this piece I am suggesting. On a related note, perhaps various other state and federal regulators/organizations could coordinate on this effort to make the Educational Comparison Piece as effective as possible.

<sup>55</sup> It would be even more helpful if the piece at least referenced other types of financial professionals (by title, designation, etc.) that investors might run into -- such as financial planners, wealth managers, insurance agents,



(typical fees, general standard of conduct (if different), etc.), along the lines of those proposed in the Proposing Release for the Relationship Summary.<sup>56</sup> This piece – and the substance contained in it – should become the centerpiece of an SEC investor education campaign, aimed at educating the public about the various investment professionals available to help investors with their investments. This should appear posted not only on investor.gov,<sup>57</sup> but should be circulated by all the other means of communication utilized by the Commission to educate the public (YouTube, email, facebook, Twitter, etc.). While the SEC’s own efforts on this should be pursued regardless, the Commission could also require BD, IA and dual-registered firms to deliver the SEC-produced Education Comparison Piece to retail investors when (for example, at inception of the relationship) and in a manner (for example, if delivered along with other documents, in the top few documents presented to ensure it does not get “buried”) similar to that proposed for the Form CRS Relationship Summary in the Proposing Release.

- (2) Relationship Summary. This document should be a short document (I would suggest 2 pages, or one page front and back) produced by each BD, IA and dual-registered firm and should provide firm-specific information on key identified items of the relationship, along the lines discussed for Form CRS in the Proposing Release (type of firm (BD or IA), specific fees, whether the firm monitors, etc.). In effect, the Relationship Summary could serve as a Summary Firm Brochure for both IAs and BDs (see more on this in point (3) below),<sup>58</sup> as it could be envisioned that the summary information in the Relationship Summary would be linked to and explained in greater detail in the Firm Brochure (allowing the Relationship Summary to be one or two pages

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retirement specialists, credit counsellors, etc. – to help investors understand that the central question they need to ask is “who am I dealing with?” and “what can they do for me (or not)?”.

<sup>56</sup> The piece could even be titled something that aims to attract investors’ attention and answer their most basic question, such as “How Do I Decide Between a Broker-Dealer and an Investment Adviser?” It could also include the “suggested questions” list proposed for Form CRS.

<sup>57</sup> Of course, this would go beyond the current investor.gov emphasis on “checking out your investment professional” (BrokerCheck/IAPD) or researching whether a particular person has an enforcement history (SALI). The closest resource I could find currently on investor.gov is the “Ask Questions” brochure ([https://www.investor.gov/system/files/publications/documents/english/AskQuestions\\_brochure\\_508\\_9-20.pdf](https://www.investor.gov/system/files/publications/documents/english/AskQuestions_brochure_508_9-20.pdf)), which is helpful as far as it goes, but does not address the specific questions about IAs versus BDs that are highlighted in the Proposal.

<sup>58</sup> The Relationship Summary might be thought of as a Summary Firm Brochure, somewhat in the nature of a Summary Prospectus that mutual funds are permitted to deliver to investors to satisfy the delivery obligation with respect to the full statutory prospectus, so long as the statutory prospectus is filed and available online in accordance with SEC regulations. See Final Rule: Enhanced Disclosure and New Prospectus Delivery Option For Registered Open-End Management Investment Companies, Release Nos. 33-8998; IC-28584 (Jan. 13, 2009) at <https://www.sec.gov/rules/final/2009/33-8998.pdf>. In the past, I chose not to advocate for IAs to be able to use a Summary Firm Brochure primarily because Firm Brochure information is not susceptible to being shown in a tabular format the way much of the information in a Summary Prospectus can be. See footnote 4 in Comment Letter, dated May 9, 2008, commenting on Release Nos. IA-2711; 34-57419; File No. S7-10-00 at <https://www.sec.gov/comments/s7-10-00/s71000-93.pdf>. Now, ten years later, I believe a Relationship Summary in the nature of a Summary Firm Brochure is worth pursuing so long as it can be kept relatively short (say, maximum 1 or 2 pages), and that delivery of the Relationship Summary satisfies the delivery obligation for the full Firm Brochure posted online.

and still be effective). For stand-alone BD firms, there should be no requirement to show or discuss a comparison to IA firms in the Relationship Summary, and vice-versa for stand-alone IA firms, since the comparison information would appear in the Educational Comparison Piece discussed above. Dual-registered firms should be required to show firm-specific information for both their BD and IA retail investor products/services, but in separate Relationship Summaries and not necessarily in a side-by-side presentation.<sup>59</sup> The Relationship Summary I am suggesting should be required to be delivered along the lines proposed for Form CRS Relationship Summary in the Proposing Release. Firms should also be required to file their Relationship Summary with the SEC, along with their Firm Brochure (see point (3) below). In addition, firms with a website should be required to post their Relationship Summary in a reasonably accessible place on their website and should be required to link the Relationship Summary to the Firm Brochure also posted on their website.

- (3) Firm Brochure. A full “firm brochure” should be produced by each BD, IA and dual-registered firm. The Form ADV Part 2A Firm Brochure would suffice for IAs. BDs should also be required to produce a similar “firm brochure,” which should include material information retail investors ought to know when deciding whether to seek assistance from or do business with a particular BD. Firms should be required to “deliver” their Firm Brochure to retail investors, but the SEC should create clear rules/guidance that deems electronic filing/posting of the Firm Brochure, via the SEC-dictated method, as sufficient to satisfy delivery requirements, so long as the correlated Relationship Summary is actually delivered (in-hand) to investors.
  - Filing through the SEC-dictated database should be required of all firms.
  - Firms with a website should also be required to post their Firm Brochure on a reasonably accessible section of their website, along with and linked to their Relationship Summary.
  - Firms that follow the SEC rules in filing, posting and linking should get the full anti-fraud benefit of the information in the Firm Brochure being deemed “delivered” when the Relationship Summary is delivered, without having to resort to arcane and outmoded language and concepts such as “incorporation by reference.”<sup>60</sup>

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<sup>59</sup> For clarity, it seems more logical that each BD and IA firm should be required to deliver separate Relationship Summaries for each type of “service” or “account” the firm offers to retail customers/clients, with the information tailored for each. For example, if an IA offers retail clients (i) a managed account service providing full discretionary management (asset-based fee, perhaps with 12b-1 “sales compensation” as well); (ii) a managed account service providing non-discretionary management (asset-based or other fee); (iii) a wrap account or sub-adviser selection arrangement (bundled fee) partnering with other BD and/or IA firms; and (iv) financial planning services (hourly fee), then the IA should provide Relationship Summaries for each of those services for which the client is eligible. That might consist of a separate one- or two-page presentation for each service, or if it could be presented in an intelligible manner, one page with each service listed under a separate column of a multi-column presentation. The aim should be to avoid having all of the firm’s offered products/services bunched together into one table (such as all the different fee types listed together, and all the different “account” or “service” types listed together), where correlating the various accounts/services with the correct type of fee would become impossible (the way it is now on Form ADV, Part 1). The Commission faced similar lay-out issues at the time it contemplated the mutual fund Summary Prospectus (Release Nos. 33-8998, IC-28584 (Jan. 13, 2009)) and lessons learned in that context should of course be applied to the Relationship Summary as relevant.

<sup>60</sup> At the same time the Commission should avoid the anti-fraud concerns that doomed widespread adoption of the old Fund Profile (see New Disclosure Option for Open-End Management Investment Companies, Release Nos. 33-7513; IC-23065 (March 13, 1998) at <https://www.sec.gov/rules/final/33-7513.htm#E11E2>), it should also avoid

- This layered approach would have multiple benefits:
  - In the Educational Comparison Piece, all retail investors would receive the same straightforward comparison of IAs versus BDs on the key issues of interest to most investors. This should help investors to better understand the significance of the firm-specific information provided in the other documents by the firm they are contemplating.
  - The Educational Comparison Piece would be supplemented by the firm-specific details in the Relationship Summary. Where appropriate, firm representatives could help investors understand how their firm-specific information relates to the categories shown in the Educational Comparison Piece. The importance of the Relationship Summary would be highlighted since it would be the only other document, aside from the Educational Comparison Piece, that firms would be required to deliver to investors directly. Its short length would encourage investors to actually read it.<sup>61</sup>
  - The Educational Comparison Piece and the Relationship Summary would be supplemented by the details contained in the Firm Brochure. Retail investors that want more detail could find it by accessing the Firm Brochure, available online,<sup>62</sup> avoiding investors being overwhelmed initially by a lengthy Firm Brochure, which could detract from the importance of the other documents being directly provided directly to them (the Educational Comparison Piece and the Relationship Summary). Having the Firm Brochure “delivered” by online filing/posting would, for the first time,<sup>63</sup> truly take advantage of advancements in technology, and the ever-increasing online accessibility to investors, to achieve the best effects of “layered” disclosure: allowing important information to be delivered to investors directly first, in a relatively uncluttered way, and to allow the full detail to be readily accessible to any investor wanting more.
  - With these 3 documents together – the Educational Comparison Piece, the Relationship Summary and the Firm Brochure -- retail investors would receive all material disclosures that a typical investor ought to know in order to make an informed decision about the firm they are contemplating to assist them with their investments.

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perpetuation of legalistic phrases like “incorporation by reference” in documents aimed at retail investors. Retail investors are not likely to understand what it means for a document to be “incorporated by reference” and, instead, precious space and reader attention should be focused on linking and sign-posting investors to where they can find the more detailed information should they want it. The aim should be to afford those registrants that follow the rules the anti-fraud protection that derives from accessible information being considered “delivered” with or included in the more summary documents.

<sup>61</sup> Of course, retail investor testing of the Relationship Summary mock-ups will be critical to understanding what exact lay-out and design maximizes investors’ inclination to read and their ability to understand the disclosure.

<sup>62</sup> Of course, firms should be required to deliver a Firm Brochure directly to those investors who request it. This should apply to the Relationship Summary as well, for investors who request another copy after the initial delivery.

<sup>63</sup> While acknowledging that the Commission has advanced somewhat by now permitting a new delivery method for fund reports under Rule 30e-3, IAs and BDs should not have to mail a paper notice to investors telling them that information is available online, so long as the availability of online detail is included in a Relationship Summary that itself is delivered by regulatorily permitted means (and linked as required).

- In particular, if BDs were required to provide a Firm Brochure, BD customers would receive written information about the *risks* of investing in particular types of investments recommended by the BD. It should be emphasized that the disclosures required by a Firm Brochure are not just a fiduciary issue, they are an anti-fraud issue, and no matter where the Commission comes out on the standard of conduct applicable to BDs (fiduciary versus best interest), retail investors are entitled to all material disclosures necessary for them to make informed decisions, as measured by the standards set under the anti-fraud provisions of the federal securities laws. This basic standard should not vary whether the investor is receiving advice from an IA or a BD. Importantly, the proposed Disclosure Obligation component of Reg BI would fall short in this regard, as it contemplates disclosure “relating to the scope and terms of the relationship” between the BD and its retail customer and disclosing “all material conflicts of interest” associated with the recommendation.<sup>64</sup> While those are important matters for investors to understand, so are the risks of the investments being recommended.<sup>65</sup>
- The Firm Brochure would put into one document the key disclosures an investor should focus on when deciding which financial firm they will choose to assist them, rather than having investors have to hunt around for the details they believe are important in multiple documents or in ephemeral or hard to understand oral disclosures or emails. As noted above, the Relationship Summary should essentially be a summary of key points taken from the Firm Brochure. Like IAs, BDs should be permitted to make material disclosures outside the Firm Brochure as well.
- Another benefit to my suggested approach to “layered” disclosure is that BDs and IAs would be subjected to the same disclosure requirements, so that one type of firm would not be competitively advantaged or disadvantaged relative to the other.
- The “layered” approach proposed in the Proposing Release raises a number of problems and should not be implemented, for the reasons outline below.
  - First, it seems particularly unwise to put into the hands of investors – IA investors in particular -- at the initial stages of a relationship *yet another* disclosure document (the Relationship Summary) on top of other disclosure documents, when retail investors understandably become overwhelmed if disclosures are too voluminous or complicated. Under the Proposal, IA clients would receive “in-hand” at the initial stages of an

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<sup>64</sup> Ironically, the Proposing Release mentions the risks of investing principally in the discussion about the care obligation, not the disclosure obligation, and suggests that the BD must understand the risks of the investments being recommended. It says nothing about the customer understanding those risks.

<sup>65</sup> Although, as the Proposing Release pointed out, BDs are already subject to the anti-fraud rules in the '34 Act, it is not clear whether, or how effectively, BDs make disclosures to their customers about matters such as the risks of the types of investments they recommend, which IAs are expressly required to address in Item 8 of their Form ADV Part 2A Firm Brochure. Further, it is unclear whether or how BDs make effective disclosure of these additional matters disclosed by IAs: Types of Clients (Item 7 of Form ADV Part 2A), Other Financial Industry Activities and Affiliations (Item 10), Code of Ethics (Item 11), Brokerage Practices (Item 12), Custody (Item 15), Proxy Voting (Item 17), and Financial Information (Item 18), just to highlight a few of the key items IAs are required to disclose per Form ADV. If these matters are material to IA clients, they would seem equally material to BD customers. And, as with investment risks, a large portion of these listed items would not appear to fall within the Commission’s proposed Reg. BI Disclosure Obligation either.

engagement the Relationship Summary in addition to the already lengthy Firm Brochure. Fewer pages for investors to juggle and absorb seems like a worthwhile goal in this situation, not more, at least when it comes to direct deliveries to investors at the initial stage of engagement.

- Second, the difference in treatment of BDs and IAs is unfair to IAs, putting them at an unwarranted competitive disadvantage. IAs already have the bulky Firm Brochure delivery requirement and adding the proposed Relationship Summary to that stack would exacerbate an already costly requirement and potentially drive away even more prospective clients. Indeed, it could create the unwarranted inference for investors contemplating both BDs and IAs that IAs are somehow riskier than – or more complicated than – BDs due to the volume of the disclosures that IAs are required to deliver.
- Third, the “layered” approach in the Proposing Release does not take full advantage of the many advances in technology – including now widespread consumer access to the Internet -- that have occurred in recent years and could afford significant cost savings and efficiencies. Although the Proposing Release offers BDs flexibility on the form and manner in which they could fulfill their Disclosure Obligation, BDs and IAs would still be required to “deliver” their disclosures to investors, on paper or per earlier Commission guidance on using electronic deliveries. More specifically, IAs would still be required to direct-deliver to clients a Firm Brochure, proposed now *in addition to* a Relationship Summary. Frankly, it is long overdue for the SEC to acknowledge that retail investors do not need -- and probably do not want -- to receive “deliveries” (meaning in-hand direct deliveries) of every document they may choose to consult in making important decisions. As such, IA Firm Brochures (and the BD Firm Brochures I am suggesting) should be deemed “delivered” when filed/posted online, so long as they are properly linked to an in-hand delivered Relationship Summary. This would go a long way to relieving the first point I outlined above about initial deliveries overwhelming investors. If initial direct deliveries were limited to a short Relationship Summary (which links to the Firm Brochure) and the even shorter SEC-produced Educational Comparison Piece, both BD and IA investors would get what they needed -- a summary of key information, along with clear direction to where more detail can be found online for those investors who want it. They might even be more inclined to read it.<sup>66</sup>
- For all these reasons, the “layered” approach to disclosure I have outlined is the alternative approach the Commission should adopt, as it is more efficient, less costly, fairer and, perhaps most importantly, more likely to be effective in actually making disclosure to retail investors.

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<sup>66</sup> Although retail investors may be considered vulnerable when it comes to investment experience and sophistication, that does not mean they are technologically inept. Indeed, among the things retail investors as a whole can probably do very well – maybe better than many investment professionals -- is find something that is reasonably accessible on an Internet website. This is why I am suggesting that firms that have websites should be required to post their Firm Brochures on their website, in a reasonably accessible manner, perhaps even with a link from the Home Page appropriately called “Firm Brochure” (or similarly, “click here for our Firm Brochure”). Of course, senior or other investors who cannot or do not prefer to access materials online will always be able to request direct-delivered paper or electronic documents.

#### 4. **SHOULD THE RELATIONSHIP SUMMARY BE REQUIRED TO BE FILED IN A STRUCTURED DATA FORMAT?**

Yes. In addition to following a “layered” approach to disclosure in this arena, the data contained in the Relationship Summary should be required to be filed in a structured data format, so the document can be utilized as a stand-alone human-readable document and serve as the source for a machine-readable data set.

- Not requiring machine-readability in the Relationship Summary is another way that the Proposal misses an opportunity to take advantage of recent technological advances. This is especially true since the Relationship Summary is intended to be a vehicle not only for investor disclosure, but also a vehicle that retail investors could use for comparing one financial professional to another across key categories (such as fees), whether that is comparing a particular IA to a particular BD, or comparing a particular IA or BD to another firm of the same type. Indeed, facilitating comparisons is one way the power of machine-readable data can truly be unleashed. However, the Proposal currently does not contemplate that the Relationship Summary will be machine-readable and, as a result, retail investors would have to resort to a burdensome, manual, less useful process to make comparisons among firms.
- In this regard, the Commission should take note of its own Deputy Chief Economist’s recent remarks<sup>67</sup> emphasizing the virtues of machine-readability in today’s world. Of particular import is Myth #3 in his remarks -- that retail investors don’t need machine-readable data -- which is not the case. Retail investors may not be able or inclined to build their own algorithms and spreadsheets to manipulate machine-readable data themselves, but third-party providers will likely step in when demand exists to provide investors publicly accessible comparison tools fueled by the machine-readable data made available by the SEC.<sup>68</sup>
- I am cognizant of the burden that would be imposed on IAs and BDs – especially smaller firms – if their Relationship Summary has to be filed in a special format, or filed twice in two different formats, such as HTML and XBRL, so that the document would be readable both by humans and machines. However, there are two mitigating factors that could make requiring machine-readability less burdensome than it would have been in the past, which may well justify this being the time to turn to structured data filings for IAs and BDs.

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<sup>67</sup> See, “The Role of Machine Readability in an AI World,” remarks of Scott W. Bauguess, SEC Deputy Chief Economist and Deputy Director, Division of Economic and Risk Analysis (May 3, 2018), accessible at <https://www.sec.gov/news/speech/speech-bauguess-050318>.

<sup>68</sup> The Deputy Chief Economist’s remarks mention Yahoo and Google Finance, examples of firms that are already providing free access to all investors various financial information derived from structured data contained in public company reports filed with the SEC. If the SEC is not willing to build a publicly-available comparison tool to help retail investors compare financial firms based on their Relationship Summary data, then at least the data should be made publicly available in a machine-readable format for third parties to do so.

- First, to the extent the Relationship Summary could be filed in “Inline” XBRL,<sup>69</sup> making it both human- and machine-readable, then firms could file only one document, but achieve the benefits of what used to take two filings in different formats. This seems preferable to a complete lack of machine-readability and preferable to requiring two filings.
- Second, if instead of requiring BDs and IAs to tag their own Relationship Summary filings in iXBRL, perhaps the SEC could allow firms (if they choose) to file their Relationship Summary through an SEC-controlled portal that would tag the information for the filer as the relevant responsive information is input into particular fields on the portal.<sup>70</sup> This would alleviate the cost, especially for smaller firms, of having to hire the iXBRL expertise necessary to make their Relationship Summary filing in the proper format.
- If a well-constructed pilot program for filing Relationship Summaries in iXBRL is successful, the Commission could then consider the future efficacy of having other required filings – such as Firm Brochures -- filed in iXBRL as well.

5. **WHY SHOULD THE COMMISSION AVOID REQUIRING DOCUMENTS BE FILED ON EDGAR?**

No matter what filing format is ultimately required for the Relationship Summary, the Commission should avoid requiring any Relationship Summary (or other disclosure document called for by the Proposal) to be filed through EDGAR, if that is the database that the SEC expects retail investors to use to find the document once filed.<sup>71</sup> Having BDs file through EDGAR is not necessarily the problem, even though it seems odd for them to file through EDGAR when they already file Form BD through CRD. The problem is relegating retail investors to the task of using EDGAR to search and retrieve documents like a Relationship Summary. EDGAR is just too difficult to use to expect retail investors to actually find what they are looking for.

- Certainly, requiring the Relationship Summary to be delivered directly to investors will help to avoid retail investors having to use EDGAR to find the Relationship Summary in cases where the investor has already made contact with a particular firm. Additionally, requiring a Relationship Summary to be posted on a firm’s website (if they have one) would help in cases where a retail investor is researching a firm but has not yet made direct contact with the firm.
- However, in any other case, if a retail investor is expected to use EDGAR to find a particular firm’s Relationship Summary, they are unlikely to be successful. EDGAR is a highly stylized database and the information stored there is quite the opposite of being “reasonably

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<sup>69</sup> I note that iXBRL is already in use at the Commission in pilot programs for various EDGAR documents and that it has recently been mandated for use under new rules coming into effect in the next few years on a phased-in basis for certain operating company and investment company documents. See Release No. IC-33139 (June 28, 2018).

<sup>70</sup> I am thinking of something akin to the IARD portal that IAs use to input data for their Form ADV Part 1, or the next generation portal with similar capabilities.

<sup>71</sup> The situation would be different if the SEC expects that retail investors will not be relying on EDGAR to find a firm’s Relationship Summary, for example, if the SEC intends to build its own publicly accessible search tool for investors to look up the Relationship Summaries of firms they are researching or if it intends to link the Relationship Summaries of BDs and IAs to results generated through IAPD and BrokerCheck searches.

accessible” to an average Internet user. Indeed, it might more readily be called “public, but hidden” information, to use Commissioner Jackson’s phrase.<sup>72</sup> Even with all the improvements that have been made to EDGAR over the years, it remains one of the most difficult databases for non-professionals -- and many professionals as well -- to use for search and retrieval of particular documents.<sup>73</sup> As such, the Commission should consider any other viable alternative for firms filing a Relationship Summary if retail investors are also expected to use EDGAR for retrieval.<sup>74</sup>

- In the same vein, it is not clear why BDs should be filing their Relationship Summary through a different filing system than IAs (IARD, which is operated by FINRA) and through a different filing system than BDs already use for Form BD (CRD, also operated by FINRA). Moreover, the public-facing components of CRD and IARD -- BrokerCheck and IAPD -- already serve to identify both BDs and IAs that meet search criteria input into the search bar. This makes it even odder for BDs to be filing their Relationship Summary via EDGAR as contemplated by the Proposal. Without pretending to understand all the technical aspects behind these systems, I urge the Commission to steer clear of EDGAR where possible in favor of CRD/IARD as a preferable alternative, if EDGAR is envisioned as the intended retrieval tool for retail investors. This is particularly true if a firm’s Relationship Summary could simply be added to the BrokerCheck/IAPD search result pulled up for that specific firm.

## 6. SHOULD BDs BE PROHIBITED FROM HOLDING THEMSELVES OUT AS “ADVISORS/ADVISERS”?

Yes. Under the Proposal, BDs would be prohibited from using the word “advisor/adviser” in their name or title unless they are registered as IAs. While this offers a partial solution to the confusion that retail investors have long endured about what it means for a financial professional to be an investment adviser, the Commission should go even further and use a principles-based approach to

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<sup>72</sup> Commissioner Jackson’s remarks about “public, but hidden” data can be heard in the webcast of the Commission’s June 28, 2018 meeting when considering agenda Item 2, at: [https://www.sec.gov/video/webcast-archive-player.shtml?document\\_id=062818openmeeting](https://www.sec.gov/video/webcast-archive-player.shtml?document_id=062818openmeeting).

<sup>73</sup> The difficulty of using EDGAR to find a Relationship Summary would be particularly onerous if the search on a particular firm name -- take “Merrill Lynch,” for example -- would retrieve every document filed on EDGAR with the words “Merrill Lynch” in the name. Just try it and you will see. To the untrained eye, the search result looks unintelligible, and there are pages and pages of it.

<sup>74</sup> On a related issue, I would also urge the Commission to consider whether or how the power of blockchain technology can be harnessed in the filing of documents with the SEC, including those under consideration in the Proposal. Specifically, could “proof of existence” or similar blockchain utilities be used as a better alternative? For example, would blockchain allow documents to simply be posted publicly by registrants via the Internet, with the cryptographic “hash” (the encrypted marker generated for that document at the time it is presented to the blockchain) being utilized to verify that the posted version of the document is the final “official” inalterable version (including an inalterable time-stamp of posting)? If so, would this avoid filing the document with the SEC at all, or would registrants then simply have to “file” a link to the document as posted on the Internet (or on the blockchain)? See Steve Cheng, Matthias Daub, Axel Domeyer and Martin Lundqvist, “Using blockchain to improve data management in the public sector” (Feb. 2017) at <https://www.mckinsey.com/business-functions/digital-mckinsey/our-insights/using-blockchain-to-improve-data-management-in-the-public-sector>.



prohibit BDs more generally from “holding themselves out” as IAs,<sup>75</sup> which would of course include using the word “advisor/adviser” in their name or title, unless registered as IAs. This would be far more protective of investors and avoid the obvious “whack-a-mole” problem referenced by Commissioner Stein in her April 18 remarks.<sup>76</sup>

7. **WHY SHOULD THE PROPOSED IA INTERPRETIVE GUIDANCE NOT BE ISSUED IN FINAL FORM, OR AT LEAST NOT WITHOUT SUBSTANTIAL REWRITING OR RESHAPING?**

The Proposed Interpretive Release No. IA-4889 (the “Interpretation”) poses significant problems when addressing an IA’s federal fiduciary duty, to the point where I would urge the Commission not to issue the Interpretation in final form, or at least not without substantial rewriting or reshaping.

Without doubt, IAs are fiduciaries owing important fiduciary duties to their clients. Indeed, one could argue that an IA’s fiduciary duties generally include the key duties referenced in the Interpretation, and perhaps other duties as well, if one considers together the duties that emanate from state common law,<sup>77</sup> as well as those that emanate from federal law, in particular Advisers Act Section 206.<sup>78</sup> However, the Commission has proposed the Interpretation ostensibly aiming to “reaffirm, and in some cases, clarify”<sup>79</sup> an IA’s federal fiduciary duty under Section 206 of the Advisers Act. It is of course important that the Commission not be attempting to interpret an IA’s fiduciary duties – or any other duties for that matter – that emanate from outside the federal securities laws where the SEC does not have jurisdiction or institutional expertise. It is equally important that the Interpretation not serve as a pathway for attempting to “make law,” since the Interpretation has not gone through the requisite legislative or rulemaking procedures required to achieve that end. Indeed, even beyond that, at least one expert source has pointed out that the Supreme Court’s decision in *Capital Gains* – by imposing on IAs a federal fiduciary duty even though the word “fiduciary” does not appear anywhere in the Act, let alone in Section 206 -- might violate

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<sup>75</sup> This should also prohibit BDs from using terms such as “financial planner,” “wealth manager,” or similar terms that imply they are acting in an advisory capacity rather than in a mere sales relationship, again, unless they are duly registered as an IA and actually offering the represented services.

<sup>76</sup> Commissioner Stein’s remarks are accessible at <https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818>.

<sup>77</sup> I am not attempting to address here the complex issue of what state laws have been preempted by the National Securities Markets Improvements Act of 1996 (Public Law 104-290), at least as they would otherwise apply to SEC-registered IAs. I would note, however, that even though the SEC takes the position that NSMIA had a broad preemptive effect over state laws applicable to SEC-registered advisers, it does not take the position that NSMIA preempted state private civil liability laws. See Advisers Act Release No. 1633 (May 15, 1997) at 73, footnote 152.

<sup>78</sup> Of course, other fiduciary requirements may also come to bear on an IA in any given case (Investment Company Act, DOL/ERISA, MSRB, CFP Board and so on).

<sup>79</sup> See the Interpretation at 5.

the Constitutional separation of powers.<sup>80</sup> All of this strongly suggests that the Commission should not release an expansive “interpretation” of an IA’s federal fiduciary duty, particularly one that stretches outside the bounds of settled federal law, which would predictably call into question the legal footing and validity of the Interpretation.

Against that backdrop, allow me to raise the following specific comments on the Interpretation:

A. The Interpretation does not “reaffirm” or “clarify” an IA’s federal fiduciary duty of care, it muddles it at best.

- In my view, one of the most problematic aspects of the Interpretation is that it does not clearly distinguish which of an IA’s duties are “federal” fiduciary duties embodied in Section 206 (where the SEC ostensibly has jurisdiction to interpret) and which are not, even if they may be duties that emanate from other sources, such as state common law.<sup>81</sup>
- One of the most obvious examples of this is the extent to which the Interpretation sweeps an IA’s duty of care into Section 206. To be clear, I am not arguing that an IA does not have a duty of care. I believe it generally does, under state common law as well as under Section 206. However, the discussion of an IA’s duty of care in the Interpretation reads more like a discussion of an IA’s duty of care under state common law than a clearly articulated, well-supported summary of the federal fiduciary duty emanating from Section 206.
  - For example, page 7 of the Interpretation says “An investment adviser’s fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty.” While it may be true under state common law that an IA has a duty of care and loyalty, an IA’s duty of care under the Advisers Act, as discussed more below, has been articulated by the Supreme Court in *Capital Gains* as a duty to employ reasonable care to avoid misleading clients. To my knowledge, there is no federal case, let alone Supreme Court case, holding that Section 206 embodies a broader fiduciary duty of care, in effect, commensurate with a state common law duty of care.<sup>82</sup> Despite this, the Interpretation’s broad statement at best implies – if not outright

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<sup>80</sup> See BU Law Review Article, *supra* note 42, at 1087: “Congress has imposed a federal fiduciary duty in certain circumstances, but not for advisers. By holding that the Advisers Act imposed this duty absent a legislative mandate, the Court arguably breached the Constitution’s division of authority between the legislative and judicial bodies...” (citing the U.S. Constitution).

<sup>81</sup> For a more detailed explanation of why an IA’s federal fiduciary duty and its common law fiduciary duty are not likely to be identical, see IA Fiduciary Chapter, *supra* note 23, at 8-6 to 8-7. See also BU Law Review Article, *supra* note 42, at 1094: “A federal fiduciary standard is likely to differ from state law fiduciary principles and from state law principles of fraud; the question is how.” See also Villanova Law Review Article, *supra* note 4, at 717: “But what does a federal fiduciary standard entail? Although disagreement exists, the standard does not incorporate the entire body of state law with respect to fiduciary obligation. One leading case, *Steadman v. SEC*, [603 F.2d 1126 (5th Cir. 1979), *aff’d on other grounds*, 450 U.S. 91 (1981)], stated explicitly that the federal fiduciary standard of *Capital Gains Research Bureau* encompasses less than the full panoply of common law fiduciary duties.” In a similar vein, the Supreme Court in *Capital Gains* explicitly rejected the idea that Advisers Act prohibitions on fraud and deceit are constrained by principles of common law fraud. *Capital Gains*, *supra* note 11, at 192–95.

<sup>82</sup> Indeed, in the *Steadman* case, referenced *supra* note 81, the 5th Circuit acknowledged the Supreme Court’s statement in *Capital Gains* that the purpose of the Advisers Act was to regulate the fiduciary nature of the advisory

- states -- that there is no distinction between the duty of care as referenced by the leading Supreme Court case on the issue (a duty of care to avoid misleading clients) and the duty of care imposed by state common law (generally regarded as a broader duty).
- Page 9 of the Interpretation raises the same issue, saying “As fiduciaries, investment advisers owe their clients a duty of care.” Cited for this general proposition are: (i) the SEC itself, in a prior release on another subject (proxy voting), which in turn cites (or perhaps mis-cites) *Capital Gains*; (ii) the Restatement (Third) of Agency, which is not purporting to explain Section 206; and (iii) a treatise, which refers to the duty of care but does not refer to the Advisers Act or Section 206. Strikingly, no court case is cited at all. Again, the statement may be literally true – IAs are fiduciaries and, as fiduciaries, they owe a duty of care. But neither the statement on page 9 nor the more detailed discussion that follows acknowledges that an IA’s duty of care under Section 206 – as stated by the Supreme Court – is in substance a duty to use reasonable care to avoid fraud.
  - The entire discussion on pages 9 - 15 of the Interpretation about the specific duties included within a duty of care -- best interest, best execution and monitoring – is similarly supported (or not) by citations to prior statements of the SEC (releases, forms, opinions) or by restatements, law review articles or treatises that generally do not specify whether they are explaining Section 206 or the state common law fiduciary duty. Again, no court opinions are cited,<sup>83</sup> underscoring the question of whether the Commission really is “reaffirming” or “clarifying” what an IA’s existing federal fiduciary duty entails or whether it has instead inextricably muddled the issue by sweeping into broad statements about the federal fiduciary duty concepts that are, if anything, only reflected in other sources of law, such as state common law.
  - The heart of the problem with respect to a duty of care is that the Advisers Act section that serves as the wellspring for an IA’s federal fiduciary duty -- Section 206 – is at its core an anti-fraud section. It is not surprising, then, that *Capital Gains*, the seminal case illuminating an IA’s federal fiduciary duty under Section 206, involved fraud. It is also not surprising, then, that *Capital Gains* characterizes an adviser’s duty of care as the duty “to employ all reasonable care to avoid misleading clients,”<sup>84</sup> i.e., to avoid fraud. Notably, the Court does not say – or imply –

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relationship, but also said: “We do not think this overall purpose is a warrant to read sections 206(1) and (2) of the [Advisers Act]...as the vehicle to reach all breaches of fiduciary trust.”

<sup>83</sup> To the extent *Capital Gains* is cited in footnote 36 of the Interpretation to support the proposition that an IA has a duty to monitor over the course of a relationship, I would simply point out that much has changed in the investment industry since 1963 when *Capital Gains* was decided, and even more so since 1935, the date of the report quoted in *Capital Gains*. At that time, the typical IA engagement likely involved discretionary management of the client’s account, where then, as today, the IA should be monitoring the account to the extent agreed with and disclosed to the client. However, today, IA engagements that do not involve discretionary management are not uncommon and indeed may not involve an “account” at all or an obligation to monitor, follow up or update (such as a one-time financial plan, or one-time use of an IA’s online asset allocation tool), as the Interpretation itself notes in footnote 28 on page 10. I would posit that an IA’s duty to monitor is today viewed more as a duty that the IA and client can readily establish by agreement and disclosure and one that can, in appropriate circumstances, be effectively contracted or disclosed “away.”

<sup>84</sup> *Capital Gains*, *supra* note 11, at 194.

that IAs have a general duty of care enforceable through Section 206, the way a treatise might reference an IA's general duty of care grounded in state common law. Indeed, the Court's statements about care in *Capital Gains* call into question whether an IA's breach of the duty of care would even constitute a breach of the federal fiduciary duty under Section 206 unless it also constituted fraud.

- This is more than merely a question about whether an IA acted with negligence versus recklessness or *scienter* in violating Section 206. Rather, it is a question of whether, if a fraud did not occur, can a breach of the duty of care constitute a federal fiduciary/Section 206 violation at all?
- One example of this might be a so-called "fat finger" trading error, where personnel at an IA firm mis-enter information (wrong trading symbol or number of shares, for example) when transmitting a client trade for execution, resulting in losses in the client's account. This error may have been negligent (for example, inadequately trained personnel) and thus might have violated the applicable state common law fiduciary duty of care. However, unless it somehow operated as a fraud, it is questionable whether that error in and of itself would violate the IA's federal fiduciary duty under Section 206.
- Certainly, circumstances could be envisioned where an IA's breach of the duty of care could operate as a fraud. One example might be an IA that negligently fails to discover that a sub-adviser's performance track record is false and nonetheless uses that information in its own firm advertisements, thus committing fraud.<sup>85</sup> Another example might be where an IA fails to conduct sufficient due diligence on recommended investments so that clients are misled about the investments.<sup>86</sup>
- In a similar way, key aspects of an IA's relationship with its client and duties to which the IA is bound can become a matter of disclosure and thus serve as the pathway toward 'fraud' if the IA fails to perform those duties due to negligence or other actionable breach of care. It is no surprise that IAs whose actions are materially inconsistent with their own disclosure

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<sup>85</sup> This is along the lines of the allegations made in Virtus Investment Advisers, Inc., Advisers Act Release No. 4266 (November 16, 2015) (settled) (IA found to have been negligent in not knowing that a sub-adviser's track record and performance were false, which when used in the IA's own sales literature and other materials resulted in violations of Section 206).

<sup>86</sup> This is the substance of the Grossman case cited in footnote 32 on page 13 of the proposed Interpretation. See In the Matter of Larry C. Grossman, Advisers Act Release No. 4543 (Sept. 30, 2016) (Commission opinion). Although the Grossman case is cited in the Duty of Care/Best Interest section of the Interpretation in support of the general proposition that an IA can be liable if it fails to reasonably or independently investigate investments before recommending them, it should be noted that the breach of care allegations in that case actually involved fraud, in that the IA's failure to investigate investments operated to defraud the IA's clients (through false claims and material omissions). Indeed, the conduct was so egregious that the IA was found to have acted with *scienter*.

- risk committing ‘fraud.’<sup>87</sup> But that does not mean an IA’s duty of care under the federal fiduciary standard is independent of fraud.<sup>88</sup>
- Throughout its 38 pages, the proposed Interpretation fails to reference the most authoritative statement about an IA’s duty of care under Section 206 – that it is a duty to employ reasonable care to avoid misleading clients -- or to acknowledge in any other way that an IA’s federal fiduciary duty is tied to an anti-fraud section under the Advisers Act. Rather, it sweeps into various broad statements about the Advisers Act fiduciary standard duties that are established, at best, only under other sources of law, such as state common law. In that way, the Interpretation winds up muddling<sup>89</sup> an IA’s federal fiduciary duty rather than “reaffirming” or “clarifying” it, most specifically with respect to the duty of care.<sup>90</sup>

B. The Interpretation in many respects appears to be “making law.”

- In addition to muddling the explanation of an IA’s existing fiduciary duties under the Advisers Act, the Interpretation in various areas appears to be “making law.”<sup>91</sup>
- In some areas, the Interpretation wanders outside of settled federal law and makes statements about an IA’s duties and related matters that are not supported by authoritative federal court cases, let alone Supreme Court cases. Indeed, the authorities cited throughout the Interpretation tend to highlight the weak footing the Commission is on when purporting to be “reaffirming” or “clarifying” existing federal law.
  - One example are the statements made about and discussion of an IA’s federal fiduciary duty of care, as I outlined in Section 7.A. above. The Commission may wish that the broad, sweeping statements about the duty of care were reflected settled federal law, but that is currently not the case.
  - Another example appears on page 7 of the Interpretation, where it says an IA’s federal fiduciary duty requires an adviser “to adopt the principal’s [client’s] goals, objectives, or

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<sup>87</sup> This is the line of reasoning used, for example, in Manarin Investment Counsel, Ltd., Manarin Securities Corp., and Roland R. Manarin, Advisers Act Release No. 3686 (October 2, 2013) (settled) (IA charged with breach of fiduciary duty stemming from mutual fund share class selections and misleading best execution disclosures).

<sup>88</sup> In my view, it is unsupportable to argue to that all duty of care violations can be pretzeled into fraud violations by essentially arguing that IAs should have disclosed their lack of care or that they failed to disclose they would be careless and therefore committed a material omission when the breach of care occurred.

<sup>89</sup> Indeed, for the reasons stated, one might argue that the Interpretation in that way misstates the federal fiduciary duty of care.

<sup>90</sup> Broadly speaking, the discussion in the Interpretation about an IA’s duty of loyalty creates the same issue, failing to make any distinction in the duty of loyalty under the Advisers Act and the duty of loyalty that may be imposed under other law, such as state common law. As a practical matter, however, this may be less obvious because breach of loyalty cases frequently involve a conflict of interest – often, an undisclosed conflict of interest – which fits more naturally into the anti-fraud nature of Section 206, unlike breach of the duty of care.

<sup>91</sup> I note Commissioner Peirce’s April 18, 2018 remarks agreeing with this sentiment, at <https://www.sec.gov/news/public-statement/statement-peirce-041818>.

ends.” It cites for this broad proposition a law review article and the Restatement (Third) of Agency. The law review article, as I read it, does not even purport to be explaining or interpreting Section 206, when it discusses how the “adoption of ends” theory could be applied to IAs. And the Restatement, again, while generally supportive of principles that may apply under the state common law of agency, is not an explanation or interpretation of any portion of the Advisers Act.

- Similarly troubling is the discussion in the Interpretation about best execution, which is supported only by statements made in other Commission releases. At this moment, I am unaware of actual court cases that could be added in support of the Interpretation’s statements.
- In other areas, the Interpretation makes significant statements about the scope and nature of an IA’s fiduciary duty – it would seem for the first time – lending further support to the viewpoint that the Interpretation is “making law.”
  - One example appears on page 17 of the Interpretation, which says disclosure of a conflict alone is not always sufficient to satisfy an IA’s duty of loyalty and Section 206 of the Advisers Act. To the extent this statement is intending to interpret an IA’s duty of loyalty aside from Section 206, the Commission ought to steer clear unless that duty emanates from somewhere else under the federal securities law where the SEC has jurisdiction. To the extent this statement is intended to apply to Section 206, I would point out that this is – to my knowledge – the first time the Commission itself has made this assertion in respect of a duty of loyalty and, moreover, I am unaware of any case law or other definitive authority supporting it. Although the Interpretation cites *Capital Gains*, I see nothing in the quoted phrases or the case more generally that adds up to the idea that disclosure alone may not be sufficient to satisfy Section 206.<sup>92</sup> This is particularly problematic given that Section 206 is an anti-fraud section where IAs have for decades relied on disclosure to discharge their obligations under that section.<sup>93</sup>
  - Another example appears on page 18 where the Interpretation says it would not be consistent with an adviser’s fiduciary duty to infer or accept client consent to a conflict where either (i) the 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. It is disturbingly unclear what this statement is intending to overlay – if anything -- onto existing anti-fraud/disclosure requirements under the Advisers Act. Significantly, the one case that is cited in the Interpretation in support, *Arleen Hughes*,

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<sup>92</sup> To the contrary, the Supreme Court’s opinion in *Capital Gains* acknowledges, if not endorses, disclosure as a means for addressing conflicts, stating that the Advisers Act reflects a congressional intent to eliminate, or at least to expose, conflicts of interest. *Capital Gains*, *supra* note 11, at 191.

<sup>93</sup> To be clear, I read the statement in the Interpretation that ‘disclosure alone is not always sufficient’ as being the statement of a legal principle, which I would distinguish from the garden variety fraud scenario where disclosure is not sufficient as a factual matter, such as when disclosure is not full and fair or is not materially complete. The Commission’s statement in the Interpretation implies – or states – that even full and fair disclosure (meaning disclosure that otherwise meets the usual standards applicable under the anti-fraud laws) might in certain cases not be enough to satisfy the “duty of loyalty” under Section 206.

is a Commission opinion that was decided under statutes other than the Advisers Act.<sup>94</sup> Perhaps most strikingly, the statement seems to create a lens through which IAs have not previously been required to look when drafting disclosure and managing client relationships. Does this statement mean that IAs have to test or somehow verify their clients' understanding when providing them disclosure, in order to establish what the client did or did not understand? Or do clients simply have to say – perhaps at an opportune moment after the fact -- “I didn’t understand” in order to establish that they did not consent to conflicts otherwise explained in full and fair disclosure? How is it that material facts “could not be” fully and fairly disclosed, and according to what standard of disclosure and client understanding, other than the anti-fraud standard of “materiality” that has applied for decades? These are just a sample of the profound and novel questions the Interpretation’s statement raises, even if it were intended to “clarify” duties under Section 206.

- In still other areas, the Interpretation purports to be “reaffirming” or “clarifying” propositions relating to certain issues that today would be more accurately described as still evolving, or, in some cases, being hotly contested.
  - For example, page 12 of the Interpretation says: “We believe that an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance.” This statement appears to be aimed principally at situations like mutual fund share class selection, which has recently been the subject of a number of enforcement actions and engendered Enforcement’s recent Share Class Selection Disclosure Initiative, which is still unfolding (even though the initial report date has passed). This statement raises troubling questions,<sup>95</sup> which would be better answered after the Commission has a more complete experience of the SCSD Initiative to inform its position. As it is, the unadulterated statement in the Interpretation, without factual context, not only does not help to clarify the law, it seems to raise even more questions in a hotly contested area that is currently still in flux.
  - Another example of this is the discussion on page 18 of the Interpretation about an IA’s use of the term “may” in disclosure, asserting that an IA disclosing that it “may” have a conflict is not adequate disclosure when the circumstances posing the conflict already exist. Despite this assertion, even one of the Commission’s own ALJs has concluded that use of

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<sup>94</sup> Moreover, despite all the discussion in the *Arleen Hughes* opinion about what the IA’s clients did or did not understand, the Commission’s determination that the IA failed to obtain client consent was based on the conclusion that the IA failed to disclose material facts to the clients whose consent was necessary, completely aside from what the clients might have understood. See *Arleen Hughes, supra* note 46, at the end of Section 3.

<sup>95</sup> For example, what if the lower-cost security is issued by a different fund family? Would that ever be considered “otherwise identical” to another security? What if shares of the lower cost shares are not available through the IA or are not available through the platform utilized by the IA? What if seeking a lower cost fund share class requires the client to purchase the shares through a ‘regular way’/direct subscription, where the shares might in some sense be available to the client but would not be held in the same account(s) as those being advised by the IA?

the word “may” can be appropriate in certain circumstances to disclose contingencies.<sup>96</sup> This serves to highlight the importance of context and facts in cases of fiduciary duty and disclosure and how different, presumably reasonable fact-finders can come to different conclusions about the adequacy of disclosure even on the same set of facts. This makes it particularly concerning for the Interpretation to make blanket statements to the effect that particular wording “is not adequate” when applied to something as contextual as disclosure.

- There are other examples illustrating where the Interpretation could well be viewed as “making law.” I have not attempted to list them all here in the interest of brevity and in the expectation that other commenters will point out even more examples.
- As in other areas of the Interpretation, these examples are in significant measure supported only by citations to Commission opinions or releases, as well as a handful of law review articles and/or treatises. While these sources may be authoritative when discussing general points or to illustrate the types of fiduciary allegations the Commission has made in the context of enforcement, those sources are not necessarily indicative of what Section 206 actually requires of IAs. To that extent, the Interpretation does less to “reaffirm” or “clarify” an IA’s existing federal fiduciary duties under the law, than reach into unsettled legal territory and appear instead to be “making law.”
- Lastly, to reiterate a point made by Commissioner Piwowar relevant to the issue of “making law”: If in this process, the Commission finds that important fiduciary obligations are currently not required by federal law but warrant the imprimatur of the Commission, the Commission should engage in rulemaking, rather than attempting to impose requirements through interpretive guidance.<sup>97</sup> Of course, if the Commission did pursue rulemaking instead of the Interpretation, it would not be the first time the Commission has participated in the proposal and adoption of fiduciary standards for an “advisor,” as the process has already been completed for municipal advisors via rules adopted by the MSRB and approved by the Commission in 2015.<sup>98</sup>

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<sup>96</sup> See *In the Matter of The Robare Group, Ltd., et al.*, Initial Decision Release No. 806, Administrative Proceeding File No. 3-16047 (June 4, 2015). There, an IA used “may” in disclosing that it “may receive” certain compensation in a revenue sharing program because, although the adviser was already receiving compensation under the program, the program agreement provided that the payments could stop at any time and that any party to the agreement could cancel it. The ALJ did not find the disclosure misleading; rather, the ALJ noted that the word “may” accounted for the possible cessation of payments. Although the case was decided differently by the Commission on appeal, see *Advisers Act Rel. No. 4566* (November 7, 2016), the point made here about the importance of facts and context when determining the adequacy of disclosure remains intact. In addition, the citation to this case in the Interpretation suggests that the case may still be under appeal and is therefore still in flux.

<sup>97</sup> See Commissioner Piwowar’s April 18, 2018 remarks at <https://www.sec.gov/news/public-statement/statement-piwowar-041818>. To be sure, this is true not only of the federal fiduciary standard applicable to IAs, but also any fiduciary standard that would apply to BDs if the Commission decides to apply a uniform fiduciary standard to both.

<sup>98</sup> See MSRB Rule G-42 Duties of Non-Solicitor Municipal Advisors at <http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-42.aspx>.



C. The structure and lay-out of the Interpretation adds to the confusion rather than helps to clarify.

- In addition to the problems already mentioned resulting from a blurring of federal and state law and reaching into unsettled territory to “make law,” the structure and lay-out of the Interpretation does not help to “clarify” an IA’s fiduciary duties either. If anything, it adds to the confusion.
- The Interpretation attempts to discuss various fiduciary duties under the key twin headings of duty of care and duty of loyalty. Certainly, various authorities discuss an IA’s fiduciary duties centered around the principal duties of care and loyalty, while others “slice and dice” which duties are considered principal duties and which are categorized under those principal duties differently. This variability in approach can lead to misunderstandings and unclarity, and the Interpretation, in my view, merely adds to the confusion.
  - One example is an IA’s duty to provide advice that is in the client’s “best interest.” This is specifically discussed in the Interpretation under the heading addressing an IA’s duty of care. However, this lay-out overlooks the fact that an IA’s best interest obligation is implicated in both the duty of care (for example, insufficient due diligence on a security leading to an investment that exceeds the risk level that the client and IA agree is best for that client) and the duty of loyalty (for example, recommending that the client invest in a more expensive affiliated mutual fund than another available fund, thereby putting the adviser’s interest ahead of the client’s). Inexplicably, however, best interest is discussed in the Interpretation only under the duty of care heading and is left to simply a passing mention under the duty of loyalty heading.
    - Even more confusingly, proposed Reg BI flips this around. There, the overarching duty is stated as a duty to act in the customer’s “best interest,” and the care obligation is laid out as a component part of “best interest.”
  - Similar to “best interest,” the Interpretation discusses an IA’s duty to seek best execution under the heading of duty of care. However, an IA’s failure to seek best execution could ostensibly result from a breach of the duty of care (for example, negligently choosing to place trades with a broker that is not on the list of brokers approved by the IA and client) or from a breach of the duty of loyalty (for example, placing client brokerage with more expensive affiliated brokers without full disclosure/client consent). Confusingly, however, the duty to seek best execution is not mentioned at all in the Interpretation under the duty of loyalty heading.
  - Duty to monitor is also mentioned in the Interpretation as part of the duty of care. However, as the Interpretation notes, an IA’s duty to monitor depends on the nature and scope of the advisory relationship. As a result, this discussion serves less to illuminate what it means for an IA to have a duty of care that includes monitoring, than to drive home the point that an IA’s fiduciary duties will vary depending on what the client and the IA have agreed the IA will do.
  - The Interpretation’s treatment of two other duties is also puzzling: (i) an IA’s duty to act with utmost good faith is not even mentioned in the Interpretation, aside from the general reference to *Capital Gains* in the second sentence; and (ii) the duty to make full and fair disclosure of all material facts is not mentioned as a main duty, but only in the discussion explaining other duties. This treatment is curious because *Capital Gains* only references

three duties that have been imposed on fiduciaries in its discussion of the history and scope of the Advisers Act, and good faith and disclosure are two of those three. As such, one would expect interpretive guidance summarizing an IA's federal fiduciary duties to highlight those duties. Not highlighting the duty of disclosure is especially perplexing since an IA's federal fiduciary duty emanates from Section 206 of the Advisers Act, the anti-fraud section, which serves as the wellspring for an IA's disclosure obligations entirely aside from its federal fiduciary duties.

- These are but a few examples of how the structure and lay-out of the Interpretation serves to confuse, rather than clarify, an IA's federal fiduciary duties, by organizing and categorizing various duties in an inexplicable way and failing to highlight or mention in any substantive way other duties referenced by the Supreme Court in *Capital Gains*, the most authoritative case about an IA's federal fiduciary duties. And while issues stemming from the Interpretation's structure and lay-out could be considered less grave than the substantive problems posed by the Interpretation discussed in prior sections of this letter, they lend further support to the point that the Interpretation as proposed should not be issued in final form.

D. Why does it matter if the Interpretation raises all these issues?

- Some might try to argue that it does not matter how far afield of settled Advisers Act law the Interpretation wanders since IAs, for the most part, are already acting as if the fiduciary standards described in the Interpretation apply to them. As a result, issuing the Interpretation in final form would have little impact since IAs would not have to do much, if anything, to come into compliance.
  - Even if that were true, there are myriad reasons that IAs might adhere to the standards expressed in the Interpretation, completely aside from their Advisers Act fiduciary duties. Some may simply want to be conservative and avoid issues with the SEC in an examination. Others may be particularly cognizant of their fiduciary duties emanating from other sources, such as state common law, the Investment Company Act, ERISA and so on. Or, IAs might have contractual obligations requiring that they meet certain of the standards referenced in the Interpretation (for example, best execution). Or, they might simply want to adhere to industry "best practices" or might believe, as a business matter, that meeting high standards of conduct will attract more and better clients and employees and enhance their reputation. While economic impact and the cost of compliance are of course important factors to consider in imposing requirements, it certainly does matter what the Interpretation says, even if every IA subject to the Advisers Act were already in compliance with the Interpretation for any of the myriad reasons mentioned, because the Interpretation purports to delineate the range of IA fiduciary obligations that are subject to the reach of the federal government through SEC oversight, inspection and enforcement.
  - Similarly, some may argue that it does not matter what the Interpretation says because the Interpretation is just that – an interpretation – in which the Commission "discusses" its "views" on an IA's federal fiduciary duty. As such, a court deciding any given case could disagree with the Interpretation and decide the case as the court sees fit based on its own view of the law. While that may be true, it does not diminish the fact that a court is likely to afford significant weight to the Commission's interpretive view of the statute it is charged

to administer, which means concerns raised about the Interpretation should not be ignored or treated as if they do not matter.

- In the end, with its muddling and blurring of Advisers Act law with other sources of fiduciary duties, its overreaching into unsettled legal territory, and its confusing structure and lay-out, the Interpretation:
    - does not serve its purported purpose to “reaffirm” or “clarify” existing IA federal fiduciary standards under the Advisers Act; and
    - raises serious questions of whether the Interpretation is actually “making law” through interpretive guidance rather than through a means that comports with applicable legal requirements.
  - Moreover, the Interpretation could serve to raise, highlight or exacerbate a Constitutional issue about the validity of the *Capital Gains* case itself,<sup>99</sup> leaving the Interpretation on even shakier legal ground and potentially undermining the oldest, clearest and most authoritative case decided to date addressing an IA’s federal fiduciary duty under the Advisers Act.
  - Lastly, it should not be overlooked in this debate that Section 206 of the Advisers Act, by its straightforward wording, applies to all persons meeting the Advisers Act definition of IA, whether SEC-registered, state-registered or unregistered.<sup>100</sup> As such, the Interpretation itself could be viewed as having an expansive reach, applying to all IAs, including IAs that, outside of anti-fraud enforcement, are largely not subject to regulation by the Commission.<sup>101</sup>
- E. As a consequence of these issues, the Commission should not release the Interpretation in final form, or if it is released, it should be substantially rewritten or reshaped.
- In light of all these significant issues about the Interpretation, the question boils down to this: Is it “appropriate and beneficial” (as the Interpretation says it is)<sup>102</sup> for the Commission to try to “reaffirm” or “clarify” in “one release” an IA’s fiduciary duty under the Advisers Act? In my view, it is not, at least not if the Commission intends to finalize the proposed Interpretation for that purpose.
    - While the Interpretation says it is addressing an IA’s federal fiduciary duty “in one release,” it simultaneously acknowledges that the Interpretation is intended to “highlight” the

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<sup>99</sup> See *supra* note 80 and text surrounding.

<sup>100</sup> Section 206 of the Advisers Act leads in by saying “It shall be unlawful for any investment adviser....” (emphasis added), which contrasts with other provisions of the Act that specifically apply to advisers “registered under” the Act. That said, it should be noted that the heading of Section 206 still reads “Prohibited Transactions by Registered Investment Advisers” (emphasis added). See <http://legcounsel.house.gov/Comps/Investment%20Advisers%20Act%20of%201940.pdf>.

<sup>101</sup> The Interpretation itself purports to reach all IAs. See Release No. IA-4889 at 21, footnote 54: “Note, however, that because we are interpreting advisers’ fiduciary duties under section 206 of the Advisers Act, this interpretation would be applicable to both SEC- and state-registered investment advisers, as well as other investment advisers that are exempt from registration or subject to a prohibition on registration under the Advisers Act.”

<sup>102</sup> See the Interpretation at 5.

principles relevant to an adviser's fiduciary duty and is not intended to be the "exclusive" resource for understanding these principles.<sup>103</sup> Of course, no "one release" could successfully summarize, let alone fully explain, an IA's fiduciary duty since it is a living, breathing relationship-based concept that has its roots in hundreds of years of legal history. Even the federal fiduciary duty under Section 206 itself is decades in the making and inextricably intertwined with the broader development of anti-fraud law under the federal securities laws, pre-dating even the seminal cases interpreting Section 206.<sup>104</sup>

- As such, I would urge the Commission not to issue the Interpretation in final form, at least not without substantially rewriting it, at a minimum to address the issues raised in this letter and, of course, significant issues raised by other commenters.
- Perhaps more fruitfully than attempting a wholesale rewrite of the Interpretation (which itself would likely warrant more public comment), the Commission could reshape the Interpretation into a straightforward summary of the duties highlighted by *Capital Gains* (as the seminal case), supplemented by a simple listing of all the key SEC materials (releases, opinions, enforcement case orders, Risk Alerts and the like) that speak to an IA's federal fiduciary duty. That way, the Interpretation could fulfill the Commission's intended purpose of reaffirming existing law (meaning specifically *Capital Gains*), as well as aggregating "in one release" all the relevant SEC materials addressing the issue. This could serve as a compendium of sorts for future reference of what the SEC or its staff have "said" about the federal fiduciary duty over the years, without an attempt to "interpret" or "clarify" the materials or to "slice and dice" them into particular categories or correlate the materials to any particular duty. Rather, the materials would simply speak for themselves.
  - In the interest of regulatory simplicity, the Commission could even forego finalizing, rewriting or reshaping the Interpretation altogether and get the same benefit of stating relevant fiduciary materials "in one place" by merely listing them in a "Fiduciary Duty" section of the Division of Investment Management's online Topical Reference Guide.<sup>105</sup>

## 8. **SHOULD FEDERAL REQUIREMENTS FOR LICENSING, ACCOUNT STATEMENTS AND/OR FINANCIAL RESPONSIBILITY BE IMPOSED ON IAs?**

I urge the Commission not to impose federal licensing or account statement requirements on IAs, although IAs with 'custody' should be required to be fidelity bonded, for the following reasons:

- Federal Licensing and Continuing Education for Personnel of SEC-Registered IAs -- To be frank, this appears to be a solution in search of a problem. Imposing federal licensing on SEC-

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<sup>103</sup> Id., footnote 7.

<sup>104</sup> See, for example, *Arleen Hughes*, *supra* note 46, a widely-cited 1948 case explaining a dual-registered BD-IA's fiduciary duty under the federal securities laws, which was not even decided under the Advisers Act.

<sup>105</sup> The Topical Reference Guide can be accessed at <https://www.sec.gov/divisions/investment/guidance.shtml#investment-adviser-resources>. Indeed, given the importance of an IA's federal fiduciary duty, it is curious that a "Fiduciary Duty" section does not appear there already.

registered IA personnel would be completely redundant of the regime already in place for Investment Adviser Representatives (IARs) who are subject to state licensing now. I am unaware of any investor protection goal that would be served, or regulatory “hole” that would be plugged, by imposing a new federal licensing requirement. Moreover, it would simply add to the federal level (and/or shift from the state level) an entire regime of licensing system administration and enforcement that the Commission can ill-afford with its already strained budget and limited personnel.

- While IARs are generally not subject to CE requirements after their initial licensing exam, any CE requirements imposed in the future should remain the purview of the states (for example, through the work being done by NASAA on IAR-CE) in order to better coordinate with state licensing requirements.
  - If, nonetheless, the Commission decides to impose federal licensing or CE requirements on personnel of SEC-registered IAs, redundant state requirements should be clearly and unequivocally pre-empted. Otherwise, the Commission will have just re-created a significant portion of the overlapping federal/state morass of regulation that Congress attempted to eliminate by enacting NSMIA and preempting state regulation of SEC-registered IAs in the first place.<sup>106</sup> Along the same lines, if federal licensing and CE requirements are imposed, the definitions in Advisers Act Rule 203A-3 should be used to determine who must license and be subject to CE. That rule has been the threshold used for the last 20+ years and, unless some material regulatory issue is illuminated that has not been illuminated to date, it would appear rational for the Commission to continue using that existing threshold.
- Provision of Account Statements – A federal regulatory requirement for IAs to send account statements to clients is unnecessary. As noted in the Interpretation, IAs with discretion over client assets are typically already sending account statements, with relevant holdings, and transactions information and, in many cases, accompanied by performance information. Most of those clients also receive account statements from their custodians with holdings and transactions information,<sup>107</sup> as well as confirms for all transactions executed for the account. For IAs with fee deduction authority, both the IA’s statement and the custodian’s statement would typically already show the IA’s fee deduction for the period covered by the statement. For IAs that do not have fee deduction authority, adding an account statement requirement in the Commission’s rules would do nothing to help illuminate the fees the client pays, unless the IA were required to manually add a section to the custodian’s account statement (if an affiliate, for example) or to the IA’s own account statement specifying the fee.
    - For other IAs, an IA “account statement” requirement would be redundant at best. For example, for clients receiving non-discretionary advice from their IA, a custodian is likely already sending the client statements showing all the relevant holdings and transactions information. Although the IA may not be sending its own account statement, in this

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<sup>106</sup> See more on NSMIA and preemption *supra* notes 18 and 77 and accompanying text.

<sup>107</sup> This includes, in particular, those accounts over which the IA has “custody” and is therefore required to establish a reasonable basis for believing that a qualified custodian is sending statements at least quarterly.

situation, an IA “account statement” would appear entirely redundant of information already being provided by the custodian, especially if the IA has fee deduction authority and fees deducted appear as an entry on the custodian’s statement. If not, advisory fees paid would again have to be manually added to the custodian’s statement (if an affiliate, for example) or the IA would have to generate its own “account statement” just for the purpose of showing advisory fees.

- In still other cases, an “account statement” requirement would not make sense. For example, for IAs providing one-time or similarly limited financial planning services, the IA might not even have complete or on-going access to the client’s “account” information to generate an “account statement.” There, the documentation the IA creates may be limited to the materials generated to explain or illustrate the actual financial plan. Aside from that, the IA may send the client a bill, but nothing akin to an “account statement.”<sup>108</sup>
- That said, I believe IA clients – and BD customers for that matter – should receive enough information that they can understand the fees and costs they are paying. I strongly suspect, however, there would be a better way to do that than imposing an “account statement” requirement on IAs. While it would be premature to impose at this stage, I urge the Commission to look into – and seek comment on -- a more straightforward requirement to achieve those ends, for example, a simple requirement that IAs make written disclosure to their clients of the fees (dollars-and-cents) paid by the client (or for its account) to the IA. This requirement could be fulfilled directly by the IA or by the custodian if the IA has reasonable basis to believe the information appears on the custodian’s statements. For IAs with fee deduction authority, this requirement would ostensibly not add anything new, as that information would typically already appear on the IA’s account statement and/or the custodian’s account statement. For IAs that do not have fee deduction authority, specific fee disclosure could be sent, for example, each quarter along with the IA’s bill for services or the receipt for payment, or whatever other documentation the IA creates in the process of collecting fees from the client. Similarly, one-time financial planner IAs could fulfill the requirement by tendering a bill upon delivery of the financial plan.
- Aside from a more straightforward requirement like that just described, I would urge you to consider the following additional aspects of fee and cost disclosure:
  - Clients who pay on-going fees should receive disclosure of the fees they have paid on some logical interval, say, quarterly. I would also urge the Commission to explore the feasibility of that information being provided on a year-to-date (or some similar) accumulated basis as well, so clients can better understand how the fee is adding up over time.
  - BDs should be subject to parallel requirements. Even if the commissions/mark-ups the BD receives are noted on individual confirms, that information should be aggregated

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<sup>108</sup> This tends to highlight a problem throughout the Proposing Release, that there is so much focus on “accounts” and “types of accounts” and an underlying assumption that all IA engagements involve accounts with on-going monitoring, that sight is lost of the fact that any particular IA-client arrangement may not involve anything recognizable as an “account,” nor involve monitoring. For example, it would seem more like an apples-to-oranges comparison for an IA that provides one-time financial planning services for a flat fee or hourly fee to have to prepare a Relationship Summary comparing that arrangement side-by-side with a hypothetical brokerage “account.”

somewhere (on an “account statement,” for example) for the customer, for both the quarterly period (or other period covered by the statement) plus on a YTD accumulated basis. Again, the aim would be for customers to better understand how small periodic amounts are adding up over time.

- It would also be beneficial, to the extent feasible, if the actual costs charged to the investor associated with having an account were also included in this disclosure in some way (such as account opening costs, account closing costs, annual account maintenance costs, account inactivity costs, SEC ticket charges, whatever other types of costs clients are actually paid by the investor to the IA or BD), so that investors can understand what the arrangement entails on an “all-in” basis, not just the “fees” charged for advice.
- I would also urge the Commission to consider further how investors should receive personalized information about the costs (dollars-and-cents) they actually pay (or bear) in respect of investments held in their accounts. I recognize that this idea has been considered in the past (multiple times) and that finding a clear, manageable way to do this is challenging at best. However, it remains an area where investors are still largely in the dark. Of course, loads paid to the investor’s BD (or rep) may be simpler to disclose but disclosing, for example, mutual fund costs borne by each shareholder can get complicated, as expense ratios and share prices change throughout the year. And, of course, while the entire fund expense ratio may be borne by the fund investor indirectly, it is not all paid to the investor’s IA or BD. Accordingly, any personalized cost disclosure should not be done in such a way as to mislead investors about who is actually receiving the internal costs of any securities they own.
- Financial Responsibility – I do not believe IA net capital requirements, SIPC membership or additional audit requirements would enhance investor protection to a degree that would be justified by the cost of compliance. In contrast, I continue to urge the Commission to require SEC-registered IAs to obtain a fidelity bond for all IA personnel who have “access” to client funds and securities such that it constitutes “custody” under the Advisers Act custody rule, for all the reasons I have outlined in a previous comment letter.<sup>109</sup> In considering this issue, it will of course be important for the Commission to get an updated understanding of how many SEC-registered IAs or their personnel are currently fidelity bonded, since bonding requirements already exist for many IAs or their personnel arising under ERISA, BD rules (for dual-registered BD-IAs or IAs with personnel licensed as BD reps), mutual fund Board requirements, client contractual requirements, state law and/or other requirements.

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<sup>109</sup> I advocated for IA fidelity bonding in 2009 in connection with comments submitted on the Advisers Act custody rule. See Question 12 in <https://www.sec.gov/comments/s7-09-09/s70909-344.pdf> at pages 15-17. For the sake of brevity, I will not repeat all those points here.

Thank you for considering my comments. If you have any questions or would like any further clarification about these or related points, I can be contacted through my professional website.

Sincerely,

*L. A. Schnase*

L. A. Schnase  
Individual Investor and Attorney at Law