The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 31299

July 25, 2018

ICI Draft Letter to SEC on Standards of Conduct Proposals for Investment Professionals

[31299]

July 25, 2018 TO: SEC Rules Committee
Small Funds Committee RE: ICI Draft Letter to SEC on Standards of Conduct Proposals for Investment Professionals

In April, the SEC issued a proposed three-part package of rulemakings and an interpretation to address standards of conduct for broker-dealers and investment advisers.[1] The proposals include Regulation Best Interest, an interpretation regarding the standard of conduct for investment advisers, and a release on the proposed Form CRS relationship summary. ICI has been developing a draft comment letter on the proposals with the assistance of our member working group. We have attached, for your review and comment, a draft of our comment letter to the SEC.

Comments on the proposals are due to the SEC on Tuesday, August 7. If you have comments on the draft letter, please provide them in writing by Wednesday, August 1, to sarah.bessin@ici.org and linda.french@ici.org.

Summary of Draft ICI Comment Letter

Our draft comment letter makes the following key points:

Fund Fees and Expenses

The SEC should confirm that proposed Regulation Best Interest's disclosure obligation would not require a broker-dealer to separately disclose fund-level fees and expenses, and that a broker-dealer may direct customers to the fund prospectus for detailed, standardized information about fund fees and expenses. We also strongly caution the SEC against requiring broker-dealers to disclose fees and expenses on an individualized basis. We recommend that the SEC revise its descriptions of fund-related fees in proposed Form CRS to make them more product agnostic and to better clarify how different types of fees would affect an investment.

Proposed Regulation Best Interest's Care Obligation, as described, overweights cost considerations and does not sufficiently acknowledge other important factors that a broker-dealer may legitimately consider in making a recommendation. We recommend that the

SEC make explicit other factors a broker-dealer could consider and request that the SEC confirm that a broker-dealer is not required to recommend the lowest cost product. We also request that the SEC clarify certain concepts it discusses in the proposals, including what are "otherwise identical" securities and "reasonably available alternatives" for purposes of a recommendation.

Conflicts of Interest

The SEC should clarify what is a "material conflict of interest" for purposes of proposed Regulation Best Interest. It also should revise the proposed Conflict of Interest Obligations to state that a broker-dealer's policies and procedures would require *disclosure* of all material conflicts of interest associated with a recommendation, but only require *mitigation or elimination* of those material conflicts of interest associated with the recommendation that create a financial incentive for the associated person of the broker-dealer to put its interests ahead of the retail customer's interests. This approach would be consistent with the approach the DOL took in the DOL fiduciary rule.

We assert that is unnecessary for the SEC to incorporate a "best interest" standard into the Care Obligation under proposed Regulation Best Interest or the duty of care under the Advisers Act. We request your feedback on whether we should include this point in the letter.[2]

Scope of Obligations

We recommend that the SEC clarify when Regulation Best Interest applies to recommendations of an account type (*i.e.*, a brokerage account or advisory account). We request your feedback on whether we should include this section and, if so, any particular changes we should make to our recommendation.[3]

The letter addresses which investors should be covered by proposed Regulation Best Interest and proposed Form CRS. We recommend that the SEC use a single definition of "retail investor" in proposed Regulation Best Interest and Form CRS. Subject to member feedback, we plan to recommend that a "retail investor" mean a natural person, or the legal representative of such person, who:

(1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and

(2) uses the recommendation primarily for personal, family, or household purposes.

Under our recommended definition, a "retail investor" would not include a natural person with total assets of at least $50 million.[4] A "legal representative" of a natural person would not include a bank, registered broker-dealer, registered investment adviser, or other financial institution or intermediary that is responsible for exercising independent judgment in evaluating the recommendation. As to employee benefit plans, we plan to recommend that a "retail investor" not include an employee benefit plan, sponsor, or plan fiduciary, regardless of plan size. Our suggested retail definition would, however, include: (A) a participant or beneficiary of (1) a qualified plan as defined in Section 3(a)(12)(C) of the Securities Exchange Act of 1934; (2) a plan that meets the requirements of Section 403(b) or Section 457 of the Internal Revenue Code; [and (3) an "employee benefit plan" as defined in Section 3(2)(A) of ERISA;] and (B) an IRA owner[5]. We request your feedback on

all aspects of this recommended definition, which is on pages 22-23 of the attached draft letter.

We also recommend that the SEC clarify delivery obligations for funds in two situations. First, the SEC should clarify that, when an investor sends a registered fund firm a "check and application" that designates an intermediary of record, the designated intermediary would retain all delivery obligations for Form CRS and Regulation Best Interest disclosure. A fund should have no obligation in this situation to notify the intermediary or deliver Form CRS or Regulation Best Interest disclosure to the investor. Second, the SEC should clarify that a fund's limited-purpose broker-dealer would be excluded from Form CRS delivery requirements.[6]

Proposed Interpretation of an Adviser's Fiduciary Duty

The SEC should clarify the scope and applicability of an adviser's fiduciary duty, recognizing that the specific obligations that flow from an adviser's fiduciary duty depend on the scope of the relationship agreed to by the adviser and client. In particular, the SEC should acknowledge that institutional advisory relationships may differ in important ways from retail advisory relationships, which are the focus of the proposed interpretation.

The letter also addresses the proposed interpretation's treatment of disclosure and consent under the Advisers Act. The SEC's statements in the proposed interpretation suggest it believes there may be circumstances in which disclosure and informed consent are insufficient to satisfy an adviser's duty of loyalty. We recommend that the SEC confirm that full and fair disclosure of material conflicts and informed consent, which may be provided implicitly or explicitly depending on the circumstances, isthe existing standard under common law and the Advisers Act.

The draft letter responds to the SEC's request for comment on three potential enhancements to advisers' existing fiduciary obligations: (i) licensing and continuing education requirements for personnel of SEC-registered investment advisers; (ii) delivery of account statements to clients with investment advisory accounts; and (iii) financial responsibility requirements for SEC-registered investment advisers. The letter urges the SEC to not propose broker-dealer rules for advisers and explains why the three potential regulatory enhancements the SEC discusses are not necessary for fund advisers.

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Attachment

endnotes

[1] For a summary of the proposals, please see ICI Memorandum No. 31185 (Apr. 26, 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31185.

[2] Please see the discussion on pages 19-21 of the attached draft letter.

[3] Please see the discussion on page 21 of the attached draft letter.

[4] *See* FINRA Rule 2210.

[5] For purposes of Regulation Best Interest, we preliminarily intend to recommend that a participant or beneficiary of a plan or an IRA owner should be treated as a retail customer only to the extent a broker-dealer makes a recommendation (within the meaning of the rule) directly to the participant, beneficiary or IRA owner as to the advisability of acquiring, holding, disposing of, or exchanging, securities held or to be held by the plan account or IRA under the investment control of the participant, beneficiary or IRA owner, or a recommendation as to how securities should be invested after the securities are rolled over, transferred, or distributed from the plan or IRA.

[6] Proposed Regulation Best Interest would not apply in the absence of a recommendation.
