



June 19, 2018

The Honorable Jay Clayton
Chairman
United States Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Clayton:

Thank you for your time to meet with the Institute for the Fiduciary Standard. Members of our Board of Directors and Board of Advisors appreciate the opportunity to express our views regarding the proposals Reg Best Interest, CRS Relationship Summary and the Interpretation Regarding Standard of Conduct for Investment Advisers. The Institute applauds your efforts to increase clarity to investors, require all financial professionals follow standards that “embody fiduciary principles,” and “have effective enforcement tools” to address false or misleading statements or conduct standards that are not followed.

In this comment we focus on Reg BI. We note your comments from your May 2 speech regarding the different standards. Specifically, “There is a gap here between what retail customers would reasonably expect the law to provide and what regulations actually require” and, “We should eliminate that gap.”

We agree that there needs to be “focused attention” on different recommendations based on different “suitable” products where one “makes the broker-dealer more money” “as compared to another security that better fits your needs but pays the broker-dealer less.” We agree there is no such thing as “conflict-free advice” and that investment advisers should not say they are “conflict free.” (However, the nature and frequency and transparency of conflicts differ a lot and these differences should be addressed just as seriously today as they were by the crafters of the Advisers Act in 1940.)

We further agree, as you noted in Philadelphia, on fee and expense disclosure and accounting, “Tell me all the ways you are making money on my money.” Eliminating or substantially addressing the “gaps” between investor expectations and market realities is a good way to frame it.

We agree fiduciary principles should guide a standard called “best interest,” as “best interest” is closely associated with “fiduciary” in legal opinions and by scholars and in the minds of investors. To offer a broker best interest standard that is not “virtually identical” to the adviser standard could well be deemed as “misleading.” We agree we must close the gaps. Here, we identify provisions to help do so.

SEC Proposed Regulation Best Interest (a) (1); 2) (ii) Care Obligation

A broker ... when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker ... ahead of the interest of the retail customer.

The broker ... exercises reasonable diligence, care, skill and prudence to ... have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers

What the Best Interest Standard Functionally Equivalent to the Fiduciary Standard Should Include

- Adopt the DOL Rule description of best interest:

“Investment advice is in the “Best Interest” of the Retirement Investor when the Adviser and Financial Institution providing the advice act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.”
- This means, among other things, that the standard should not only be applied “at the time” of the recommendation, (perhaps just a few seconds). Further it means, the standard is not putting the interest of the retail customer *equivalent* to the interest of the broker, but *ahead* of the broker.
- This also means the standard is not directed to “at least some” retail customers or any unidentified “particular” retail customer

SEC Proposed Regulation Best Interest (2) (i) Disclosure Obligation

The best interest obligation ... shall be satisfied if the ... broker ... prior to or at the time of such recommendation, reasonably discloses to the retail customer, in writing, the material facts ... including all material conflicts of interest that are associated with the recommendation.

What the Best Interest Standard Functionally Equivalent to the Fiduciary Standard Should Include

- The standard should include making material conflicts disclosed *prior to* (not “at the time of”) the recommendation to allow the retail customer time to review it, separate from the broker.

SEC Proposed Regulation Best Interest (2) (iii) Conflict of Interest Obligations

The broker or dealer establishes, maintains and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

What the Best Interest Standard Functionally Equivalent to the Fiduciary Standard Should Include

Background. Eliminating or disclosing and mitigating conflicts are not practices with which brokers generally have training and experience. This reflects the current different conduct standards. Policies and procedures should be designed to reflect this fact – the fact that mitigating material conflicts is hard. These policies and procedures are meant to be hard. They need to be learned to be clearly understood, faithfully complied with, and become the backbone of the best interest standard. They need to include more narrow “conduct-specific” mandates. They should require the broker will:

- State legal and contractual differences. Require disclosure of the differing legal and contractual obligations of BDs and IAs. Highlight the difference between “three” and “two.” For example:

In securities offerings with a broker, there are three parties. The issuer, the broker, and customer. The business of brokers is to distribute and sell securities on behalf of the issuer. They are paid commissions to sell issuers’ products to customers and only if they *make a sale*. The broker’s advice can only be deemed “solely incidental.”

With an adviser there are only two parties: the adviser and client. The business of advisers is to render fiduciary advice to a client for a client fee. The adviser’s legal duty is to the client. The courts and regulators say it’s an “intimate relationship” and your adviser must be loyal to clients.

- Stop the worst conflicts. Eliminate egregious conflicts (sales contests, bonuses) that appear designed to impair objectivity and undermine investors’ best interests.
- State material conflicts inherent harms. Start with the consensus in academic literature and on Main Street that material conflicts are inherently harmful to investors. The consequent urgency to avoid and eliminate conflicts if humanly possible is then made clear.
- State the burden to overcome conflicts and what “mitigation” means. Consistent with the inherent harms of material conflicts, state the need to overcome significant burdens to proceed with the transaction. Provide guidance on proactive disclosure, clear written informed client consent and determining fairness and reasonableness in concrete and practical terms.
- State personalized fees and expenses. Provide specific personalized fees and expenses that the broker and brokerage earns, and the customer pays, expressed in dollars, and % of AUM.



Mr. Chairman, thank you, again, for meeting with us this morning. The leadership of the Institute is dedicated to advancing fiduciary principles and practices and providing further input on these proposed rules to assist the Commission in any way possible.

Sincerely,

Knut A. Rostad

Knut A. Rostad

President

XC: The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner
The Honorable Hester M. Pierce, Commissioner
The Honorable Robert J. Jackson, Jr., Commissioner