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August 30, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Study Regarding Obligations of Brokers, Dealers, and Investment Advisers (File No. 4-606)

Dear Ms. Murphy:

The Investment Company Institute[1] is pleased to offer its views to the Securities and Exchange Commission to inform its study on the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and persons associated with them. The SEC is undertaking this review in the context of personalized investment advice and recommendations about securities to retail investors, and evaluating whether there are gaps, shortcomings, or overlaps in the current legal or regulatory standards of care applicable to these intermediaries.[2] We strongly believe that the clients and customers of investment advisers and broker-dealers deserve a strong, fiduciary standard of care that puts their interests above those of their intermediaries. This standard should be designed with differences between the two business models in mind, and with the goal of avoiding overlapping or unnecessary regulations.

Many commentators, both within and outside the Commission, have identified the statutory divide between the supervision of broker-dealers under the Securities Exchange Act of 1934 and that of investment advisers under the Investment Advisers Act of 1940 as a regulatory gap that ought to be

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[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 $11.18 trillion and serve almost 90 million shareholders.

[2] *Study Regarding Obligations of Brokers, Dealers, and Investment Advisers*, SEC Release Nos. 34-62577 and IA-3058 (July 27, 2010), available on the SEC's website at http://sec.gov/rules/other/2010/34-62577.pdf.

addressed. We agree. This system had its roots in real distinctions in the businesses of advisers and broker-dealers at the time the relevant statutes were developed; those distinctions, in many cases, have become almost indiscernible over time, making it imperative that steps be taken to rationalize the regulatory systems for financial intermediaries who perform similar roles but are subject to differing legal standards. Any solution should create a level playing field that is functionally related to the financial service provided. Investors, especially retail investors, should not have to peruse lengthy disclosures to determine which "hat" their intermediary may be wearing at any given time. This is particularly important as the RAND study conclusively determined that from a retail investor's perspective, advisers and broker-dealers engage in activities that are virtually indistinguishable.[3]

Fiduciary Duty

In devising a consistent standard, strong investor protection must guide the final result, with the higher federal fiduciary principle of the *Capital Gains Research Bureau* case governing intermediary conduct.[4] Investment advisers are subject to a fiduciary duty that requires them to act in the best interests of their clients and place the interests of their clients before their own. An adviser also must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients, and, at a minimum, make full disclosure of any material conflict or potential conflict. Practically speaking, the fiduciary duty means that investment advisers, in the course of providing investment advice, must disclose all material information to their clients, including conflicts of interests, business practices, fees, and any material disciplinary information involving the adviser or its investment personnel. As fiduciaries, whenever an adviser's interests differ from those of the client, the adviser also must explain the issue to the client and act to mitigate or eliminate the conflict so that the adviser can act in the best interests of the client. Indeed, the benefits of the fiduciary duty standard to investors (and therefore the requirements that flow from this duty) should apply equally to customers of broker-dealers that provide services that are substantially the same as those provided by investment advisers.

Specific Areas of Consideration

Brokers providing personalized advice or recommendations should be held to the higher fiduciary standard under the Advisers Act, rather than changing the standard long applicable to investment advisers; the evolution of this standard would be consistent with the evolution of the brokerage business from a transaction and commission-based business to one that mirrors the historical–and current–business engaged in by investment advisers. Over a decade ago, Commission Chairman Arthur Levitt requested the formation of a special committee to examine brokerage practices

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[3] LRN-RAND Center for Corporate Ethics, Law, and Governance, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (March 2008).

[4] The most commonly cited source of the federal fiduciary duty under the Investment Advisers Act is the Supreme Court's 1963 *Capital Gains* decision. *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 84 S. Ct. 275 (1963) (holding that Section 206 of the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisers by operation of law).

in the United States. That committee identified fee-based brokerage services as one of its "best practices," because the payment of such a fee rather than a commission for traditional, transaction-based brokerage could help align customers' interests with those of the broker-dealer.[5] In part responding to those recommendations, the brokerage community began to develop fee-based accounts that offered advisory as well as brokerage services as an alternative means for customers to pay for services. Full service brokers also began offering electronic trading for reduced brokerage commissions and made available online tools and other services to assist clients in managing their investments. As the fee-based business model evolved, it often became indistinguishable from that of traditional advisory businesses, but the regulatory standards and disclosures to investors remain vastly different.

The SEC should consider providing particular guidance on the following when undertaking its study and any subsequent rulemaking:

- Allowing investors to place unsolicited trades, including through telephone call centers, internet websites, or similar means without the provider of those mechanisms being subject to the fiduciary duty, if no personalized investment advice is being given and clients are informed that the provider does not offer investment advice nor recommend the purchase or sale of any specific securities;
- Allowing the provision of financial calculators or similar investment tools or information, without the provider being subject to the fiduciary duty for providing personalized investment advice or recommendations (because the provider has no means to monitor the identity or inputs of a particular investor, and the recordkeeping burdens under the Advisers Act, as applied to these calculators, are difficult and costly to comply with);
- Those servicing orphaned accounts should not be subject to a fiduciary duty standard when personalized advice or recommendations are not being made;
- As the standard of care is harmonized, the label applied to the type of compensation received should no longer be relevant; investment advisers and broker-dealers providing personalized investment advice or recommendations should equally be permitted to receive, and share, both asset-based fees and commissions;
- Investment advisers and broker-dealers should equally be able to clearly disclose conflicts of interest, rather than have potential conflicts prevent an activity from occurring;
- Broker-dealers may enter into contractual arrangements with fund companies to sell fund shares; the existence of these arrangements should not be deemed inappropriate, provided that

[5] The Report of the Committee on Compensation Practices (Apr. 10, 1995) (commonly referred to as the "Tully Report"). For purposes of this Memorandum, we use the term "fee–based brokerage" to refer to accounts that are similar to traditional full service brokerage accounts providing a package of services, including execution, incidental investment advice and custody.

the broker discloses to its customer at or before the time of sale the compensation it receives from the sale and any conflicts that the arrangement may entail;

- Both investment advisers and broker-dealers should be permitted to disclose any material limitations on the range of investment products about which advice will be given, and whether similar products are available outside that range; this disclosure should address concerns by many in the brokerage community about the ability to offer proprietary products; and
- Both investment advisers and broker-dealers should be permitted to disclose any limitations on the nature and anticipated duration of the relationship with the client/customer; brokers currently may engage in transactions on a periodic basis with customers, rather than engage in an on-going relationship, whereas investment advisers may offer ongoing, quarterly or annual reviews of client positions.

Finally, the SEC should retain the "principles based" approach to this standard of care embodied in the Advisers Act, rather than adopt the rules based regime currently applied by FINRA in its oversight of the broker-dealer community[6]. While arguably less clear from a "check the box" standpoint, the fiduciary principles that have guided the advisory community for 70 years have worked well, because one simple question lies at their heart: what is best for the investor? An adviser answering that question need not fear a breach of his or her fiduciary duty. In contrast, a more rigid approach may lead to interpretations that, while legal on their face, are not in an investor's best interests. When engaging in any "harmonization" endeavor, the SEC must retain the more protective standard.

Importantly, the fiduciary duty articulated by the Supreme Court in *Capital Gains* should not be altered by SEC action.[7] That standard has been widely interpreted in court cases and SEC enforcement actions, and a clear body of law has developed that has guided advisory conduct for the protection of investors for many years. The standard will apply equally effectively to the broker-dealer community engaged in providing investment advisory services. Reworking that standard creates the very real risk that the activities of both advisers and broker-dealers will be subject to legal challenge as the limits of the newly articulate test are explored.

Intersection of Study with Other SEC Initiatives

A thoughtful and deliberate approach to rationalizing this regulatory regime is also important to lay the foundation for appropriate reforms to Rule 12b-1, which deals with the use of fund assets to compensate intermediaries, and point of sale disclosure initiatives that are product-neutral. As it has evolved over time, Rule 12b-1 has come to play an important part in the structure through which

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[6] We note that broker-dealers are long accustomed to being governed by a specific and detailed rulebook. The SEC may need to provide guidance to that industry on the continued applicability of those rules.

[7] In *Capital Gains*, the Court held that an investment adviser is subject to an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts." 375 U.S. at 194. This standard has proved to be both protective of investors and flexible enough to allow growth and innovation in the advisory business.

brokers and investment advisers are compensated for a variety of services they perform for fund investors—including offering ongoing services, effecting discrete transactions, and performing administrative support of different kinds. It would seem the regulatory label applied to compensation received by, and attendant limitations on, advisers and brokers ought to be resolved first, or at a minimum as part of an integrated process and initiative, with the operation of Rule 12b-1 tailored accordingly.

Further, the thought process that goes into developing this regulatory regime may inform the Commission's work on another important investor protection initiative that should be developed in conjunction with the Commission's work on investment adviser/broker-dealer harmonization—effective and concise point of sale disclosure by intermediaries. The Institute has long supported enhanced point of sale disclosure to help investors assess and evaluate a broker's recommendations and services, provided that any point of sale disclosure obligation is product-neutral. Indeed, this type of disclosure is equally important for investors to consider with respect to *any* investment or service offered by the intermediary, not just mutual funds. We also believe any point of sale disclosure requirement should be fully consistent with the industry's existing customer service model and should seek to find the best way to provide investors with timely and convenient access to the required information without imposing inappropriate costs and burdens on brokers.

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We look forward to working with the SEC as it continues to examine these critical issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 326-5815.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
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