INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

July 3, 2013

Comment Letter to SEC in Response to RFI on Possible Fiduciary Duty for Broker-Dealers and IA-BD Harmonization (pdf)

July 3, 2013 Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission 100 F Street, NE Washington, DC 20549 Re: Duties of Brokers, Dealers, and Investment Advisers (File No. 4-606) Dear Ms. Murphy: The Investment Company Institute1 appreciates the opportunity to comment on the Securities and Exchange Commission's request for data and other information on the duties of brokers, dealers, and investment advisers (the "RFI").2 While nothing in the RFI is specific to the recommendation or sale of shares issued by registered investment companies (including mutual funds, ETFs, closed-end funds, and UITs, which are generally referred to as "funds" in this letter), the fund industry has a significant interest in this topic. Investors in nearly 30 million U.S. households own funds purchased through or with the help of financial professionals such as broker-dealers and investment advisers.3 The strength of the regulatory regime that applies to those financial professionals, the standard of care applicable to each, and the effectiveness of the system of oversight are issues of great importance to these millions of investors. For reasons described below, ICI continues to support the SEC staff's 2011 recommendation that the SEC adopt a fiduciary standard of conduct for broker-dealers when they are providing personalized investment advice about securities to retail investors that is no less stringent than the fiduciary duty that applies to investment advisers. The first section of our letter outlines our position on this issue. The second section of the letter provides data and other information on the ownership of funds by retail customers in the United States. The final two sections address the potential impact of a 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.3 trillion and serve more than 90 million shareholders. 2 SEC Release Nos. 34-69013 and IA-3558 (March 1, 2013), 78 FR 14848 (March 7, 2013), available at http://www.sec.gov/rules/other/2013/34-69013.pdf. 3 See 2013 Investment Company Fact Book, available at http://www.icifactbook.org, at Chapter 6, Figures 6.1 and 6.8. See also Schrass, Daniel, "Ownership of Mutual Funds Through Investment Professionals, 2012," ICI Research Perspective 19, no. 2 (February 2013), available at http://www.ici.org/pdf/per19-02.pdf. Ms. Elizabeth M. Murphy July 3, 2013 Page 2 of 14 fiduciary duty on broker-dealers with respect to their recommendation and sale of fund shares and the concept of harmonization of the investment adviser and broker-dealer regulatory regimes. Section 913 and Fiduciary Duties Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") required the SEC staff to study the appropriate standard of care applicable to broker-dealers when providing personalized investment advice about securities to retail customers. The staff delivered that study to Congress in January 2011.4 The study recommended, among other things, that the SEC exercise its discretionary rulemaking authority to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when they are providing personalized investment advice about securities to retail investors. Importantly, the study further recommended that the uniform standard of conduct be "no less stringent" than the fiduciary duty that applies to investment advisers. ICI agrees with these recommendations. We, too, believe that the SEC should establish a fiduciary standard for broker-dealers that provide personalized advice or recommendations about securities to retail customers. When acting in this capacity, a broker-dealer is performing substantially the same function as an adviser, and the legal distinctions between the two types of financial professionals are often unclear and largely irrelevant to investors.5 And if the conduct is substantially the same, the same standard should apply. In both contexts, the customer deserves a strong, fiduciary standard of care that puts his or her interests above those of the intermediary. As then-SEC Chairman Mary L. Schapiro stated, it is "difficult to justify why there should be different rules and standards of conduct for the two roles—especially when the same or substantially similar services are being provided. Investment professionals' first duty must be to their clients."6 We also agree with the 913 Study's recommended approach to implementation—namely, that the SEC would adopt rules establishing the new uniform fiduciary standard for advisers and broker- dealers as an "overlay" to supplement, and not supplant, the existing investment adviser and broker-dealer regimes. We support that approach because it would preserve the strong fiduciary standard that applies to investment advisers, along with existing precedent, while applying the same high standard to both advisers and brokers when they are providing substantially similar services to retail clients. 4 Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers (January 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf (the "913 Study"). 5 See LRN-RAND Center for Corporate Ethics, Law, and Governance, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (March 2008). 6 Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission, Testimony on "Enhanced Oversight After the Financial Crisis: The Wall Street Reform Act at One Year" Before the United States Senate Committee on Banking, Housing and Urban Affairs (July 21, 2011), available at http://www.sec.gov/news/testimony/2011/ts072111mls.htm#P39_10026. We have repeatedly cautioned, however, that in crafting implementing rules, the SEC must take care to apply the fiduciary standard to broker-dealers in a way that will not chill legitimate practices. For example, broker-dealers should be permitted to: • Maintain a commission-based business that does not involve the provision of personalized advice. Simply selling an investment product should not be a fiduciary act. • Limit the scope, nature, and anticipated duration of the relationship with the customer. An adviser's fiduciary duty is not unlimited in scope; a broker's should not be either. • Sell proprietary investment products. Both advisers and brokers must be able to disclose any material limitations on the range of investment products about which they advise clients, and whether similar products are available outside that range. • Offer the use of financial calculators or similar investment tools for general informational purposes without, in most instances, taking on fiduciary status (although we recognize that the use of these types of tools may, in some circumstances, entail the provision of personalized advice). • Provide information about investment products derived from third-party sources, such as prospectuses, fund fact sheets, and independent third-party ratings information, without taking on fiduciary status. • Execute unsolicited trades without taking on fiduciary status. • Service orphaned accounts without taking on fiduciary status. • Engage in trading as principal, subject to appropriate limitations, disclosure, and customer consent. The RFI sets forth a number of assumptions directly in line with these recommendations. It instructs us to assume, for example, that a broker or dealer with a fiduciary duty could maintain a commission-based business, recommend proprietary products, or recommend a limited range of products. We recognize that the assumptions in the RFI are not intended to suggest the SEC or staff's policy views or the ultimate direction of the SEC's actions on these issues. We would like to highlight one set of assumptions, however, where we believe the SEC's ultimate action should differ from the RFI's assumptions—those relating to principal trading. The RFI asks commenters to assume that the uniform fiduciary standard of conduct would permit broker-dealers to continue to engage in principal trades, and the rule would not incorporate the transaction-by-transaction disclosure and consent requirements of Section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act"). It also expressly states that the new rule would not relieve an investment adviser from its obligations under Section 206(3), which would continue to apply to investment advisers. We agree with several aspects of this assumption. Even as fiduciaries, broker-dealers should be permitted to engage in principal trading, which has the potential to benefit customers through enhanced liquidity, expanded investment choices, and better execution of trades. There is, however, the potential for self-dealing when any fiduciary—whether a broker-dealer or adviser—acts as principal in transactions with customers. While Section 206(3) of the Advisers Act provides a model for dealing with this potential conflict,7 we agree that imposing all of the requirements of that section, including trade-by-trade disclosure and customer consent, may not be warranted. We disagree, however, with the suggestion that Section 206(3) should continue to apply to advisers in its current form. Given the demonstrated difficulties that advisers have faced in complying with this regime, we would encourage the SEC to use this opportunity also to revisit its interpretations under Section 206(3) for registered investment advisers. There also is one assumption not made in the RFI that is worth highlighting. In several places, the 913 Study stated that the SEC staff has taken the position that a person's receipt of transaction- based compensation (i.e., commissions) is a hallmark of broker-dealer activity, and that investment advisers receiving transaction-based compensation would need to consider whether they are obligated to register as broker-dealers under Section 15 of the Securities Exchange Act of 1934.8 As the standard of care for broker-dealers and advisers is harmonized, the label applied to the type of compensation they receive should no longer be relevant. Advisers and broker-dealers providing personalized investment advice or recommendations should equally be permitted to receive—and share—both asset-based fees and commissions. Ownership of Funds by Retail Customers in the United States We estimate that in 2012, 53.8 million U.S. households—44 percent of all U.S. households—owned mutual funds.9 These fund investors purchase and sell mutual funds through four principal sources: employer-sponsored retirement plans; fund companies, directly; fund supermarkets; and 7 Section 206(3) makes it unlawful for an adviser, acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to the transaction. See pages 24– 27 of the 913 Study for a more complete description of Section 206(3). 8 See 913 Study at n.164, Section II.B.2, and n.514. The SEC elsewhere has sought comment on whether the opposite is also true—whether a broker-dealer’s receipt of ongoing compensation such as 12b-1 fees might require it to register as an investment adviser. See Mutual Fund Distribution Fees; Confirmations, SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010), at 124–25. 9 Many ICI survey statistics relate solely to mutual funds and not other types of registered investment companies. Mutual funds, by far, account for the largest share of overall fund assets. Ms. Elizabeth M. Murphy July 3, 2013 Page 5 of 14 investment professionals such as advisers, full service broker-dealers, and independent financial planners. Of those that owned mutual funds outside workplace retirement plans, 82 percent held funds purchased with the help of an investment professional.10 Households owning mutual funds outside of workplace retirement plans purchased their funds through a variety of sources (Figure 1). Forty-seven percent of investors who owned funds outside employer-sponsored retirement plans purchased their funds solely with professional financial help, while another 35 percent owned funds purchased from investment professionals and fund companies directly, fund supermarkets, or discount brokers. Eleven percent solely owned funds purchased directly from fund companies, fund supermarkets, or discount brokers. 10 For these purposes, we define investment professionals to include registered investment advisers, full-service brokers, independent financial planners, bank and savings institution representatives, insurance agents, and accountants. Ms. Elizabeth M. Murphy July 3, 2013 Page 6 of 14 Nearly half (48 percent) of mutual fund-owning households held mutual funds through multiple sources (Figure 2). In May 2012, 17 percent of mutual fund-owning households held mutual funds both inside employer-sponsored retirement plans and through investment professionals; 5 percent owned mutual funds both inside employer-sponsored retirement plans and directly through fund companies, fund supermarkets, or discount brokers; and 10 percent held mutual funds through investment professionals and fund companies, fund supermarkets, or discount brokers. Another 13 percent owned mutual funds through all three source categories. When owning funds through only one source category, the most common route to fund ownership was employer-sponsored retirement plans: 35 percent of mutual fund-owning households owned funds only through their employer- sponsored retirement plans. History of Fund Distribution and the Compensation of Financial Professionals The ways that financial professionals are compensated for their services has changed significantly over time. Before 1980, many funds compensated investment professionals for providing advice, assistance, and ongoing services to shareholders through front-end sales loads. Other funds sold shares directly to investors without a sales load. Investors in these funds either did not receive advice and assistance or obtained and paid for these services separately. Ms. Elizabeth M. Murphy July 3, 2013 Page 7 of 14 In 1980, the SEC adopted Rule 12b-1 under the Investment Company Act permitting funds, subject to largely procedural conditions, to pay distribution-related costs directly from fund assets.11 The rule, as adopted, prohibited an open-end fund from using its own assets to pay for any distribution costs unless it had adopted a written plan approved by the fund’s board and its shareholders and the fund’s distribution payments were made pursuant to the plan. These distribution fees, known as 12b-1 fees, provide a way for investors to pay indirectly for some or all of the services they receive from financial professionals (such as their broker) and other financial intermediaries (such as retirement plan recordkeepers and discount brokerage firms). These fees also can be used to pay for the fund’s advertising and marketing expenses, but in practice such usage is minor. In 1982, the SEC issued the first of nearly 300 exemptive orders permitting mutual funds to adopt a “spread load”12 consisting of an asset-based fee, charged in accordance with Rule 12b-1, in combination with a contingent deferred sales load (“CDSL”).13 The advent of spread-load arrangements provided mutual fund investors who rely on the advice and assistance of financial professionals in making their investment decisions the option of paying for those services over time. Beginning in 1985, the SEC issued nearly 200 exemptive orders permitting mutual funds— subject to a series of conditions—to issue multiple classes of shares. A fund with a multi-class structure has one portfolio of securities managed pursuant to the fund’s investment objectives and policies, but multiple classes of shares, each with unique shareholder services and/or distribution arrangements and therefore different fees and expenses. In 1995, concurrently with the adoption of Rule 6c-10 governing CDSLs, the SEC adopted Rule 18f-3 under the Investment Company Act, which essentially codified the exemptive orders and streamlined the conditions applicable to funds implementing a multi-class structure.14 11 See Bearing of Distribution Expenses by Mutual Funds, SEC Release No. IC-11414 (Nov. 7, 1980). 12 A spread load is a plan under which a fund uses annual 12b-1 fees in place of, rather than as a supplement to, a traditional front-end sales load to cover the cost of distribution efforts. 13 A CDSL is a sales charge that is imposed only if an investor redeems his shares within a specified period of time following purchase. The rate of the CDSL, typically starting between 2 percent and 6 percent, declines over time, usually at a rate of 1 percent per year. Although CDSLs had been used with variable insurance products before the adoption of Rule 12b-1, they had not been used in connection with mutual funds. 14 See Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, SEC Release Nos. 33-7143, IC-20915 (Feb. 23, 1995). Common Types of Fund Share Classes The proliferation of fund share classes since 1985 reflects the evolution of fund distribution. Generally speaking, “load” classes serve investors who own fund shares purchased through broker- dealers and certain other financial professionals; “no-load” fund classes usually serve investors who purchase shares without the assistance of a financial professional or who choose to compensate the financial professional separately, such as the typical arrangement with a fee-based adviser. As described in detail below, over the last decade, mutual fund investors increasingly compensate financial professionals through fee-based channels that use load-waived share classes or institutional no-load pricing. No-Load Share Classes No-load share classes have no front-end load or CDSL, and have a 12b-1 fee of 0.25 percent (25 basis points) or less. Originally, no-load share classes were sold directly by mutual fund sponsors to investors. Now, investors can purchase no-load funds through employer-sponsored retirement plans, mutual fund supermarkets, discount brokerage firms, and bank trust departments, as well as directly from mutual fund sponsors. Many investment advisers who charge investors separately for their services, rather than through a load or 12b-1 fee, use no-load share classes. Load Share Classes Load share classes have a sales load or a 12b-1 fee or both. The sales load and 12b-1 fee are used to compensate brokers and other financial professionals for their services. Types of common load share classes include front-end load shares, level-load shares, and “other” load shares: • Front-end load shares, which are predominantly Class A shares, were the traditional way investors compensated financial professionals for assistance. These shares generally charge a sales load—a percentage of the sales price or offering price—at the time of purchase. They also generally have a small 12b-1 fee, often 0.25 percent (25 basis points). • Level-load shares, which include Class C shares, generally do not have front-end loads. Investors in this kind of share class compensate financial advisers with a combination of an ongoing 12b-1 fee (typically 1 percent) and a small CDSL that shareholders pay if they sell their shares within the first year after purchase (also often 1 percent). • Other load shares include all other commissionable share classes. This category is primarily comprised of classes designed specifically for use with retirement plans, often denominated as R shares. Our statistics include a fourth category of load shares called back-end load shares, which are primarily Class B shares. Back-end load shares utilize a combination of an annual 12b-1 fee and a CDSL. The CDSL is paid if fund shares are redeemed before the end of a given period of ownership. Back-end load shares usually convert after a specified number of years to a share class (e.g., A shares) with a lower 12b-1 fee. The assets in back-end load shares have declined substantially in recent years due to the combination of fewer new sales and ongoing conversions, becoming for the most part economically insignificant. Current Data and Trends in Share Class Ownership There have been two related recent trends with respect to fund share class ownership by retail investors. First, there has been a definite shift by investors toward no-load share classes, particularly institutional no-load share classes. Some of this movement may be attributed to "do-it-yourself" investors who do not engage a financial professional. As explained below, however, the majority of the shift is more likely a function of changes in the way investors pay for the services they receive from brokers and other financial professionals and a migration to fee-based accounts.15 Second, among load share classes, there has been a marked decline in the loads actually paid by fund investors, with front- end loads that investors actually paid declining to 1 percent or less in 2012. The shift toward asset-based fees is an important element in the changing distribution structure of funds and an important trend to understand in the context of the RFI. Over time, brokers and other financial professionals who sell funds have increasingly been compensated through asset-based fees. An investor may pay an asset-based fee indirectly through a fund's 12b-1 fee, which is included in the fund's expense ratio, as is the case with level-load shares sold by a broker-dealer. Alternatively, an investor may pay an asset-based fee directly (out-of-pocket) to the financial professional. This is the case with fee- based accounts with an investment adviser that make use of institutional shares or load-waived front- end load shares. In part because of this trend toward payment of asset-based fees (either through the fund or out-of-pocket), assets in front-end and back-end load share classes have declined in recent years while those in level load, other load, and no-load share classes have increased substantially (Figure 3). For example, in the past five years, front-end and back-end load share classes have experienced net outflows totaling $456 billion (Figure 4) and seen their assets fall from $2,377 billion in 2007 to $1,920 billion in 2012. Gross sales of back-end load share classes have dwindled to almost zero. Meanwhile, level load, 15 Many commentators have recognized this trend. See, e.g., Strategic Insight, The U.S. Mutual Fund Marketplace: Evolution, Distribution Structure, Fees, and Financial Advisor Compensation Trends (January 2013) ("Strategic Insight 2013 Trends") (explaining how, over the past two decades, fees have shifted from commissions to "almost exclusively" fee-based compensation); Corrie Driebusch, "The New ABCs of Mutual Funds," Wall Street Journal (May 31, 2013) ("The transformation reflects broader shifts in how financial advisers get paid, as financial advisers have moved more toward fee-based compensation and away from selling certain classes of shares depending on what the classes pay in commissions."). Ms. Elizabeth M. Murphy July 3, 2013 Page 10 of 14 other load (such as share classes designed for retirement plans), and no-load share classes have seen net inflows and rising asset levels over the past ten years.16 16 No-load share classes have in the past 10 years accumulated the bulk of the inflows to long-term funds. In 2012, no-load share classes accounted for 61 percent of the assets of long-term funds compared to 49 percent in 2003. Since 2007, level load and other load share classes have experienced modest inflows and growth in assets. Ms. Elizabeth M. Murphy July 3, 2013 Page 11 of 14 Among load shares, there has been a marked decline in loads paid by fund investors. The maximum front-end load that shareholders might pay for investing in mutual funds has changed little since 1990, but the front-end loads that investors actually paid have declined markedly, from nearly 4 percent in 1990 to 1 percent or less in 2012 (Figure 5). This in part reflects the increasing role of mutual funds in helping investors save for retirement, as funds that normally charge front-end loads often waive loads on purchases made through defined contribution plans, such as 401(k) plans. Also, as noted above, front-end load funds offer volume discounts, waiving or reducing loads for large initial or cumulative purchases. Ms. Elizabeth M. Murphy July 3, 2013 Page 12 of 14 The Potential Impact of a Fiduciary Duty on Broker-Dealers with Respect to their Recommendation and Sale of Fund Shares Part III of the RFI seeks data and other information on the potential implications for the marketplace with respect to establishing a uniform fiduciary standard of conduct for broker-dealers and investment advisers. It is impossible to predict how imposing a fiduciary duty on broker-dealers would affect the sale of fund shares. As is evident from the data provided above, funds are sold through multiple channels with a variety of share classes designed to accommodate the ways investors choose to compensate their broker-dealers and advisers. Regardless of the approach ultimately taken by the Commission, we expect Ms. Elizabeth M. Murphy July 3, 2013 Page 13 of 14 that fund sponsors will continue to design share classes to meet the needs of their various distribution partners and to make adjustments as those needs evolve. It is true that advisers generally favor institutional or no-load pricing when using fee-based accounts with retail customers, and it is possible that the imposition of a fiduciary duty may encourage broker-dealers similarly to favor institutional or no-load pricing. Certain assumptions in the RFI suggest, however, that this will not necessarily be the result. For example, the RFI instructs commenters to “assume that the uniform fiduciary standard of conduct would be designed to accommodate different business models and fee structures of firms, and would permit broker-dealers to continue to receive commissions; firms would not be required to charge an asset-based fee.”17 Given this assumption, it appears possible that broker-dealers could continue to recommend and sell C shares and other level load shares to their customers consistent with a fiduciary duty, providing an alternative to advisers using institutional shares in fee-based accounts. In such case, the imposition of a fiduciary duty may have little or no impact on the sale of fund shares.18 Harmonization of the IA and BD Regulatory Regimes The RFI seeks data and other information on potential areas, other than the standard of conduct, where the Commission might consider harmonizing the regulatory obligations of broker- dealers and investment advisers. These areas include advertising and other communications, the use of finders and solicitors, supervision, licensing and registration of the firms, continuing education requirements for associated persons, and books and records requirements. Unlike the rest of the RFI, this section is not expressly limited to those instances in which broker-dealers and investment advisers perform the same or substantially similar functions while providing personalized investment advice about securities to retail customers. In our view, the Commission’s consideration of harmonization issues, at least in the near term, should be linked to its consideration of a fiduciary duty and limited to the same context. We note that the business models of broker-dealers and advisers in most respects are very different, and in many ways the regulatory models have been designed appropriately to address those differences. We suggest that the Commission wait until markets have had a chance to adjust to any new fiduciary standard and then determine whether the imposition of the new standard has resulted in greater convergence of business models. If so, then further consideration of additional harmonization might be warranted. * * * * * 17 See RFI at 26. 18 In any event, however, the existence of a fiduciary duty is not the only factor influencing a financial professional’s choice of share class. See, e.g., Strategic Insight 2013 Trends at 8 (“In Strategic Insight’s view, a key reason for such transition has been the desire of fund distributors to establish a more stable revenue base for their financial advisors. The fees-for-advice model provided this more stable base, as compared to the revenue generated by ‘transactions’—which can decline dramatically during periods of financial uncertainty.”). Ms. Elizabeth M. Murphy July 3, 2013 Page 14 of 14 We appreciate your consideration of our views on this important topic. If you have any questions or need additional information, please contact me at (202) 326 5815. Sincerely, /s/ Karrie McMillan Karrie McMillan General Counsel cc: The Honorable Mary Jo White The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable

Troy A. Paredes The Honorable Daniel M. Gallagher Norm Champ, Director, Division of Investment Management

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