The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

August 7, 2017

ICI Comment Letter on Best Interest Standards for BDs (pdf)

August 7, 2017 The Honorable Jay Clayton Chairman Securities and Exchange Commission 100 F Street, NE Washington, D.C. 20549 Re: Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers Dear Chairman Clayton: The Investment Company Institute1 commends you for inviting public comment in connection with the SEC's assessment of standards of conduct for investment advisers and broker-dealers, and for committing to work constructively on these standards with the Department of Labor (DOL).2 The registered investment company ("fund") industry has a significant interest in the conduct standards that apply to financial professionals. Investors in nearly 27.9 million US households own funds purchased through or with the help of financial professionals such as broker-dealers and investment advisers.3 These investors deserve advice from financial professionals that is in their best interests, regardless of whether they are saving for retirement or other financial goals. The Commission's inquiry is timely, given the harmful effects that DOL's adoption of its "fiduciary rulemaking" has caused. The fiduciary rulemaking re-defined who the Employee Retirement Income 1 The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$20.0 trillion in the United States, serving more than 95 million US shareholders, and US$6.0 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC. 2 Chairman Jay Clayton, Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers (June 1, 2017), available at https://www.sec.gov/news/public-statement/statement- chairman-clayton-2017-05-31 ("Statement"). 3 See 2017 Investment Company Institute Fact Book (2017), available at http://www.icifactbook.org/ch6/17_fb_ch6. The Honorable Jay Clayton August 7, 2017 Page 2 of 17 Securities Act of 1974 (ERISA) will treat as a fiduciary in connection with providing investment advice, expanded the application of ERISA fiduciary status, and thereby limited the types of activities in which financial professionals may engage.4 While DOL intended the rule to improve the quality of the financial advice that retirement investors receive, the rule, in practice, instead has harmed these investors in multiple ways. Many financial professionals serving retirement investors find that the fiduciary rulemaking's BIC exemption is unworkable for certain products, that they cannot justify the resulting risk and liability (including the substantial threat of unwarranted litigation) for certain accounts, or

that complying with the BIC exemption is simply too burdensome. This has caused dislocations and disruption within the financial services industry, significantly limiting the ability of retirement savers to obtain the guidance, products, and services they need to meet their retirement goals. The SEC has considered issues related to standards of care for financial professionals many times over the years.5 Yet this is a critical opportunity for the SEC to act to ensure that retail investors' interests are put first, while preserving investors' access to the products and services necessary to meet their savings goals. We believe the Commission should adopt—and DOL should recognize in a streamlined exemption—a best interest standard of conduct for broker-dealers that would apply when they make recommendations to retail investors in non-discretionary accounts, whether those investors are saving for retirement or other important goals. This best interest standard would achieve your stated objectives of clarity, consistency, and coordination with DOL.6 4 DOL issued a final regulation defining who is a fiduciary of an employee benefit plan under ERISA or an individual retirement account (IRA) under section 4975 of the Internal Revenue Code ("Code"), as a result of giving investment advice to a plan or its participants or beneficiaries, or an IRA or IRA owner. See 81 Fed. Reg. 20946 (Apr. 8, 2016). The Department issued the Best Interest Contract or "BIC" exemption, published at 81 Fed. Reg. 21002 (Apr. 8, 2016), at the same time as the final rule with the stated intent—subject to its many conditions—of permitting intermediaries to receive commissions and other compensation that the rule otherwise would prohibit. Public reports of intermediary actions responding to the rule document that the BIC exemption has failed to meet its intended purpose of continuing to allow commission-based models. See, e.g., "Edward Jones Shakes Up Retirement Offerings Ahead of Fiduciary Rule," Wall Street Journal, August 17, 2016, available at https://www.wsj.com/articles/edward-jones-shakes-up-retirement-offerings-ahead- of-fiduciary-rule-1471469692; "Fiduciary ready: Edward Jones Unveils Compliance Plans," On Wall Street, August 19, 2016, available at http://www.onwallstreet.com/news/fiduciary-ready-edward-jones-unveils-compliance-plans; and "JPMorgan Chase to Drop Commissions-Paying Retirement Accounts," Reuters, November 10, 2016, available at http://www.reuters.com/article/us-jpmorgan-wealth-compliance-idUSKBN1343LK. 5 See, e.g., Angela A. Hung, et al., RAND Institute for Civil Justice, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2008), available at https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf; Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers (Jan. 2011) ("2011 SEC Study"), available at https://www.sec.gov/news/studies/2011/913studyfinal.pdf; and Duties of Brokers, Dealers, and Investment Advisers, SEC Rel. No. 34-69013, IA-3558 (Mar. 1, 2013) ("2013 SEC Request for Data"), available at https://www.sec.gov/rules/other/2013/34-69013.pdf. 6 See Statement, supra note 2 (describing key elements of clarity, consistency, and coordination). The Honorable Jay Clayton August 7, 2017 Page 3 of 17 We briefly describe below our key recommendations to the Commission: • The SEC should take the lead in establishing and enforcing a best interest standard of conduct for broker-dealers providing recommendations to retail investors in non-discretionary accounts, across both retirement and non-retirement accounts.7 • The SEC should coordinate closely with DOL so that DOL explicitly recognizes the best interest standard of conduct in a new, streamlined prohibited transaction exemption for financial services providers that are subject to an SEC-governed standard of conduct. • The SEC should maintain the existing fiduciary duty standard for investment advisers that has served investors well for over seven decades. We explain each of these points in more detail below. We first discuss how the DOL's fiduciary rulemaking has harmed investors and disrupted the financial advice market. I. Current DOL

Standard of Conduct for Retirement Accounts Is Harming Investors and Disrupting the Market (Response to Questions 5, 6, 7)8 As you are aware, to receive commission-based compensation, the fiduciary rulemaking (through the BIC exemption) requires broker-dealers to comply with a series of complex and burdensome conditions, which expose broker-dealers to significant litigation risk. Many broker-dealers already have limited their product offerings and advice options, and have jettisoned longstanding clients, because of concerns about their ability to satisfy the burdensome conditions of DOL's BIC exemption.9 Moreover, the financial professionals that sell mutual funds require product offerings that are consistent with the compensation requirements under the BIC exemption. Bringing these new product offerings to market in an environment of regulatory uncertainty and shifting intermediary demands has created—and continues to create—significant and unrecoverable costs for the fund industry. 7 For ease of reference, throughout this letter we refer to our recommended standard of conduct as the "best interest standard of conduct," and to the SEC-registered brokers and dealers to which it would apply simply as "broker-dealers." 8 As the Statement requests, we identify throughout our letter the particular question to which our response relates. 9 The BIC exemption requires a broker-dealer to comply with a series of complex and abstruse conditions, including for IRA clients, a written contractual obligation to adhere to specific warranties about policies and procedures to mitigate conflicts, unclear standards relating to compensation arrangements that seem to require identical compensation with respect to all mutual fund products regardless of differences in selling agreements and service offerings, a variety of disclosure obligations at various points in time, and a ban on class action waivers. The Honorable Jay Clayton August 7, 2017 Page 4 of 17 A. Investor Harm (Response to Question 5) If implemented in its current form, and without accompanying changes to the retail market, the current fiduciary rulemaking will bring an estimated $109 billion in financial harm to retirement savers, according to ICI analysis.10 The increasing difficulty of providing commission-based accounts under the fiduciary rulemaking is leading to reduced product choice, a move to asset-based arrangements that may be more costly for buy-and-hold investors, and an increase in account minimums for commission- based accounts. Many of those harmed will be savers with small account balances that cannot obtain affordable financial advice as a result of the fiduciary rulemaking. Many of these investors may find that broker-dealers are unwilling to continue offering them transaction-based accounts, but that they do not meet the minimum balance that many investment advisers require for a fee-based arrangement.11 As widely reported, intermediaries have announced a variety of changes to service offerings, including no longer offering mutual funds in brokerage IRA accounts and raising account minimums or discontinuing advisory services and commission-based arrangements for lower balance accounts. Other firms have announced that they no longer will offer IRA brokerage accounts at all, or will reduce web-based financial education tools.12 Indeed, in many instances, intermediaries have informed our members that they will no longer service certain account holders because of concerns about being deemed an ERISA fiduciary under the fiduciary rulemaking. When an intermediary resigns from an account, this "orphaned" account loses the benefit of the advice and other services that intermediary provided. These "orphaned" accounts already number in the hundreds of thousands, and industry participants indicate that the numbers will climb substantially as implementation efforts proceed.13 10 See Letter from Dorothy M. Donohue, Acting General Counsel, and David M. Abbey, Deputy General Counsel— Retirement Policy, Investment Company Institute, to Office of Exemption Determinations, Employee Benefits Security Administration, Department of Labor, dated July 21, 2017, available at https://www.dol.gov/sites/default/files/ebsa/laws- and-regulations/rules-and-regulations/public-comments/1210-AB82/00229.pdf ("ICI's July 21, 2017 Letter to DOL"). This would amount to $780 million per month in investor losses. 11 Whether a fee-based or

a transaction-based account is more cost-effective for a particular investor may depend on factors including the investor's account balance, time horizon, and trading frequency. 12 See "A Complete List of Brokers and Their Approach to 'The Fiduciary Rule,'" Wall Street Journal, February 6, 2017, available at https://www.wsj.com/articles/a-complete-list-of-brokers-and-their-approach-to-the-fiduciary-rule- 1486413491. 13 Orphaned accounts are those from which an intermediary has resigned as broker-dealer of record because of its concerns about complying with the DOL's fiduciary rulemaking. ICI informally surveyed its members in March regarding notifications of dealer resignations. Thirty-one out of thirty-two mutual fund companies surveyed reported either having received orphaned accounts or receiving notices regarding some volume of accounts that will become orphaned. Many smaller mutual fund complexes have not yet received resignation notifications from intermediaries. Members have indicated that, depending on the outcome of the rulemaking, they expect the volume of orphaned accounts to increase and that a The Honorable Jay Clayton August 7, 2017 Page 5 of 17 Other accounts, while not orphaned, will receive automated, rather than human, advice. Some have asserted that so-called "robo-advisors" will be an adequate substitute for this lost human interaction, but this may not be true in all cases, particularly for investors who seek guidance regarding event- specific questions. Investors may benefit significantly from human advice on issues such as whether to stay the course or shift investments to cash in time of market downturns or stress, whether to take a withdrawal (or a loan, in the case of a plan), or whether to keep assets in a plan versus rolling them over to an IRA. In short, there is now clear evidence that the fiduciary rulemaking is harming investors in a number of ways. The rulemaking is limiting retirement savers' choices, restricting their access to information they need for retirement planning, and increasing costs, particularly for those savers who can least afford it.14 B. Market Disruption (Response to Question 5) DOL estimated that implementing the fiduciary rulemaking would cost $5 billion in the first year of the final rule's application.15 The Department's estimate, however, does not include any allowance for the amount that asset managers, including mutual funds, will spend to develop products to assist broker-dealers in complying with the BIC exemption, such as T shares16 and so-called "clean shares."17 In fact, intermediary requests for new product offerings are causing funds to incur significant and unrecoverable costs as intermediaries continue to change course on the product offerings they need to comply with the fiduciary rulemaking. significant increase could affect their ability to service shareholders. The expectation is that the number of orphaned accounts likely will run into the hundreds of thousands. 14 We discuss the "advice gap" that the fiduciary rulemaking is creating in Appendix B to our August 7 letter to DOL. See Letter from Dorothy M. Donohue, Acting General Counsel, and David M. Abbey, Deputy General Counsel—Retirement Policy, Investment Company Institute, to Office of Exemption Determinations, Employee Benefits Security Administration, Department of Labor, dated August 7, 2017 ("ICI's August 7, 2017 Letter to DOL"). 15 See DOL Regulatory Impact Analysis, 82 Fed. Reg. 16902, at 16907-8; and US Department of Labor, Employee Benefits Security Administration, Regulating Advice Markets, Definition of the Term "Fiduciary" Conflicts of Interest—Retirement Investment Advice Regulatory Impact Analysis for Final Rule and Exemptions (April 2016), at p. 10, available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210- AB32-2/conflict-of-interest-ria.pdf. 16 T shares generally have a uniform front-end load similar to an A share, but with a lower commission, generally around 2.5 percent. 17 "Clean shares" generally have no front-end load, deferred sales charge, or other asset-based fee for sales or distribution. See SEC Interpretive letter (Jan. 11, 2017), available at https://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm. The Honorable Jay Clayton August 7, 2017 Page 6 of 17 For

example, we estimated in March 2017 that funds already had spent upwards of $17 million in sunk costs relating to only one segment of product changes—the creation of T shares.18 The launch of a new share class is complex and costly. Direct costs that funds incur related to a share class launch generally include legal consultation, audit work, system modifications and establishment of product parameters (e.g., account minimums, shareholder eligibility, rights of accumulation calculations), various filing fees (e.g., NASDAQ, CUSIP), Blue Sky registration fees by state, print and typesetting costs for production of regulatory documents, and seed money. These direct costs do not include compensation of full-time employees, overhead, and other "soft" costs. While the cost to launch a share class can vary widely depending on several factors, the data from our members show that on average the direct cost to launch a fund share class is $31,000. We estimated that funds may need to launch more than 3,500 T share classes to comply with the rule. The cost of creating approximately 3,500 new share classes would total at least $111 million. The move toward T shares is a primary example of the inadvertent market disruption that the fiduciary rulemaking has caused. Many funds have been developing T shares, which in most cases the industry expects to use only as a temporary solution. A sampling of our members19 reports intermediaries' declining interest in T shares, and confirms that this development is due in part to a growing perception that "clean shares" offer a better long-term solution. ICI members also report that many of their key intermediary partners are strongly considering using mutual fund clean share classes in both fee-based 18 See Letter from Brian Reid, Chief Economist, and David W. Blass, General Counsel, Investment Company Institute, to DOL, dated March 17, 2017, available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB79/01073.pdf. 19 ICI informally surveyed its members regarding their adoption of T shares. Two-thirds of respondents to ICI's member survey indicated they had requested SEC approval to introduce T shares to the market, yet only 17% of respondents have actually launched T shares, and another 11% plan to launch later this year. The majority of respondents (approximately 72%) indicated there is not sufficient intermediary demand to warrant the launch of T shares. The Honorable Jay Clayton August 7, 2017 Page 7 of 17 and commissionable account arrangements but that certain obstacles20 prevent rapid adoption of clean shares.21 II. SEC Should Establish and Enforce a Best Interest Standard for Broker-Dealers; DOL Should Create an Exemption that Defers to an SEC-Governed Standard (Response to Questions 5, 6, 8, 9, 14, 17) We recommend below that the SEC take the lead in establishing and enforcing a best interest standard for broker-dealers that would apply consistently across retirement and non-retirement accounts.22 This enhanced standard of conduct would better serve investors and would mitigate the harms that the fiduciary rulemaking is causing. We urge the SEC to coordinate closely with DOL so that DOL explicitly recognizes the best interest standard of conduct in a new, streamlined prohibited transaction exemption for financial services providers that are subject to an SEC-governed standard of conduct. We explain below the contours of our recommended standard of conduct for broker-dealers, including using the FINRA definition of "recommendation," and recommend that investment advisers remain subject to their existing fiduciary duty. 20 These obstacles include: (1) intermediaries must modify significantly both brokerage and sub-account recordkeeping systems to apply the intermediary's own commission, rather than apply the traditional fund sales charge, on account transactions and report this information on shareholder confirmations; (2) intermediaries must determine how clean shares fit within the intermediary's ongoing business model for adviser compensation and coverage of account servicing costs; and (3) funds may require intermediaries to execute an addendum to selling agreements to clarify their role as broker when offering clean shares. The contract vetting and sign-off process takes time to execute, especially considering that funds responding to ICI's survey reported

an average of 864 retail intermediary arrangements. While not all intermediaries may choose to offer clean shares, the number of agreement updates to allow intermediaries to sell clean shares to retail investors could be significant. ICI estimates that the total cost to the fund industry to implement clean shares could approach $100 million. 21 A number of our members also report that a large portion of their intermediary partners have not contacted them regarding their compliance plans, which leaves fund firms uncertain about which product offerings they should be developing. 22 This standard would be consistent with Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Section 913 provides that the Commission may promulgate rules to establish a best interest standard of conduct for brokers and dealers that is "no less stringent" than the standard applicable to investment advisers under the Investment Advisers Act of 1940. Section 913 explicitly provides that receiving commission-based compensation, in itself, should not be considered a violation of any such standard, nor should the sale of only proprietary or other "limited range of products." The Honorable Jay Clayton August 7, 2017 Page 8 of 17 A. SEC Should Take the Lead in Establishing and Enforcing a Best Interest Standard for Broker-Dealers (Response to Questions 5, 6, 8, 9) We agree with you that the principles of clarity, consistency, and coordination should guide reform in this area.23 We explain below why an SEC-led effort to establish a best interest standard of conduct, in coordination with DOL's efforts to issue a streamlined exemption, will best achieve these objectives. 1. SEC Standard Would Provide Clarity (Response to Questions 8, 9) Only the Commission, as the primary regulator of broker-dealers, is in a position to issue a best interest standard of conduct that will achieve the clarity that both investors and markets sorely need. Only the Commission can issue a standard of conduct that will apply to broker-dealers' conduct across both retirement and non-retirement accounts. Doing so would avoid the confusion of applying two inconsistent standards to broker-dealer conduct—and would make clear to broker-dealers their obligations, and to investors the duties that the broker-dealers that service their accounts owe them. Appropriate disclosure obligations under the standard would help ensure that investors understand the broker-dealer's role and the standard of conduct that applies to the relationship.24 The SEC also could enforce a best interest standard directly, unlike the DOL. As the primary regulator of broker-dealers, the SEC has enforcement authority over them both directly and through FINRA. An SEC-issued best interest standard therefore would avoid the risk, expense, and uncertainty that the DOL's BIC exemption has created because of its reliance on a private right of action for enforcement.25 2. SEC-Governed Standard of Conduct Would Create Consistency Across Retirement and Non-Retirement Accounts (Response to Questions 8, 9) A best interest standard for broker-dealers also would ensure a consistent standard for broker-dealers whether they are providing recommendations to investors with respect to their retirement or non- retirement accounts. Broker-dealers that choose to comply with the BIC exemption currently find themselves subject to an ERISA-based fiduciary standard of conduct that, as the DOL applies it, is 23 See Statement, supra note 2. 24 Id. (Question 1). 25 DOL included the private right of action specifically because it does not have enforcement authority over IRAs. The SEC's and FINRA's examination and enforcement programs, however, provide strong protections for investors, including retirement investors, and would serve to enforce compliance with the SEC's conduct standards, making the BIC exemption's contractual warranties and private right of action unnecessary. Our letter to DOL discusses these points in further detail. See ICI's August 7, 2017 Letter to DOL, supra note 14. The Honorable Jay Clayton August 7, 2017 Page 9 of 17 consistent with neither the fiduciary standard that applies to investment advisers nor the suitability standard that applies to broker-dealers.26 We set out in an appendix to this letter the existing standards of conduct that apply to investment advisers providing advice to their clients, broker-dealers providing recommendations to their customers, and

intermediaries providing certain types of advice to plans subject to ERISA. 3. SEC Should Work with DOL to Ensure a Coordinated Approach Across Investors' Retirement and Non-Retirement Accounts (Response to Question 5, 6) Were the SEC to develop a best interest standard, and DOL to establish a corollary exemption recognizing the standard, it would ensure a coordinated approach across investors' retirement and non- retirement accounts. DOL recently released a request for information (RFI) that identifies a number of possible changes to the BIC exemption and questions that imply likely future changes to the fiduciary rule itself.27 Among other things, the RFI requests comment on whether, if the SEC were to "adopt updated standards of conduct applicable to the provision of investment advice to retail investors . . . a streamlined exemption or other change [could] be developed for advisers that comply with or are subject to those standards . . . ."28 We believe it could, and recommend that DOL explicitly recognize the best interest standard of conduct in a new streamlined prohibited transaction exemption for financial service providers that are subject to an SEC-governed standard of conduct.29 The application of and compliance with one of these standards of conduct should be sufficient to meet a prohibited transaction exemption for advice under ERISA and the Code. We cannot overstate the importance of SEC-DOL coordination given the upcoming January 1, 2018 full compliance date for the fiduciary rulemaking. In addition, we urge the SEC and DOL to synchronize efforts with respect to timing to prevent further investor harm and confusion, and avoid unnecessary implementation and compliance costs. For example, to provide time to coordinate with 26 For example, under the fiduciary rulemaking, an investment adviser may be deemed an ERISA fiduciary when engaging in discussions with a prospective client about whether to hire the adviser. Imposing ERISA fiduciary status at this stage of the relationship creates unnecessary operational complexities. 27 Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions, 82 Fed. Reg. 31278 (Jul. 6, 2017), available at https://www.gpo.gov/fdsys/pkg/FR-2017-07-06/pdf/2017-14101.pdf. ICI submitted a response to the RFI today. See ICI's August 7, 2017 Letter to DOL, supra note 14. 28 Id. The RFI asks further "[t]o what extent does the existing regulatory regime for IRAs by the Securities and Exchange Commission, self-regulatory bodies (SROs) or other regulators provide consumer protections that could be incorporated into the Department's exemptions or that could serve as a basis for additional relief from the prohibited transaction rules?" 29 We explain this recommendation in detail in separate correspondence that we provided to DOL today. We recommend to DOL that this streamlined prohibited transactions exemption also cover SEC-registered investment advisers that are subject to an SEC-governed fiduciary duty standard of conduct. The Honorable Jay Clayton August 7, 2017 Page 10 of 17 respect to a consistent standard of conduct, we have urged DOL to immediately—by August 15, 2017—issue an interim final rule delaying the January 1, 2018 applicability date for one year.30 In conjunction with the postponement, we recommended that DOL announce that it expects to finalize modifications to the fiduciary rule and related prohibited transaction exemptions prior to January 1, 2019 and that the applicability date of the modified rule and exemptions will become effective no sooner than January 1, 2020. The SEC should work with the DOL to issue the SEC's new best interest standard of conduct for broker-dealers within this same timeframe, so that a corollary DOL exemption for SEC-regulated entities can be operational. Coordinated efforts toward a consistent standard would enhance investors' protections without imposing unnecessary, harmful burdens, and legal risks on the financial professionals serving them. A coordinated effort also aligns with other Administration directives31 and reflects the reality that individuals who seek financial guidance often have both retirement accounts and non-retirement accounts. It would permit these individuals to receive guidance that reflects consistent and compatible regulatory requirements. We also urge the SEC to work with state regulators through the

North American Securities Administrators Association (NASAA) as the SEC considers standards of conduct for financial professionals. This coordination should help forestall states from adopting inconsistent standards of conduct. One state recently revised its law to impose a fiduciary duty on certain investment advisers and broker-dealers.32 We understand that other states may have enacted, or be considering, similar laws. If states move in this direction, not only might standards differ among the states, but they may be inconsistent with any federal standards, causing confusion for both financial professionals and their customers. To avoid this result, we urge the Commission to exercise its authority under Section 19(d) of the Securities Act of 1933 ("Securities Act")33 to encourage a consistent best interest standard of 30 See ICI's July 21, 2017 Letter to DOL, supra note 10. 31 See Presidential Executive Order on Enforcing the Regulatory Reform Agenda, issued on February 24, 2017 (stating that "[i]t is the policy of the United States to alleviate unnecessary regulatory burdens placed on the American people" and encouraging agencies to eliminate regulations that "create a serious inconsistency or otherwise interfere with regulatory reform initiatives and policies"), available at https://www.whitehouse.gov/the-press-office/2017/02/24/presidential- executive-order-enforcing-regulatory-reform-agenda; and Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs, issued on January 30, 2017 (directing agencies to identify at least two existing regulations to be repealed for every new regulation proposed), available at https://www.whitehouse.gov/the-press-office/2017/01/30/presidential-executive-order-reducing-regulation-and-controlling. 32 See Nevada Senate Bill No. 383, 79th Sess. (2017). 33 Section 19(d) of the Securities Act sets out a policy of greater federal and state cooperation in securities matters including, among other things, maximum uniformity in federal and state regulatory standards. See Section 19(d)(2)(B) of the Securities Act. The Honorable Jay Clayton August 7, 2017 Page 11 of 17 conduct for broker-dealers. Coordination with the states will promote uniformity and predictability of regulation, to the benefit of investors, regulators, and financial professionals. B. Best Interest Standard of Conduct for Broker-Dealers (Response to Question 8, 9, 14, 17) We recommend that the SEC establish a clearly articulated best interest standard of conduct that would apply to broker-dealers providing recommendations to retail investors, regardless of whether those recommendations are made with respect to retirement accounts. The best interest standard of conduct that ICI recommends for broker-dealers would enhance the existing suitability requirements and other obligations that currently apply to broker-dealers under the Exchange Act, the rules thereunder, and FINRA rules. 34 Our recommended best interest standard of conduct is consistent with the historical broker-dealer business model. A best interest standard would fit well with the transactional nature of a broker- dealer's business, including the transaction-based compensation broker-dealers typically receive. It also would permit broker-dealers to continue to provide the types of products and services that they offer in the ordinary course and customers have come to expect. The standard would require appropriate disclosure, including of material conflicts. 1. Description of Best Interest Standard of Conduct for Broker-Dealers (Response to Questions 8, 9, 17) Best Interest Standard of Conduct. Our recommended best interest standard would require that a broker-dealer's "recommendation" to a retail customer in a non-discretionary account be in that customer's best interest at the time the recommendation is made, incorporating an explicit duty of loyalty and a duty of care, with the following affirmative obligations: Duty of Loyalty • Client's Interest First. The standard would require that a broker-dealer's recommendation to a retail customer not put the broker-dealer's interests (or the interests of anyone else) above the client's interests. 34 Generally, broker-dealers that exercise discretion or control over customer assets, or have a relationship of "trust and confidence" with their customers, owe customers a fiduciary duty. See 2011 SEC Study, supra note 5, at p. 54 (citing, e.g.,

U.S. v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found “most commonly” where “a broker has discretionary authority over the customer’s account”)). The Honorable Jay Clayton August 7, 2017 Page 12 of 17 Duty of Care • Diligence, Care, Skill, and Prudence. The standard would require a broker-dealer’s recommendation to a retail customer to reflect (1) reasonable diligence;35 and (2) reasonable care, skill, and prudence based on the customer’s investment profile.36 Fair and Reasonable Compensation. A broker-dealer would be required to charge no more than reasonable compensation for services to its customer.37 Disclosure. The best interest standard would require that the broker-dealer disclose to the customer certain key aspects of its relationship with the 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 conflict of interest. No Misleading Statements. A broker-dealer would be prohibited from making any misleading statements about the transaction, compensation, or conflicts of interest. Policies and Procedures. Broker-dealers would be subject to existing regulation requiring them to adopt policies and procedures reasonably designed to prevent violations of the applicable standard of conduct.38 FINRA already requires a broker’s written procedures and supervisory system to be reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules. The recommended policies and procedures would fall within the scope of this FINRA requirement. Application of Standard. The standard would be triggered whenever a broker-dealer makes a recommendation to any customer having a non-discretionary account. For this purpose, FINRA’s definition of “recommendation” would apply.39 Scope of Standard. A best interest standard of conduct for broker-dealers would permit the broker- dealer to limit the scope, nature, and anticipated duration of the relationship with the customer. 35 See FINRA Rule 2111. 36 See FINRA Rule 2111.04. 37 See FINRA Rules 2121 and 2122. 38 See FINRA Rule 3110. 39 See FINRA Rule 2111. The Honorable Jay Clayton August 7, 2017 Page 13 of 17 A broker-dealer would be able to engage in the following activities or practices, consistent with the best interest standard, if the broker-dealer provides appropriate disclosure and the product or service is in the customer’s best interest: • Selling an investment product and receiving compensation in the form of commissions or other traditional broker-dealer compensation for customer transactions.40 • Selling proprietary investment products. • Engaging in principal trading, subject to appropriate limitations, disclosure, and customer consent. We recognize that principal trading is one of the more difficult areas that the SEC will need to address through any rulemaking articulating a standard of conduct.41 A broker-dealer acting as principal in transactions with customers raises the potential for self-dealing. The SEC must address this potential conflict, but also must recognize that dealer activities such as trading as principal have the potential to benefit customers through enhanced liquidity, expanded investment choices, and better trade execution. Just as we did in 2013, we agree with the SEC’s suggestion that certain aspects of Section 206(3) of the Advisers Act could serve as a model to address the potential conflicts that principal trading raises for broker-dealers, without imposing all the requirements of the section, including trade-by-trade disclosure and customer consent. 42 In considering the appropriate restrictions and disclosures that 40 We note that a principal underwriter of a mutual fund (i.e., a limited-purpose broker-dealer) that simply sells fund shares should not be subject to a best interest standard of conduct provided, of course, it does not make a recommendation to a retail investor. 41 The SEC’s 2011 Study on Investment Advisers and Broker-Dealers noted that Dodd-Frank Act Section 913(g) requires that the standard of conduct applicable to broker-dealers should be “no less stringent” than Section 206(1) and (2) of the Investment Advisers Act of 1940 (“Advisers Act”), and does not refer to Advisers Act Section 206(3). The report explains that the omission of a reference to Section 206(3) appears to reflect a Congressional intent not to mandate the application of that provision to broker-dealers

when providing personalized investment advice about securities to retail investors (though granting the Commission the authority to impose these types of restrictions). 2011 SEC Study, supra note 5, at p. 119. 42 See Question 17 of the Statement (asking whether the Commission should consider any material changes to the assumptions in its 2013 request for data as part of its continued review and analysis of this area). This request for data, in connection with the Dodd-Frank Section 913 study, sought information on the benefits and costs that could result from various alternative approaches to standards of conduct for broker-dealers and investment advisers. See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, US Securities and Exchange Commission, dated July 3, 2013, available at https://www.sec.gov/comments/4-606/4606-3103.pdf (providing comments on 2013 SEC Request for Data, supra note 5). The Honorable Jay Clayton August 7, 2017 Page 14 of 17 should apply to broker-dealers' principal trading, however, we recommend that the SEC also revisit its interpretations under Section 206(3) of the Advisers Act for registered investment advisers.43 Certain common activities not constituting the making of a recommendation also should not cause broker-dealers to be subject to a best interest standard. For example: • Offering the use of financial calculators or similar investment tools for general informational purposes.44 • Providing information about investment products derived from third-party sources, such as prospectuses, fund fact sheets, and independent third-party ratings information. • Executing unsolicited trades. • Servicing orphaned accounts, including a limited purpose broker-dealer (i.e., fund distributor) providing information about the shareholder's options. This would include holding an account directly with the fund and not re-establishing an intermediary relationship. 2. Definition of "Recommendation" (Response to Question 14, 17) In crafting a best interest conduct standard for broker-dealers, we urge the SEC to define "recommendation" consistently with FINRA's definition of "recommendation." It should not base the definition on the DOL fiduciary rule's expansive approach to "recommendation" or look to the concept of "investment advice" under the Advisers Act. We explain the basis for this suggestion below.45 FINRA's definition of "recommendation" and related guidance clearly identify conduct that would subject a broker-dealer to a best interest standard, and appropriately reflect the typically episodic nature of a broker-dealer's relationship with its customer. FINRA generally takes a facts and circumstances 43 For example, the Commission should consider the circumstances under which trade-by-trade disclosure and consent should be required, and how the requirements of Section 206(3) should apply to broker-dealers that are affiliated with registered investment advisers. 44 We recognize that the use of these types of tools may, in some circumstances, entail a recommendation, in which case the broker would be subject to the best interest standard. 45 We note that because we are suggesting a distinct best interest standard of conduct for broker-dealers, and that the FINRA definition of "recommendation" should apply, the term "personalized investment advice," which the SEC used in its 2013 request for data, would not be applicable, as that term was intended to encompass both "recommendations" under the FINRA rules and "investment advice" under the Advisers Act. See SEC 2013 Request for Data, supra note 5; Question 17 of the Statement. The Honorable Jay Clayton August 7, 2017 Page 15 of 17 approach to whether a communication constitutes a recommendation46 using objective criteria.47 In determining whether a communication is a recommendation, key considerations are: (1) whether— given the content, context and manner of presentation—a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy;48 and (2) the extent to which the communication is individually tailored to the customer.49 FINRA has issued a robust body of guidance around the definition of "recommendation" that provides practical guidance for

common situations and activities. Of particular note, existing FINRA guidance provides clarity around the treatment of certain activities that currently is uncertain, ambiguous, or problematic under the fiduciary rulemaking—e.g., certain call center activities50 and recommendations to increase contributions to a retirement account.51 The clarity and objectivity of the FINRA definition also would provide needed certainty to fund transfer agents and limited purpose broker- dealers providing services to so-called "orphaned" fund accounts—which are expected to number in the hundreds of thousands as a result of the fiduciary rulemaking.52 46 See, e.g., Online Suitability, NASD Notice to Members 01-23, at p. 2 (Apr. 2001) ("NASD Notice to Members 01-23"), available at www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003887.pdf. 47 Know Your Customer and Suitability, FINRA Regulatory Notice 11-02 (Jan. 2011) ("FINRA Regulatory Notice 11-02"), available at http://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf. 48 Id.; see also NASD Notice to Members 01-23, supra note 47. 49 Specifically, "the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation." FINRA Regulatory Notice 11-02, supra note 48; see also NASD Notice to Members 01-23, supra note 47. 50 FINRA has taken the view that responding to a customer's request for information does not, in itself, result in a recommendation. In contrast, DOL's fiduciary rule has created a great deal of uncertainty and ambiguity as to how broker- dealers could conduct certain call center activities. Even the most basic information could trigger ERISA fiduciary status and prohibited transactions. While the definition of advice under ERISA technically excludes some of this information, the rule's broad interpretation has cast a chill on broker-dealers providing investment education to retirement savers, due to the risk of inadvertently triggering ERISA fiduciary status. See Letter from Brian Reid, Chief Economist, and David W. Blass, General Counsel, Investment Company Institute, to DOL, dated April 17, 2017, at p. 19, available at https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210- AB79/01409.pdf. 51 See FINRA Reminds Firms of Their Responsibilities Concerning IRA Rollovers, Regulatory Notice 13-45 (Dec. 2013), available at http://www.finra.org/sites/default/files/NoticeDocument/p418695.pdf. The fiduciary rule treats an IRA rollover recommendation as fiduciary advice, even when no discussion of specific securities or investment property takes place. See ICI's August 7, 2017 Letter to DOL, supra note 14. 52 See supra note 13. The Honorable Jay Clayton August 7, 2017 Page 16 of 17 C. Investment Advisers' Fiduciary Duty Should Remain (Response to Question 8) We recommend that investment advisers remain subject to the strong, longstanding fiduciary duty that governs their conduct and requires them to place their client's interests above their own, as discussed above. The SEC comprehensively regulates registered investment advisers under the Advisers Act, and registered funds under the Investment Company Act of 1940. These laws, the rules thereunder, and the robust body of formal and informal staff guidance that has developed around them, create a comprehensive framework governing all aspects of the registered fund advisory business. A rich body of case law has developed over the years interpreting an investment adviser's fiduciary duty. This case law contemplates the advisory business model rather than the transaction-based broker-dealer business model. This high standard of conduct, with its well-developed body of law, has served investors, including those in registered investment companies, for over seven decades.53 * * * 53 It would be inconsistent with the Statement's goals of clarity and consistency to extend to investment advisers the Exchange Act or FINRA rules that apply to broker-dealers. FINRA rules reflect the transactional nature of the broker- dealer business. These rules are inconsistent with the typically ongoing, relationship-based business of an investment adviser, and applying them in addition to the existing Advisers Act regulatory

structure would result in overlapping and conflicting regulatory requirements. The Honorable Jay Clayton August 7, 2017 Page 17 of 17 III. Conclusion We hope that our views assist you and the full Commission as you consider how to proceed in this area. We suggest that the Commission move forward promptly with a formal proposal on an enhanced standard of conduct for broker-dealers, and look forward to commenting in more detail. We and our members are glad to assist in any way that would be helpful. Please contact me at (202) 218-3563 or ddonohue@ici.org, Sarah Bessin at (202) 326-5835 or sarah.bessin@ici.org, or Linda French at (202) 326-5845 or linda.french@ici.org if you have questions, or we may be of assistance. Sincerely, /s/Dorothy M. Donohue Dorothy M. Donohue Acting General Counsel cc: The Honorable Michael S. Piwowar The Honorable Kara M. Stein David W. Grim, Director, Division of Investment Management Heather Seidel, Acting Director, Division of Trading and Markets A-1 Appendix We explain below the different standards of conduct that apply to investment advisers providing advice to their clients, broker-dealers providing recommendations to their customers, and intermediaries providing certain types of advice to plans subject to ERISA. This discussion provides context for the best interest standard of conduct we recommend for broker-dealers, and the corollary streamlined prohibited transaction exemption that we recommend DOL adopt. I. Investment Advisers Under the Investment Advisers Act of 1940 ("Advisers Act"), an investment adviser is subject to a fiduciary duty that requires it to act in the best interests of its clients, including a duty of loyalty and a duty of care.1 As part of its duty of loyalty, an investment adviser either must eliminate, or fully disclose to its clients and obtain their consent regarding, any material conflicts of interest.2 Investment advisers typically charge asset-based fees and have discretionary authority over client accounts. Their fiduciary duty generally applies on an ongoing basis, reflecting the typically ongoing nature of the adviser's relationship with its client. 3 II. Broker-dealers Under the Securities Exchange Act of 1934 ("Exchange Act") and FINRA rules, a broker-dealer is subject to a suitability standard that requires the broker-dealer to "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer."4 This standard may require a broker-dealer making a recommendation, under certain 1 This fiduciary standard is not set forth explicitly in the Advisers Act. Rather, the Supreme Court has interpreted the antifraud provisions of the Advisers Act as imposing a fiduciary duty on advisers. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963); see also Transamerica Mortgage Advisors, Inc., 444 U.S. 11, 17 (1979) ("[T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations."). This fiduciary duty standard has been interpreted further through a series of court cases and SEC guidance over the years. 2 See Capital Gains, supra note 1 (an adviser must fully disclose to its clients all material information that is intended "to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested"). 3 Although an investment adviser's fiduciary duty is ongoing, it is not unlimited in scope. Instead, the parameters of the duty may depend on the scope of the advisory relationship. See, e.g., Duties of Brokers, Dealers, and Investment Advisers, SEC Rel. No. 34-69013, IA-3558, at n.37 (Mar. 1, 2013), available at https://www.sec.gov/rules/other/2013/34-69013.pdf. 4 FINRA's Rule 2111, known as the suitability rule, requires a broker to "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile." A-2 circumstances, to disclose certain material conflicts of interest to its customers.5 Broker-dealers typically do not exercise discretionary authority over customer accounts6 and generally provide advice that is incidental to their business as broker-

dealers.7 A broker-dealer's relationship tends to be transactional in nature—with transactions effected at the behest or with the approval of the customer—and as such may be episodic. The suitability standard of conduct applies to broker-dealers when they provide recommendations to their customers and generally does not apply on an ongoing or continuous basis. Broker-dealers also are subject to a well-established body of prescriptive rules and guidance governing their conduct under the FINRA rules (e.g., just and equitable practices, best execution, fair and reasonable compensation, books and records). III. Advice Providers under ERISA When an investment adviser, broker-dealer, or other intermediary provides certain types of advice with respect to a plan or account subject to ERISA, it is subject to a broad fiduciary standard of conduct. The DOL's recent rulemaking significantly expanded who is a fiduciary, and therefore would be subject to the ERISA fiduciary standard of conduct. An ERISA fiduciary is subject to a duty of loyalty, a duty of prudence,8 and must comply with plan documents, diversify plan investments, and pay only reasonable plan expenses from plan assets.9 In contrast to the SEC's disclosure-based approach to regulation,10 ERISA takes a per se prohibition- based approach, prohibiting ERISA fiduciaries from engaging in a broad range of transactions that may present a conflict of interest, such as providing advice that impacts their compensation (e.g., receiving variable compensation).11 These transactions are prohibited even if the potential conflict has been 5 See FINRA Report on Conflicts of Interest (Oct. 2013), available at http://www.finra.org/sites/default/files/Industry/p359971.pdf. 6 Generally, broker-dealers that exercise discretion or control over customer assets, or have a relationship of "trust and confidence" with their customers, can be said to owe customers a fiduciary duty. See Study on Investment Advisers and Broker-Dealers, at p. 54 (Jan. 2011), available at https://www.sec.gov/news/studies/2011/913studyfinal.pdf (citing, e.g., U.S. v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found "most commonly" where "a broker has discretionary authority over the customer's account")). 7 See Section 202(a)(11)(C) of the Advisers Act. 8 See ERISA Section 404(a)(1)(B) (i.e., the "prudent man" rule), which provides that a fiduciary must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man 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." 9 See ERISA Section 404. 10 See Speech by Jay Clayton, Chair, Securities and Exchange Commission, at the Economic Club of New York (Jul. 12, 2017), available at https://www.sec.gov/news/speech/remarks-economic-club-new-york (discussing the soundness of the SEC's historically disclosure-based approach to regulation). 11 See ERISA Sections 406-407 (29 CFR, et. seq.). A-3 disclosed fully and the investor provides his or her written consent. To engage in a prohibited transaction, an ERISA fiduciary must meet one of the prohibited transaction exemptions, such as the recently adopted BIC exemption that permits financial professionals to receive variable compensation if it complies with certain conditions. Unfortunately, the BIC exemption is unworkable for certain products and imposes significant class action risk that many financial intermediaries are unwilling to incur, particularly for smaller balance accounts.