MEMO# 31072

February 5, 2018

ICI Submits Supplemental Letter to SEC on Best Interest Standard of Conduct for Broker-Dealers

[31072]

February 5, 2018 TO: ICI Members
Investment Company Directors
ICI Global Members
Broker/Dealer Advisory Committee
Investment Advisers Committee
Pension Committee
Pension Operations Advisory Committee
SEC Rules Committee
Small Funds Committee
Transfer Agent Advisory Committee SUBJECTS: Compensation/Remuneration
Compliance
Disclosure
Distribution
Fees and Expenses
Intermediary Oversight
Investment Advisers
Operations
Pension
Transfer Agency RE: ICI Submits Supplemental Letter to SEC on Best Interest Standard of Conduct for Broker-Dealers

Today, ICI submitted the attached letter to SEC Chairman Jay Clayton. The letter supplements our August 2017 letter to the SEC[1] with a more detailed and somewhat revised best interest standard that would apply to broker-dealers providing recommendations to retail investors in non-discretionary accounts, across both retirement and non-retirement accounts. We explain that our goal in submitting a revised recommendation is to assist the SEC and staff by more clearly articulating a best interest standard of conduct for broker-dealers providing personalized recommendations to retail customers, and providing a framework that places the key elements of the best interest standard in the context of existing regulatory requirements. In particular, we place the standard in the context of existing broker-dealer obligations under the Securities Exchange Act of 1934 and FINRA rules, investment adviser duties under the Investment Advisers Act of 1940, and obligations of financial services providers under the Impartial Conduct Standards set forth in Department of Labor's Best Interest Contract exemption. Finally, we evaluate our recommended standard against the standards set forth in Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Revised Recommended Best Interest Standard of Conduct

Our recommended best interest standard would require that a brokerdealer, when making a "personalized recommendation about securities"[2] to a "retail customer,"[3] satisfy explicit duties of loyalty and care. A broker-dealer also would be obligated, under FINRA rules, to adopt policies and procedures reasonably designed to prevent violations of the best interest standard of conduct. The key elements of our recommended standard of conduct are summarized below.

Duty of Loyalty

Our recommended best interest duty of loyalty would have several components:

1. **Retail Customer's Interest First.** The standard would require that a brokerdealer, when making a personalized recommendation about securities to a retail customer, act in the retail customer's best interest and not put the brokerdealer's interests ahead of the customer's interests.

   The best interest duty of loyalty also would broaden a broker-dealer's disclosure obligations. A broker-dealer would be prohibited from effecting a recommended transaction that raises a material conflict between the broker-dealer's interests and the customer's interests unless the broker-dealer discloses all material facts about the conflict and obtains the customer's consent.

2. **Disclosure.** The standard would require that the brokerdealer disclose to the retail customer (perhaps in a standard format) certain key aspects of its relationship with the retail customer—such as the type and scope of services provided, the applicable standard of conduct, the types of compensation it or its associated persons receive, and any material conflicts of interest.

3. **No False or Misleading Statements.** The standard would explicitly prohibit a brokerdealer from making false or misleading statements about a recommended transaction or its compensation or material conflicts of interest.

4. **Fair and Reasonable Compensation.** The standard would explicitly require a brokerdealer to receive no more than fair and reasonable compensation for a recommended transaction.

Duty of Care

Diligence, Care, Skill, and Prudence. Our recommended best interest standard would require that a personalized recommendation about securities made by a broker-dealer to a retail customer reflect reasonable diligence, care, skill, and prudence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the customer's investment profile.

Placing the Best Interest Standard in Context

Our supplemental letter explains that our recommended best interest standard would subject broker-dealers to additional, affirmative obligations. The standard would be consistent with the standard of conduct that applies to investment advisers, as interpreted under Section 206(1) and (2) of the Advisers Act, and would satisfy the requirement under Section 913 of the Dodd-Frank Act that any standard of conduct rule adopted pursuant to that section be "no less stringent than the standard of conduct applicable to investment advisers" under Section 206(1) and (2). The best interest standard, however, differs from the fiduciary duty applicable to investment advisers because it reflects certain key differences between the investment adviser and broker-dealer business models. Importantly, it would preserve investors' ability to obtain the guidance, products, and services they need to meet their retirement and other important financial goals.

We explain that our recommended best interest standard also reflects requirements of the DOL's "Impartial Conduct Standards," which generally obligate an intermediary to provide prudent advice that is in the retirement investor's best interest, based on a duty of loyalty and a duty of care, require the intermediary to charge no more than reasonable compensation, and prohibit misleading statements. In particular, the duty of care would, consistent with DOL's Impartial Conduct Standards, include a "prudent investment professional" standard, in addition to a suitability obligation.

Sarah A. Bessin
Associate General Counsel

Attachment

endnotes

[1] Letter to the Honorable Jay Clayton, Chairman, Securities and Exchange Commission, from Dorothy M. Donohue, Acting General Counsel, dated Aug. 7, 2017, *available at* https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2188873-160255.pdf.

[2] A "personalized recommendation about securities" would mean a customer-specific "recommendation" to a retail customer within the meaning of FINRA Rule 2111.

[3] A "retail customer" would mean a natural person, or the legal representative of such person, who receives a personalized recommendation about securities that is to be used primarily for personal, family, or household purposes.