

Recommendation of the Investor as Purchaser Subcommittee Regarding Proposed Regulation Best Interest, Form CRS, and Investment Advisers Act Fiduciary Guidance

The SEC's Investor Advisory Committee (IAC) appreciates the opportunity to share with the Commission our views on the proposed Regulation Best Interest,¹ Form CRS,² and Investment Advisers Act fiduciary guidance.³ We congratulate the Commission for moving forward on this critical issue and believe that the Commission's proposals seek to raise the bar for the provision of personalized investment advice by broker-dealers.

The IAC has previously submitted a recommendation on this issue to the Commission. In that recommendation, we advocated that all personalized investment advice to retail customers be governed by a fiduciary duty, regardless of whether that advice is provided by an investment adviser or a broker-dealer.⁴ We appreciate that, while the Commission has chosen to adopt a regulatory approach that differs from the prior IAC recommendation, the Commission's regulatory proposals and our proposed approach share common goals and certain common elements. In particular, we share the goal, expressed by Chairman Clayton and others, that the standard for broker-dealers and investment advisers alike be based on fiduciary principles designed to ensure that financial professionals act in their customers' best interests and do not place their own interests ahead of their customers' interests.⁵

In order to further the underlying goals of the Commission proposals, a majority of the IAC believes that more can and should be done to strengthen and clarify these proposals. Specifically, a majority of the IAC:

- Believes the standard for broker-dealers and investment advisers alike should be clarified with regard to the obligation to act in customers' best interests.
- Supports expanding the best interest obligation to cover rollover recommendations and recommendations by dual registrant firms regarding account types.
- Believes that the best interest standard is, and should be characterized explicitly as, a fiduciary duty, while making clear that the specific obligations that flow from that duty will vary based on differences in business models.
- Believes that, before adopting the disclosure obligations, the Commission should conduct usability testing of the proposed Form CRS disclosures and, if necessary, revise them to

¹ Regulation Best Interest, File No. S7-07-18 <https://bit.ly/2vqxvEL>.

² Form CRS Relationship Summary, File No. S7-08-18 <https://bit.ly/2vLZL2u>.

³ Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, File No. S7-09-18 <https://bit.ly/2MihsRx>.

⁴ Recommendation of the Investor Advisory Committee, Broker-Dealer Fiduciary Duty <https://bit.ly/2jWB4rz>.

⁵ *See, e.g.*, Transcript of Miami Investor Roundtable, at 13 <https://bit.ly/2BBvjx3> (Chairman Clayton: "We then raise the standard of care that broker-dealers owe their clients to embody what I would call a true fiduciary concept, that a broker can't put their interests ahead of the client's.") *See, also*, Transcript of Denver Investor Roundtable, at 72 (Chairman Clayton responding to a question from INVESTOR 4 about the meaning of best interest: "It's the fiduciary obligation not to put your interests ahead of the clients', and it's the care obligation to have a series of policies and procedures such that you are exercising care in the recommendations you're making. You know the product -- you know the product you're recommending, you know its attributes, and you've made an assessment about whether it is appropriate for INVESTOR 4. That's what it means.")

ensure that they enable investors to make an informed choice among different types of providers and accounts.

The remainder of this recommendation explains each of these points in greater detail.

The Best Interest Standard Needs to be Clarified

A majority of the IAC believes that the Commission should clarify what it means when it states that brokers and advisers are required to act in their customers' best interests. This same terminology has been used to describe standards as different as the existing suitability requirement under FINRA rules⁶ and the now defunct Department of Labor conflict of interest rule.⁷ As a result, both investors and firms are likely to struggle to understand precisely what firms' obligations to the customer are under a best interest standard. Of course, the Commission can provide particularized guidance through the interpretive process. However, while we share the Commission's view that the best interest standard should not be turned into a one-size-fits-all, prescriptive rule,⁸ we believe the basic meaning of best interest should be clarified when the Commission moves forward with its rulemaking, without abandoning the principles-based approach favored by the Commission.

Specifically, we believe the meaning of the best interest obligation should be clarified to require broker-dealers, investment advisers, and their associated persons to recommend the investments, investment strategies, accounts, or services, from among those they have reasonably available to recommend, that they reasonably believe represent the best available options for the investor. This determination regarding the best reasonably available options should be based on a careful review of the investor's needs and goals, as well as the full range of the reasonably available products', strategies', accounts', or services' features, including, but by no means limited to, costs. In adopting this approach, the Commission should recognize that there will often not be a *single* best option and that more than one of the available options may satisfy this standard. Moreover, compliance with the standard should be measured based on whether the broker or adviser had a reasonable basis for the recommendation *at the time it was made*, and *not* on how the recommendation ultimately performed for the investor.

Under this approach, the nature and extent of the required analysis would follow the contours of the relationship. For example, a broker or adviser who was offering recommendations as part of a financial planning or goals-based approach would have obligations that would likely differ from those of a broker who was simply responding to a request to recommend an appropriate target date fund. Similarly, an investment adviser providing ongoing portfolio management would have different obligations than a broker-dealer providing episodic recommendations. As

⁶ FINRA Rule 2111 (Suitability) FAQ, <https://bit.ly/2Ktkix1> ("The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests.")

⁷ Department of Labor, Employee Benefits Security Administration, Best Interest Contract Exemption, Federal Register / Vol. 81, No. 68 / Friday, April 8, 2016 ("The exemption strives to ensure that Advisers' recommendations reflect the best interest of their Retirement Investor customers, rather than the conflicting financial interests of the Advisers and their Financial Institutions.")

⁸ Rita Raagas De Ramos, SEC Chair: Government Should Not Drive Away the Broker-Dealer Model ("Redfearn says it was better not to be prescriptive with the definition of best interest because 'what is in the best interest of one customer may not be in the best interest of another.'")

such, this approach would retain the facts-and-circumstances based determination favored by the Commission.⁹

In this regard, the standard would be structured similarly to FINRA's suitability standard, in that it would start with a careful review of the client's financial situation along the lines of the requirement under FINRA's know-your-customer rule.¹⁰ A key difference is that the best interest standard, in contrast with the suitability standard, would not be satisfied by recommending any of what may be many suitable options. Instead, the broker, adviser, and their associated persons would be required to narrow down the selection to those that are most favorable for the investor, rather than those that are most profitable for the broker or adviser,¹¹ recognizing that more than one of the reasonably available options may be equally good matches for the investor.

We appreciate that the Commission has included a requirement for a prudent process under Reg BI's care obligations.¹² But, while the Release makes clear that this should include an evaluation of the available options,¹³ it does not take the logical next step of specifying that the result of that review should be recommendation of the best of the reasonably available options (as described above). A majority of the IAC members believe the Commission should provide this additional clarification, which is consistent with what investors have been led to expect under a best interest standard. In addition, we believe the best interest standard should be applied to the broker-dealer's monitoring of the customer account, where brokers provide ongoing services to the account. In essence, this would apply the best interest standard to the implicit "no recommendation" recommendation that a broker makes when reviewing the account and recommending no change.

⁹ Reg BI Release at 52 ("[W]e preliminarily believe that whether a broker-dealer acted in the best interest of the retail customer when making a recommendation will turn on the facts and circumstances of the particular recommendation and the particular retail customer, along with the facts and circumstances of how the four specific components of Regulation Best Interest are satisfied.")

¹⁰ See FINRA, Regulatory Notice 11-02, Know Your Customer and Suitability, Effective Date: October 7, 2011 <https://bit.ly/2Mnv6Td> at 3-4 ("The new rule includes an expanded list of explicit types of information that firms and associated persons must attempt to gather and analyze as part of a suitability analysis. The new rule essentially adds age, investment experience, time horizon, liquidity needs and risk tolerance to the existing list (other holdings, financial situation and needs, tax status and investment objectives). Recognizing that not every factor regarding a "customer's investment profile" will be relevant to every recommendation, the rule provides flexibility concerning the type of information that firms must seek to obtain and analyze." (citations omitted))

¹¹ Denver Investor Roundtable at 74 (Lourdes Gonzalez, Division of Trading and Markets Assistant Chief Counsel: "The other thing that's really important is the broker is going to have to manage, mitigate its conflicts, so that that recommendation is not tainted by the broker's financial incentive.")

¹² Reg BI Release at 133 ("The Commission proposes to require, as part of Regulation Best Interest, a Care Obligation that would require a broker-dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, to exercise reasonable diligence, care, skill, and prudence ...")

¹³ Reg BI Release at 135 ("Under the Care Obligation, a broker-dealer generally should consider reasonable alternatives, if any, offered by the broker-dealer in determining whether it has a reasonable basis for making the recommendation.")

Nothing about our proposed approach would change certain limitations on brokers' obligations, as outlined in Reg BI.¹⁴ Associated persons of brokers and advisers would not, for example, be required to review and compare *every* investment available in the marketplace, but rather only those *reasonably available*. Of course, what is reasonably available will in turn depend on a variety of factors. For example, firms would not be precluded from offering a limited menu of proprietary investment products, though it might be possible for a firm to have a menu that is so limited or specialized that none of the available options would be in a *particular* investor's best interests. Nor would our proposed approach limit brokers' ability to earn commissions or other transaction-based payments or require them to consider investments that do not involve such payments. Finally, our suggested approach would not require recommending the lowest cost option. On the contrary, as is proposed in Reg BI, our suggested approach would require brokers to take into account the full range of material characteristics of an investment, strategy, account or service in developing their recommendations. As the Commission moves forward with this rulemaking, a majority of the IAC believes the Commission should provide additional guidance to help broker-dealers, investment advisers, and their associated persons understand how they can best meet their obligations.

Recommendations Regarding Account Types Should Be Made in the Investor's Best Interest

Some of the most important decisions investors make arise at the outset of the relationship, before they receive recommendations regarding specific transactions. These include decisions about whether to roll money out of a retirement account and into an IRA, what type of account to open (where the firm has more than one account type available), and the scope of services to be provided. Those central decisions, generally made at the beginning of a brokerage or advisory relationship, set up the contours of the relationship. They will often have a far greater impact on the investor than subsequent recommendations regarding which specific securities to invest in.

Rollover recommendations, for example, are frequently provided at a critical juncture in an investor's life – retirement – and are often irrevocable decisions. Similarly, while some investors (including those who trade frequently) may be best served by paying an asset-based fee, others (including buy-and-hold investors who rarely trade) may be better served by paying transaction fees. Decisions about which type of account to open have the potential to greatly affect their costs. Moreover, both rollover and account type recommendations are recommendations of an “investment strategy involving securities” that can have substantial potential long-term impacts on investors. And both types of recommendations inherently involve potential conflicts of interest, making it critical that advisers and brokers put their clients' interests ahead of their own in making such recommendations.

As such, a majority of the IAC believes that such recommendations should be subject to a best interest standard. We therefore recommend that the Commission revise its proposed rules to cover these types of recommendations under the best interest standard, as described above.

The Best Interest Standard is a Principle-Based Fiduciary Obligation

¹⁴ Reg BI Release at 53-55. *See also*, Reg BI Release at 197, specifying that the neglect, refusal, or inability of a retail customer to provide or update information necessary to evaluate the customer's situation and needs would excuse the broker-dealer from obtaining that information.

We share the Commission's view that investors benefit from having a choice among different business models for receiving investment advice and recommendations.¹⁵ And we agree with the Commission that both the broker-dealer and investment adviser business models provide valuable choices for investors that should be preserved.¹⁶ However, a majority of the Committee believes it is possible, based on the approach outlined above, to preserve beneficial differentiation between the investment advisory and broker-dealer business models while adopting a fiduciary best interest standard that is uniform in principle for both brokerage and advisory accounts but flexible in its application based on differences in business model.

A majority of the IAC believes that a best interest standard *is* a fiduciary standard, as Commission officials have indicated in public remarks since the proposal was released for comment.¹⁷ Thus, in our view, the Commission should explicitly recognize that the best interest obligation outlined in Reg BI is a fiduciary standard and adopt an approach to its implementation that would be uniform with the Advisers Act standard in principle, but vary in its application, depending on the facts and circumstances. Adopting this standard for broker-dealers and refining the application and enforcement of the investment adviser fiduciary obligation to reflect the clarifications described above could therefore go a long way toward creating an even playing field in which brokers and advisers alike are held to a fiduciary standard that is appropriately tailored to their business models.

We believe, moreover, that this could be accomplished without sacrificing beneficial differentiation between broker-dealers and investment advisers. As the Commission has explained in the proposed Advisers Act Guidance, a fiduciary duty “follows the contours of the relationship.”¹⁸ As a result, its application “will vary with the terms of the relationship.”¹⁹ So, for example, an investment adviser that provides portfolio management services has an obligation, as a fiduciary, to provide continuous management and monitoring of that account throughout the relationship. But an investment adviser who enters into an agreement with a client to provide one-time advice for an hourly fee would have no such on-going duty. And an investment adviser who provides investment advice as part of a financial planning engagement would have different obligations tailored to that role.

The same flexibility that makes it possible for the Advisers Act fiduciary duty to be adapted to three such different advisory business models would, in the view of a majority of the IAC, also be adaptable to the various broker-dealer business models. The clarifications of the best interest standard described above would, in the view of a majority of the Committee, achieve that goal. As with advisers, the scope of the services broker-dealers provide varies, from order taking to single or episodic recommendations to ongoing relationships with monitoring between trades,

¹⁵ Reg BI Release at 21 (“Among other things, the Commission and our staff, commenters and others have recognized the benefits of the broker-dealer model for advice and the access to advice and the choice of products, services and payment options, that the brokerage model provides retail customers.”)

¹⁶ Reg BI Release at 330 (“A fiduciary standard for broker-dealers could produce greater uniformity between broker-dealers’ and investment advisers’ standards. . . . The Commission preliminarily believes such uniformity . . . could lead to the potential loss of differentiation between two important business models, each of which can serve a valuable function for retail customers.”)

¹⁷ See fn 5, *supra*.

¹⁸ IA Guidance at 8.

¹⁹ *Id.*

among others. As such, we believe that the standard that applies to brokers should, like the Advisers Act fiduciary duty, follow the contours of the relationship.

Such an approach would be consistent with the Commission's stated goals. In fact, as noted above, statements from Commission officials clearly indicate an intention to establish a fiduciary standard, without using that term, in adopting a principles-based best interest standard for broker-dealers under Reg BI.²⁰

The majority sees several advantages to this approach. First, it would significantly reduce the confusion caused by the two differing standards that have been proposed.²¹ Making it clear that both broker-dealers and investment advisers, regardless of business model, are working as fiduciaries under a standard tailored to the functions they perform would simplify the issues for investors and the regulated community alike. It would eliminate the debate over whether some financial professionals are subject to a higher standard than others and thereby reduce incentives to select business models and registration status (broker-dealer vs. investment adviser) based on regulatory considerations. It also has the potential to greatly reduce the complexity of Form CRS, since it would no longer be necessary to educate investors on the difficult to grasp differences between fiduciaries and non-fiduciaries. Rather, an investor could select his or her financial professional based on the business model that best matches the investor's needs.

The Committee's recommendation to clarify the meaning of best interest, and to explicitly recognize it as a fiduciary standard, would deliver many, but not all, of the potential benefits associated with rulemaking to adopt a uniform fiduciary standard in reliance on the Commission's authority under Section 913(g) of the Dodd-Frank Act, as the Committee previously recommended.²² Specifically, it would, at least for now, forego the opportunity to make investment advisers' obligation to act in the best interests of the investor explicit.

While it has become routine to describe the Advisers Act as requiring investment advisers to act in their clients' best interests at all times and prohibiting them from suborning their clients' interests to their own,²³ there is concern that the Commission is not well enough armed to enforce these obligations because the fiduciary duty under the Advisers Act is implied rather than explicit and arises out of the anti-fraud provisions of the Act. Because disclosure is generally considered adequate to satisfy a fraud standard, there may be gaps between what

²⁰ Rita Raagas De Ramos, SEC Chair: Government Should Not Drive Away the Broker-Dealer Model, Financial Advisor IQ, May 23, 2018 <https://bit.ly/2O8NxYs> ("Despite the proposal being called Regulation Best Interest, 'it is definitely a fiduciary principle; just like the fiduciary duty in the investment advisor space is a fiduciary principle,' Clayton said.") Adoption of such a standard is supported by the authority granted to the SEC under Section 913(g) of the Dodd-Frank Act.

²¹ Past testing conducted on behalf of the Commission has suggested that disclosure alone may not be adequate to clarify those differences for investors. *See, e.g.*, Siegel & Gale, LLC and Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures, Report to the Securities and Exchange Commission, March 10, 2005, <https://bit.ly/1MkdujW>. *See also*, Angela A. Hung, et al., RAND Institute for Civil Justice, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, at 90, (2008), <https://bit.ly/2LSD0sr>.

²² ADD CITE

²³ *See, e.g.*, IA Guidance at 7 ("This fiduciary duty requires an adviser 'to adopt the principal's goals, objectives, or ends.' This means the adviser must, at all times, serve the best interest of its clients and not subordinate its clients' interest to its own." (citations omitted)).

investors reasonably expect from someone who is pledged to act in their “best interests” and what the law, as enforced by the SEC, actually requires. In reality, investment advisers, like broker-dealers, may engage in practices that put their own interests ahead of their clients’ interests – for example by recommending higher cost proprietary funds when the firm has better options available – but they typically run afoul of the Commission only if they fail to disclose those practices on their ADV forms.²⁴ For these reasons, a majority of the Committee believes that enhancing the fiduciary standard under the Advisers Act, and making the best interest obligation implied under that standard explicit, is a critical investor protection initiative for the Commission to pursue.

However, we recognize that the Commission has chosen not to proceed under its 913(g) authority in its current proposal, and it is not our intent to derail that proposal by advocating that the Commission change the legal basis for its rulemaking. Moreover, we believe the clarifications we have outlined above to the meaning of best interest, if implemented, have the potential to deliver immediate benefits to customers of broker-dealers and investment advisers alike.²⁵ Should the Commission determine, however, that it cannot enforce the clarified best interest standard under the Advisers Act, a majority of the Committee believes the Commission should reconsider rulemaking under its 913(g) authority to close that regulatory gap.

The Commission Should Test Form CRS Disclosures for Effectiveness

A centerpiece of the Commission’s proposed regulatory approach is its proposal to require broker-dealers and investment advisers to provide a brief relationship summary (Form CRS) to prospective clients. The purpose of the relationship summary is to help investors make an informed choice among different types of providers and different types of accounts. A majority of the IAC supports the concept behind the Commission proposal, which is consistent with our prior recommendation that the Commission “adopt a uniform, plain English disclosure document [for brokers and advisers] that covers basic information about the nature of services offered, fees and compensation, conflicts of interest, and disciplinary record.”

At the June 2018 IAC meeting, we received extensive input, reflecting a variety of perspectives, raising concerns about the proposed disclosures and suggesting that Form CRS, as currently proposed, is unlikely to achieve its intended purpose of reducing investor confusion and

²⁴ See, e.g., Press Release, SEC, J.P. Morgan to Pay \$267 Million for Disclosure Failures, December 18, 2018 <https://bit.ly/1PKkkjO>.

²⁵ In the view of a majority of the Committee, the proposed IA Guidance perpetuates the problem rather than addressing it. The specific examples it offers suggest that, in many if not most cases, investment advisers would remain free to engage in conduct that is not in their clients’ best interests, and to place their own interests ahead of their clients’ interests, as long as they fully disclose those practices on their ADV Form. See, e.g., IA Guidance at 12 (“For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client’s return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict.”). Disclosure in the ADV Form has been deemed sufficient to satisfy this disclosure obligation.

supporting informed decisions.²⁶ That concern has since been reflected in many of the comment letters submitted to the Commission.²⁷ Given the central role that the disclosures play in the Commission’s proposed approach of maintaining separate standards for broker-dealers and investment advisers, a majority of the IAC believe the disclosures should be subjected to usability testing in order to determine their effectiveness. Should the usability testing find that the disclosures do not achieve their intended purpose of reducing investor confusion and promoting informed decision-making, we encourage the Commission to work with a disclosure design expert to rectify this significant shortcoming before finalizing the document.

We have been encouraged by indications from Commission officials that they plan to engage in such testing. This is consistent with our previous recommendation encouraging 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.” In order to ensure that the Form CRS disclosures fulfill their intended purpose, we believe the Commission should engage in such usability testing, and make the results public, before acting to finalize the disclosure provisions contained in the regulatory package.²⁸ Moreover, we believe the testing should include financially unsophisticated investors (by which, in this context, we mean those who do not have a clear understanding of the differences between brokerage and advisory accounts) as they will be most reliant on the disclosures to understand key differences between broker-dealers and investment advisers, including with regard to the services they offer, the nature and extent of their conflicts of interest, and the legal obligations under which they operate.

Conclusion

The IAC appreciates that the Commission has turned its attention to an issue that we have previously identified as a priority. We share the Commission’s goal of ensuring that all financial professionals meet a high standard of conduct when providing advice and recommendations to retail investors. We offer the above suggestions in the hope that they will assist the Commission in refining its proposed approach to better achieve the goal of ensuring investors receive the best interest advice and recommendations they expect from the financial professionals they turn to for help with their investments.

²⁶ Information on the June 2018 panel is available here: <https://bit.ly/2Mg5S4b>. In addition, the IAC had a panel on retail investor disclosure at the December 2017 meeting. Information on that panel is available here: <https://bit.ly/2jiADKl>.

²⁷ Tracey Longo, Will Consumers Understand The SEC’s Disclosure Documents?, Financial Advisor, August 17, 2018 <https://bit.ly/2vSjF73> (“The bulk of comment letters that have poured into the SEC on the proposal seem to agree that the disclosure fails to provide that clarity.”).

²⁸ For this purpose, it would be sufficient for the Commission to include the testing results in the comment file on the rule proposal, with an opportunity for interested parties to comment on the testing results, before acting on the rule.