D R A F T

Recommendation of the Investor as Purchaser Subcommittee
Broker-Dealer Fiduciary Duty

Findings:

- Both broker-dealers and investment advisers play an important role in helping Americans organize their financial lives, accumulate and manage retirement savings, and invest toward other important long-term goals, such as buying a house or funding a child's college education.

- When the federal securities laws were enacted, Congress drew a distinction between broker-dealers, who were regulated as salespeople under the Securities Exchange Act of 1934, and investment advisers, who were regulated as advisers under the Investment Advisers Act of 1940.

- Over the last several decades, however, the roles of some broker-dealers and investment advisers have converged. While differences remain, many broker-dealers today offer advisory services, such as investment planning and retirement planning, that are similar to the services offered by investment advisers. In addition, many broker-dealers use titles such as financial adviser for their registered representatives and market themselves in ways that highlight the advisory aspect of their services.

- Because federal regulations have not kept pace with changes in business practice, broker-dealers and investment advisers are subject to different legal standards when they offer advisory services. Those legal standards – a suitability standard for broker-dealers and a fiduciary duty for investment advisers – afford different levels of protection to the investors who rely on those services. Key differences include the requirements that investment advisers, as fiduciaries, act in the best interests of their clients and appropriately manage and fully disclose conflicts of interest that could bias their recommendations.

- Investors typically make no distinction between broker-dealers and investment advisers, and most are unaware of the different legal standards that apply to their advice and recommendations. Although many investors don't understand the meaning of "fiduciary duty," or know whether it or suitability represents the higher standard, investors generally treat their relationships with both broker-dealers and investment advisers as relationships of trust and expect that the recommendations they receive will be in their best interests.

- Investors may be harmed if they choose a financial adviser under a mistaken belief that the financial adviser is required to act in their best interest when that is not the case, receive recommendations that comply with a suitability standard but carry additional costs or risks without affording additional benefits, or fail to receive the on-going account supervision that they expect based on the manner in which brokers' advisory services are sometimes marketed.

- Although they are more subtle and more difficult to measure than the harm that results from outright fraud, these types of harm can nonetheless have a significant impact on investors' financial well-being. Despite the difficulty of quantification, the Committee believes it is essential that the economic analysis currently being undertaken by the Commission acknowledge both the existence and importance of investor harms of this type that can result from advice delivered under a suitability standard.

Recommendations

The Investor Advisory Committee believes that personalized investment advice to retail customers should be governed by a fiduciary duty, regardless of whether that advice is provided by an investment adviser or a broker-dealer.[1] The Committee further believes that the fiduciary duty for investment advice should include, first and foremost, an enforceable, principles-based obligation to act in the best interest of the customer. In approaching this issue, the SEC's goal should be to eliminate the regulatory gap that allows broker-dealers to offer investment advice without being subject to the same fiduciary duty as other investment advisers but not to eliminate the ability of broker-dealers to offer transaction-specific advice compensated through transaction-based payments. Though it may require both regulatory flexibility to permit the existence of conflicts of interest and some regulatory changes to reduce the most severe conflicts of interest in the broker-dealer business model, the Committee believes that advisory services offered as part of a transaction-based securities business can and should be conducted in a way that is consistent with a fiduciary standard of conduct.

<u>Recommendation 1</u>

The Commission should conduct a rulemaking to impose a fiduciary duty on broker-dealers when they provide personalized investment advice to retail investors.

A. The Committee favors an approach that involves rulemaking under the Investment Advisers Act to narrow the broker-dealer exclusion from the Act while providing a safe harbor for brokers who do not engage in broader investment advisory services or hold themselves out as providing such services.

B. At the same time, the Committee recognizes that the Commission is considering rulemaking under Section 913(g) of the Dodd-Frank Act. Should the Commission choose to conduct rulemaking under Section 913, the Committee supports the following approach:

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[1] While this recommendation deals specifically with advice to retail customers, the Committee notes that Dodd-Frank authorizes the SEC to extend fiduciary protections to other vulnerable market participants. The Commission should consider whether action beyond the retail arena is needed and appropriate.

a. In order to ensure that the standard is no weaker than the existing Advisers Act standard, any fiduciary rule adopted must incorporate an enforceable, principles-based obligation to act in the best interests of the customer.

b. In order to ensure the continued availability of transaction-based recommendations, any standard adopted should be sufficiently flexible to permit the existence of certain sales-related conflicts of interest, subject to a requirement that any such conflicts be fully disclosed and appropriately managed.

c. While recognizing that some forms of transaction-based payments would be acceptable under a fiduciary standard, the Commission should fulfill its Dodd-Frank mandate to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

Supporting Rationale:

The Commission should conduct a rulemaking to impose a fiduciary duty on broker-dealers when they provide personalized investment advice to retail investors.

A broad consensus exists among widely disparate groups (representing investors, state securities regulators, investment advisers, and broker-dealers) that broker-dealers and investment advisers should be subject to a uniform fiduciary standard when they provide personalized investment advice to retail investors. In a recent letter to the Commission, the Securities Industry Financial Markets Association stated, for example, that it "has long supported a uniform fiduciary standard for BDs and RIAs when providing personalized investment advice about securities to retail clients."[2] Meanwhile, organizations such as the North American Securities Administrators Association (NASAA), Consumer Federation of America (CFA), AARP, Fund Democracy and the various investment adviser/financial planning groups have been calling for enhanced fiduciary protections for the advisory clients of broker-dealers for two decades or more. Adoption of a uniform fiduciary standard was also the recommendation of the SEC staff in its 913 Study.[3]

Rather than opposing fiduciary rulemaking, the leading broker-dealer trade associations have sought to ensure that any rules adopted provide sufficient clarity regarding their regulatory

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[2] July 5, 2013 letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, available here: http://www.sec.gov/comments/4-606/4606-3128.pdf. *See also*, July 5, 2013 letter from David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, (available here: http://www.sec.gov/comments/4-606/4606-3138.pdf), which listed a uniform fiduciary standard as one component of a regulatory approach that can provide "widespread benefits to all stakeholders."

[3] SEC Staff, *Study on Investment Advisers and Broker-Dealers, As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, January 2011 (available here: http://www.sec.gov/news/studies/2011/913studyfinal.pdf).

obligations and continue to permit them to offer traditional, transaction-based brokerage services.[4] While there are disagreements among the various stakeholder groups over some important implementation issues, there is general agreement that the Commission should adopt a regulatory approach that preserves the ability of brokers to offer transaction-specific recommendations compensated through transaction-based payments.[5] In keeping with this goal, the various stakeholder groups also generally agree that the fiduciary duty should not apply to all brokerage services, but only to those services that fall within a reasonable definition of personalized investment advice to retail customers. The Committee shares these views.

The limited opposition that exists to rulemaking in this area is based first on the argument that broker-dealers are already extensively regulated under existing state and federal laws and self-regulatory organization rules. While this is true, it is largely irrelevant to the question of what standard should apply when broker-dealers provide personalized investment advice to retail customers. Put another way, the question is not whether broker-dealers are adequately regulated when they act as *salespeople* but whether they are adequately regulated when they act as *advisers*. In the view of the Committee, the existing securities regulatory scheme that treat broker-dealers as salespeople does not offer adequate investor protection when broker-dealers offer advisory services, since under a suitability standard they generally remain free to put their own interests ahead of those of their customers. As SIFMA stated in its recent comment letter to the SEC, "a uniform fiduciary standard would result in a heightened focus on serving the best interests of retail clients."

Some others have suggested that regulation is not needed because investors are capable of choosing for themselves whether they prefer to work with a broker-dealer operating under a suitability standard or an investment adviser who is a fiduciary. This might have been true if the Commission had over the past several decades adopted a regulatory approach that maintained a bright line between broker-dealers and investment advisers. But that has long since ceased to be the case. As the RAND Study,[6] the SEC's recent financial literacy study,[7] and numerous outside surveys have all documented, investors today do not have the tools to make an informed choice. Specifically, investors do not distinguish between broker-dealers and investment advisers, do not know that broker-dealers and investment advisers are subject to different legal standards, do not understand the differences between a suitability standard and a fiduciary duty, and expect broker-dealers and investment advisers alike to act in their best interests when giving advice and making recommendations. This is the natural result of regulatory policy that has allowed brokers to rebrand themselves as advisers without being regulated as advisers.

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[4] See, for example, the July 14, 2011 letter from Ira D. Hammerman, SIFMA Senior Managing Director and General Counsel, to SEC Chairman Mary Schapiro regarding a "Framework for Rulemaking under Section 913 (Fiduciary Duty) of the Dodd-Frank Act" (File No. 4-604).

[5] See, for example, March 28, 2012 letter from CFA, Fund Democracy, AARP, Certified Financial Planner Board of Standards, Inc., Financial Planning Association, Investment Adviser Association, and National Association of Personal Financial Advisors to SEC Chairman Mary Schapiro (available here: http://www.sec.gov/comments/4-606/4606-2973.pdf), which provides a framework for rulemaking that seeks to enhance investor protection without sacrificing investor choice.

[6] Hung, Angela A. et al, *Technical Report: Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, sponsored by the U.S. Securities and Exchange Commission, RAND Institute for Civil Justice, 2008 (available here: http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf).

[7] Staff of the Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors (As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act)*, August 2012.

In light of the evidence that the blurring of the lines between broker-dealers and investment advisers has made it difficult, if not impossible, for typical retail investors to make an informed choice between broker-dealers and investment advisers, the Committee believes that a regulatory solution that reduces the potential for investor harm is necessary. As the SEC staff stated in the 913 Study, “Retail investors are relying on their financial professional to assist them with some of the most important decisions of their lives. Investors have a reasonable expectation that the advice that they are receiving is in their best interest. They should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations.”

The Commission has a range of options available to it for achieving this regulatory goal. These include the approach recommended in Section 913(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. But the Commission also has other grounds for action, including existing authority under the Investment Advisers Act to regulate non-incidental advice by broker-dealers. In deciding on the optimal regulatory approach, the Commission should weigh its various options with an eye toward determining which will best ensure an outcome that strengthens investor protections, preserves investor choice with regard to business models and compensation methods, and is workable for broker-dealers and investment advisers alike.

A. The Committee favors an approach that involves rulemaking under the Investment Advisers Act to narrow the broker-dealer exclusion from the Act while providing a safe harbor for brokers who do not engage in broader investment advisory services or hold themselves out as providing such services.

The Committee believes that the dual goals of strengthening investor protections while preserving investor choice could best be achieved through rulemaking under the Advisers Act. By significantly narrowing of the broker-dealer exclusion from the Investment Advisers Act, such an approach would restore the functional regulation intended by Congress when it adopted the ’34 and ’40 Acts. Under such an approach, broker-dealers who choose to offer personalized investment advice to retail investors, such as retirement planning or investment planning, that goes beyond the buy/sell recommendations inherent to securities transactions would be regulated in the same fashion as other investment advisers when they engage in those advisory activities.[8] Broker-dealers who “hold themselves out” as advisers, based either on the titles they use or the manner in which they market their services, would be precluded from relying on the exclusion. (This is consistent with the approach the Commission adopted with regard to accountants and attorneys when it was first interpreting how the Advisers Act applied to those professionals who held themselves out as financial planners.)[9]

One significant benefit of such an approach is that it would provide a firm assurance that the fiduciary standard for investment advice by broker-dealers and investment advisers would be the same and would be no weaker than the existing standard. It would, for example, ensure that

[8] The Commission would still need to define what activities by broker-dealers constitute investment advice subject to regulation under the Advisers Act and which do not. Non-advisory activities by these broker-dealers would continue to be regulated under the Securities Exchange Act.
[9] See, for example, SEC Investment Advisers Act Rel. No. 770 (1981) as well as SEC Rel. No. IA-1092 (1987).

the existing legal precedent, staff interpretations, and no-action positions developed under the Advisers Act and accompanying rules would also apply to investment advice by brokers. And it would achieve this without the necessity of creating a whole new parallel body of law under the '34 Act. To the degree that specific aspects of that existing body of Advisers Act law and interpretation would need to be amended or revised for the purpose of applying it to the broker-dealer business model, that could be accomplished through adoption of appropriate rules and guidance under the Advisers Act.[10]

Under this approach, there would be minimal risk that existing investor protections would be weakened as a result of efforts to accommodate the broker-dealer business model. Under such an approach, broker-dealers who wish to avoid regulation under the Advisers Act could do so by limiting themselves to transaction-specific recommendations while avoiding holding themselves out as advisers or as providing advisory services. In order to ensure clear communication to investors, it may also be necessary for the Commission to require some sort of affirmative disclosure in such circumstances to the effect that the broker-dealer is acting solely as a salesperson and not as an objective adviser. Broker-dealers who complied with these conditions would in effect have a safe harbor from Advisers Act regulation.

Brokerage firms would then face a clear business decision: do the benefits of offering advisory services and marketing themselves accordingly outweigh the costs of regulation under the Advisers Act? Faced with a similar decision when the courts determined that fee-based accounts were advisory accounts, most broker-dealers chose to accept regulation under the Advisers Act. We believe the outcome would be similar in this instance. But investors would also benefit even if certain broker-dealers chose to avoid Advisers Act regulation if the result was that those broker-dealers stopped characterizing their services as advisory services when making recommendations that are not required to promote the best interests of the customer. Thus, this approach would also preserve investors' ability to choose to receive transaction-based advice subject to a fiduciary duty or non-advisory transaction-based services subject to a suitability standard, and their ability to distinguish between those different types of services would be enhanced.

B. *At the same time, the Committee recognizes that the Commission is considering rulemaking under Section 913(g) of the Dodd-Frank Act. Should the Commission choose to conduct rulemaking under Section 913, the Committee supports the following approach:*

   a. *In order to ensure that the standard is no weaker than the existing Advisers Act standard, any fiduciary rule adopted must incorporate an enforceable, principles-based obligation to act in the best interests of the customer.*

[10] This is the approach that the Commission has taken in the wake of the court decision requiring all fee-based accounts to be regulated as advisory accounts. Without taking a position on the temporary principal trading rules adopted by the Commission in the wake of that decision, the Committee believes this show the feasibility of providing targeted carve-outs for broker-dealers from Investment Advisers Act rules that are incompatible with the broker-dealer business model. The goal in devising any such carve-outs should be to ensure that the best interests of the customer are protected.

b. *In order to ensure the continued availability of transaction-based recommendations, any standard adopted should be sufficiently flexible to permit the existence of certain sales-related conflicts of interest, subject to a requirement that any such conflicts be fully disclosed and appropriately managed.*

c. *While recognizing that some forms of transaction-based payments would be acceptable under a fiduciary standard, the Commission should fulfill its Dodd-Frank mandate to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."*

The Committee recognizes that, since passage of the Dodd-Frank Act, much of the impetus behind fiduciary rulemaking has had as its source the authorizing language contained in Section 913(g) of that act. In insisting that the fiduciary standard be the same for broker-dealers and investment advisers and no weaker than the existing Advisers Act standard, Section 913 provides an appropriate basis for rulemaking. Importantly, it recognizes that a fiduciary duty that is identical in principle is, because of its facts-and-circumstances-based application, flexible enough to be applied differently in different circumstances and to different business models. This is key to developing an approach that strengthens investor protections without unduly limiting investor choice.

However, the statutory language of Section 913 poses some significant implementation challenges as well. Specifically, it includes provisions specifying that certain prevalent broker-dealer business practices – such as earning commissions, selling proprietary products, and selling from a limited menu of products – should not automatically be deemed to constitute a violation of the fiduciary standard. It intentionally avoids applying Advisers Act provisions with regard to principal trades to brokers, but without specifying how principal trades by brokers should be regulated under a fiduciary standard. And it specifies that brokers would not have an on-going duty of care "after" the advice is rendered. Depending on how certain of these provisions are interpreted and enforced – particularly those with regard to selling from a limited menu of products and the on-going duty of care – such an approach could result in a significant weakening of the existing Advisers Act standard.

We encourage the Commission to arrive at a rule based on Section 913 that is strong and effective, but it is also possible that rulemaking under Section 913 could weaken protections for investors who receive advice from investment advisers without providing meaningful improvement in protections for those who invest through broker-dealers. For example, if the Commission were to interpret Section 913 as permitting sale from a menu of products so limited as to preclude any recommendation from that menu's being in the best interests of the customer, that would leave unchallenged some of the most troubling practices permitted under the suitability standard. Similarly, if the Commission were to interpret Section 913 as permitting broker-dealers to switch in and out of a fiduciary duty even where there is an on-going relationship with that client and an implication of ongoing account management, such an approach could leave investors more confused than ever and at greater risk of being misled. [11] Furthermore, Section 913 anticipates that the Commission would undertake parallel rulemaking under both the Investment Advisers Act and the '34 Act and produce rules that are the same for broker-dealers and investment advisers. Because new rules would supersede past interpretation of the Advisers Act standard, any weaknesses in the rules adopted in order to accommodate the broker-dealer business model and the specific directives in the Section 913 statutory language would have a spill-over effect, weakening existing protections under the Advisers Act for clients of investment advisers. The Committee would strongly oppose such a result and urges the Commission to avoid this outcome at all costs.

In order to do so, the Commission must include, in its definition of fiduciary duty, an enforceable principles-based obligation to act in the best interests of the customer. This is consistent with the statutory language of Section 913(g), which authorizes the Commission to "promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." Such an interpretation is also consistent with the recommendation of the SEC staff in its 913 Study, which notes that an important distinction between the fiduciary duty and suitability standard is the inclusion in the fiduciary duty of an obligation to act in the best interests of clients.

The Committee believes this legislative mandate can be achieved through a fiduciary rule that requires all those who provide personalized investment advice to retail investors to have a reasonable basis for believing their recommendations are in the best interest of the customer. In addition to performing the analysis necessary to determine the customer's best interest (comparable to the current know-your-customer obligations), those providing investment advice should be required to document the basis for their belief that their recommendation is in the customer's best interests. Such an approach would not require broker-dealers to avoid all conflicts of interest. But it would require them to attempt to act in their customers' best interests despite their conflicts of interest, put policies and procedures in place to better ensure compliance, and hold them accountable when they fail to do so.

Both SIFMA and FSI have voiced support for a fiduciary standard that includes a best interest obligation. Their key concern has been to ensure that they have adequate guidance before a rule is finalized for how that standard would be applied in the context of the broker-dealer business model. The Committee agrees that brokers and investors alike will be best served if brokers understand their obligations under a new fiduciary standard. In the Committee's view, however, it would be a mistake to try to spell out every aspect of a broker's fiduciary obligations through rules. Instead, the Commission should adopt guidance before the

[11] The Committee believes that it is important that an ongoing fiduciary duty apply in circumstances in which broker-dealers hold themselves out in ways that imply they are providing ongoing account oversight and management. Thus, the ongoing duty of care would not apply to all brokerage services, but only in those instances in which a reasonable expectation of ongoing advice had been created. If the Commission were to proceed with rulemaking under Section 913, it would be important that it interpret the provision regarding ongoing duty of care in a way that is consistent with this principle.

rule is implemented to help clarify how the fiduciary duty in general and the best interest obligation in particular would apply in the context of the transaction-based broker-dealer business model. The guidance should cover the key issues brokers are likely to face in adapting to the new standard. While avoiding an overly prescriptive rules-based approach, the Commission should supplement that guidance by adopting supporting rules in areas such as disclosure obligations where more specific standards are needed. Such an approach would provide the clarity that brokers need while preserving the flexibility of the fiduciary duty as a facts-and-circumstances-based standard.

Another way to ensure that the rule is compatible with the broker-dealer business model is for the Commission to adopt a regulatory approach that permits the existence of certain sales-related conflicts of interest while requiring that any such conflicts be disclosed and appropriately managed. Toward that end, we recommend that the Commission adopt a rule that requires broker-dealers and investment advisers who provide personalized investment advice to retail customers: to identify any material conflicts of interest that a reasonable investor would view as compromising their ability to act in the customer's best interest; to develop a plan for appropriately managing those conflicts to ensure that the best interests of the customer prevail; to have policies and procedures in place designed to ensure that the individuals providing the advice have a reasonable basis for believing their recommendations are in the best interest of the customer and document the basis on which they reached that conclusion; and to monitor compliance. Such an approach should preserve the ability of broker-dealers to receive transaction-based compensation and preserve this option for customers who prefer to receive transaction-based advice.

At the same time, the Dodd-Frank Act requires the Commission to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors." We believe it is of important for the Commission to conduct this analysis both as part of its fiduciary rulemaking and as an ongoing aspect of its market oversight. Where it finds practices that are clearly inconsistent with a broker-dealer or investment adviser's fiduciary obligations and that cannot be appropriately managed through other means, it has an obligation to act through rulemaking to limit or ban those practices. As previously discussed, outright prohibitions would not be appropriate in instances where conflicts can be managed through other means and where the provider of the investment advice can document a reasonable basis for believing recommendations are in the best interest of the customer.

Recommendation 2

As part of its rulemaking, the Commission should adopt a uniform, plain English disclosure document to be provided to customers and potential customers of broker-dealers and investment advisers that covers basic information about the nature of services offered, fees and compensation, conflicts of interest, and disciplinary record.

Supporting Rationale:

The Committee does not believe that disclosure alone is sufficient to address the harm that can result when broker-dealers are free to offer "advice" that puts their own interests of ahead of the interests of their customers. On the other hand, we do believe that improved disclosure should be included as part of any fiduciary rulemaking. One area needing improvement is the disclosure investors receive to help them select a financial professional. While investment advisers are required to provide pre-engagement disclosure to all prospective clients, broker-dealers are not subject to a comparable requirement.

We believe investors would benefit from receiving uniform, plain English disclosure documents from broker-dealers and investment advisers covering key factors that are relevant to the selection of an investment professional.[12] Relevant topics might include: What services do you provide? What and how do I pay? How are you compensated? What are your conflicts of interest? Are there other limitations on your services? What is your professional background? Are there any blemishes on your disciplinary record? And, particularly if the Commission fails to adopt a uniform fiduciary standard, what is your legal obligation to me?

The ADV form that investment advisers use to disclose to their clients provides a reasonable starting point for designing such a document. However, we encourage the Commission to continue to review the ADV form to determine whether it could be further refined to make it a more user-friendly document. The results of the SEC's recent financial literacy study suggest that additional work may be needed to improve investors' ability to make good use of disclosed information whose significance they struggle to comprehend. Among other things, we encourage the Commission to develop an approach to disclosure of disciplinary record that makes it easier for investors to assess the significance of disclosed events, particularly for firms that may have a large number of relatively insignificant technical violations. As part of that analysis, the Commission should look at whether it might be beneficial to adopt a layered approach to such disclosures, with the goal of developing a more abbreviated, user-friendly document for distribution to investors. In general, we would encourage the Commission to work with disclosure design experts to ensure that any document it develops is effective in conveying the relevant information to investors in a way that enables them to act on that information.

[12] While the content of the disclosures would vary to reflect differences in the businesses of broker-dealers and investment advisers, the topics covered, format, and presentation of the information should, to the degree possible, be consistent.