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Paul Schott Stevens, PRESIDENT AND CEO

FAX:

August 7, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *SEC Proposals on Standards of Conduct for Investment Professionals (File Nos. S7-07-18; S7-08-18; and S7-09-18)*

Dear Mr. Fields:

The Investment Company Institute[1] commends the Securities and Exchange Commission for its recent proposals regarding standards of conduct for investment professionals.[2] We strongly support the SEC—the primary regulator of broker-dealers[3] and investment advisers—taking the lead to ensure that retail investors, regardless of whether they are investing for retirement or other important goals, are

[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$22.0 trillion in the United States, serving more than 100 million US shareholders, and US$7.6 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] *Regulation Best Interest*, 83 Fed. Reg. 21574 (May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08582.pdf ("Best Interest Proposal"); *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, 83 Fed. Reg. 21203 (May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08679.pdf ("Adviser Interpretation Proposal"); *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles*, 83 Fed. Reg. 21416 (May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08583.pdf ("Disclosure Proposal," together with the Best Interest Proposal and Adviser Interpretation Proposal, the "Proposals").

[3] For ease of reference in this letter, we use the term "broker-dealers" to mean broker-dealers and their associated (natural) persons, unless noted otherwise.

afforded strong protections when they receive recommendations from a broker-dealer or an investment adviser.

I. Background and Executive Summary

The Commission's Proposals come at a crucial time in the debate over standards of conduct for financial professionals. The Department of Labor's fiduciary rulemaking attempted to redefine who is a fiduciary in connection with providing investment advice under the Employee Retirement Income Security Act of 1974 (ERISA). In doing so, the rulemaking would have expanded the universe of individuals and entities treated as "fiduciaries" under ERISA, thereby limiting the types of activities in which many financial professionals could engage.[4] DOL simultaneously issued its Best Interest Contract (BIC) exemption, intending to limit the rule's far-reaching effects. Despite those intentions, the rulemaking 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. Although DOL intended the rulemaking to improve the quality of financial advice that retirement investors receive, in practice, it harmed these investors in multiple ways. The Fifth Circuit Court of Appeals ultimately vacated the rule for regulatory overreach.[5]

Even in the absence of the DOL fiduciary rule, however, the potential for inconsistent and confusing standards of conduct remains. Specifically, recent activity at the state level again has raised the specter of multiple and differing standards of conduct (or related disclosure requirements), which could result in inconsistent protections for investors and a patchwork of confusing and burdensome requirements for firms with business in multiple states.[6]

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[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 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 documented that the BIC exemption was failing 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 (Aug. 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 (Aug. 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 (Nov. 10, 2016), *available at* http://www.reuters.com/article/us-jpmorgan-wealth-compliance-idUSKBN1343LK.

[5] *Chamber of Commerce v. United States Department of Labor*, 885 F. 3d 360 (5th Cir. 2018).

[6] *See, e.g.*, Nevada Senate Bill 383, enacted on June 2, 2017 (extending state fiduciary duty to broker-dealers, sales representatives, and investment advisers); New York Assembly Bill 2464, introduced on January 20, 2017 (would require

We therefore greatly appreciate Chairman Clayton's recognition, from the start of his tenure, that clarity, consistency, and coordination are key elements to effectively regulate standards of conduct applicable to broker-dealers and investment advisers.[7] Our comments are intended to assist the Commission in achieving these worthy and important goals in any final rulemaking package.

In an area such as this, that is overseen by more than one regulatory body, coordination is crucial. Therefore, we strongly encourage the SEC to continue to coordinate closely with DOL so that DOL explicitly recognizes the SEC's best interest standard of conduct (once adopted in final form) in a new, streamlined prohibited transaction exemption for financial professionals that are subject to an SEC-governed standard of conduct. Likewise, we urge the SEC, in any final rule on Regulation Best Interest, to explicitly affirm, consistent with Sections 15(i) of the Securities Exchange Act of 1934 ("1934 Act") and Section 203A of the Investment Advisers Act of 1940 ("Advisers Act"), that SEC standards of conduct would preempt any standards under state law that are inconsistent with SEC regulation.

The remainder of our comments focus on the Proposals' implications for registered investment companies, including mutual funds, exchange-traded funds, and closed-end funds (together, "funds" , and their shareholders, reflecting the important role funds play in helping retail investors achieve their investment goals.[8] Many of our comments are intended to enhance the clarity of any final rules, others are intended to preserve for investors the ability to choose the type of investment professional and product that can best help them pursue their investing goals, and a few recommended refinements to assure consistency with existing law. These comments are summarized below.

We comment on the scope of a broker-dealer's obligation to disclose and consider fund fees. We recommend that the SEC confirm that it would permit a broker-dealer to direct customers to the fund prospectus for detailed, standardized information about fund fees and expenses, and would not require a broker-dealer to separately calculate fund-level fees and expenses, provide personalized fee disclosure at the outset of the customer relationship, or consider only costs to the exclusion of other relevant factors in making recommendations. Specifically, we explain that: (i) funds producing comprehensive,

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certain non-fiduciary investment advisors to make a specified disclosure to clients explaining that the advisor is not a fiduciary and not required to act in the client's best interest and to maintain signed acknowledgements of the disclosure).

[7] *See* Public Statement, SEC Chairman Jay Clayton, *Public Comments From Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers* (May 31, 2017), *available at* https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31.

[8] This letter builds on our other recent letters to the Commission. *See* Letter to the Honorable Jay Clayton, Chairman, SEC, from Paul Schott Stevens, President and CEO, ICI, dated Feb. 5, 2018, *available at* https://www.ici.org/pdf/31072a.pdf ("ICI February Letter"); Letter to the Honorable Jay Clayton, Chairman, SEC, from Dorothy M. Donohue, Acting General Counsel, ICI, dated Aug. 7, 2017, *available at* https://www.sec.gov/comments/ia-bd-conduct-standards/cll4-2188873-160255.pdf.

comparable, standardized fee disclosure, as they do now, is better than requiring brokers to independently calculate fund fees, which would compromise comparability and potentially confuse investors; (ii) it would be challenging and extremely costly for broker-dealers to provide individualized cost disclosure at the outset of the customer relationship; and (iii) overemphasizing cost may discourage broker-dealers from recommending funds that offer investors other important benefits.

We then comment on SEC statements in the Proposals that are likely to discourage broker-dealers from recommending proprietary products or a limited range of products, when such a recommendation may be in the customer's best interest. Specifically, we recommend that the SEC tailor proposed Regulation Best Interest's Conflict of Interest Obligations to require broker-dealers to have policies and procedures reasonably designed to: i) identify and disclose material conflicts of interest associated with a recommendation; and (ii) mitigate, or eliminate, those material conflicts of interest associated with the recommendation that create a financial incentive for the broker-dealer representative that is making the recommendation to put his or her interests ahead of the customer's interests. We point out that this approach would be consistent with the DOL's approach in the fiduciary rule and would appropriately focus the mitigation obligation on incentives that create a material conflict of interest for the *representative* that may influence the recommendation to the customer.

We reply to the SEC's request for comment on the proposed definitions of retail investor/customer for purposes of Regulation Best Interest and Form CRS and recommend that the SEC adopt a single definition of "retail investor" for purposes of both rulemakings, limited to natural persons. We explain that: (i) using a single definition of "retail investor" in both rules would provide important administrative efficiencies, facilitate compliance, and avoid confusion; and (ii) treating natural persons that are retirement plan participants, beneficiaries, or IRA owners, as "retail investors" is critical to provide consistent protections to retail brokerage customers, whether they are saving for retirement or other important goals.

We next turn our attention to the SEC's proposed interpretation of an investment adviser's fiduciary duty. We urge the SEC to refine the interpretation so that it is more consistent with existing law regarding an adviser's fiduciary duty. Specifically, we request that the SEC: (i) acknowledge that institutional advisory relationships may differ in important ways from retail advisory relationships, which are the focus of the proposed interpretation; and (ii) confirm that the standard for client consent under the Advisers Act is whether the adviser has provided full and fair disclosure of material conflicts and obtained informed client consent.

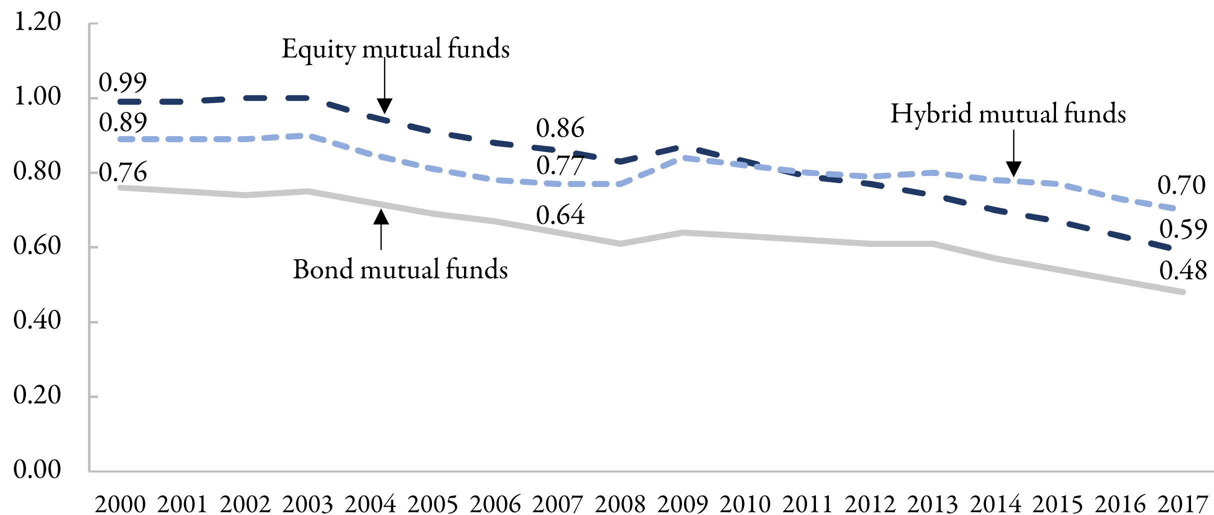
Finally, we reply to the SEC's requests for comment on incorporating certain broker-dealer rules into the investment adviser regulatory framework. We recommend that the SEC not pursue these changes. We explain that the SEC has neither articulated why these potential changes would be beneficial, nor has it addressed key concerns and questions they raise.

To begin, we provide background on fund fees and distribution trends to provide context for our comments related to fee disclosure.

II. Fund Fees and Expenses

The SEC discusses fund fees and expenses extensively throughout the Proposals, yet the Proposals do not reflect important distinctions among types of fees that may be associated with investing in funds. The Proposals also do not appear to take into account significant changes in mutual fund distribution trends. Notably, average expense ratios for long-term mutual funds[9] have fallen over time. For example, asset-weighted average expense ratios for equity mutual funds declined from 0.86 percent in 2007 to 0.59 percent in 2017 (Figure 1 .[10] This downward trend in long-term mutual fund expense ratios reflects, among other things, a long-running shift by investors toward lower-cost funds. In particular, the share of fund assets in no-load share classes has increased.

Figure 1
Expense Ratios Incurred by Mutual Fund Investors Have Declined Substantially Since 2000
Percent, 2000–2017



Note: Expense ratios are measured as asset-weighted averages. Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.
Sources: Investment Company Institute, Lipper, and Morningstar

[9] Long-term mutual funds are a mutual fund industry designation for all mutual funds other than money market funds. Long-term mutual funds are broadly categorized into equity (stock), hybrid, and bond mutual funds.

[10] ICI evaluates fee trends using asset-weighted averages to summarize the expenses that shareholders actually pay through funds. To compute the asset-weighted average, ICI multiplies the expense ratio for each share class of a fund by that share class' share of industry end-of-year total net assets. Simple averages (counting each fund's expense ratio equally) overstate the impact of the expenses of funds in which investors hold few dollars.

We provide, below, some background on fund fees and distribution trends that provides context for the comments that follow.

A. Types of Fund Fees and Expenses

Investors in mutual funds, the most common type of fund, incur two primary types of fees and expenses as a result of their investments: shareholder fees and fund expenses:[11]

Shareholder fees are paid directly by an investor and will vary based on the investor's share class[12] eligibility and selection as well as advice and account servicing relationships. Examples of shareholder fees that may pertain to an investor include the following:

- Sales load: Depending on the share classes offered by a fund, shareholders may pay a sales load at the time of share purchase ("front-end load"), when shares are redeemed ("back-end load"), or not at all ("no-load").[13]

- Direct broker commission: Investors may pay a commission or other sales charge directly to the broker when purchasing certain no-load share classes through the broker.

- Other transaction-based fees: Investors purchasing or selling fund shares through fund platforms[14] may pay a per-transaction fee, such as a trading fee, directly to the broker-dealer sponsor of the platform.

- Asset-based fees: Investors may pay fees directly to an investment adviser in connection with mutual fund investments, such as an asset-based investment advisory fee or a "wrap" fee that includes both investment advice and brokerage services.

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[11] For more information about mutual fund fees and expenses, please see ICI, 2018 Investment Company Fact Book (58th ed.), *available at* https://www.ici.org/pdf/2018_factbook.pdf; Duvall and Mitler, *Trends in the Expenses and Fees of Funds, 2017*, ICI Research Perspective (April 2018), *available at* https://www.ici.org/pdf/per24-03.pdf.

[12] Many funds offer multiple share classes, each distinguished by unique shareholder eligibility requirements, certain shareholder services offered, and a combination of fees and expenses for fund distribution.

[13] No-load shares generally are defined as those that do not have a load, and do not charge a Rule 12b-1 fee of more than 0.25 percent. *See* FINRA Rule 2341(d)(4).

[14] Fund platforms, sponsored by a broker-dealer, offer a broad selection of funds to retail investors. Diverse financial services firms often offer fund platforms as part of a larger array of services. Fund platform sponsors sign a contract with the fund's principal underwriter that authorize the sale of fund shares through this channel.

Fund expenses may cover portfolio management, fund administration, daily fund accounting and pricing, shareholder services (such as call centers and websites), distribution charges (known as "Rule 12b-1 fees"), and other fund operating costs. These expenses are included in a fund's expense ratio—the fund's annual expenses expressed as a percentage of its assets. Because these expenses are paid from fund assets, fund shareholders pay these expenses indirectly.

B. Fund Distribution Trends

Over the past few decades, the way in which investors buy and sell fund shares has changed, especially for assets held outside of employer-sponsored retirement plans. Rather than obtaining financial services through more traditional commission-based arrangements, investors have increasingly paid investment advisers asset-based fees for financial services. In part because of the shift toward asset-based fees, the total net assets of front-end and back-end load share classes have declined in recent years, while those in no-load share classes have increased substantially. The percentage of long-term mutual fund total net assets held in front-end and back-end load share classes fell from 27 percent at year-end 2007 to 13 percent at year-end 2017 (see Appendix A, Figure A1). By contrast, at year-end 2007, no-load share classes accounted for 51 percent of long-term mutual fund total net assets, rising to 70 percent by year-end 2017.

Although some movement toward no-load funds can be attributed to "do-it-yourself" investors, two other factors likely explain most of the shift. First, the increased use of investment advisers that charge an asset-based fee has resulted in an increase in sales of no-load share classes. Second, 401(k) plans and other retirement accounts, which often invest in no-load share classes, have bolstered assets and flows to these share classes.[15] Gross sales to no-load mutual funds without Rule 12b-1 fees[16] have grown to 85 percent of total gross sales to long-term mutual funds (see Appendix A, Figure A2). The shift toward no-load share classes has been important in driving down the average expense ratio of mutual funds.[17]

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[15] At year-end 2017, 92 percent of 401(k) plans' mutual fund assets were in no-load funds, up from 66 percent at year-end 2000. *See* Figure 5 in Holden, Duvall, and Chism, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2017*, ICI Research Perspective (June 2018), *available at* https://www.ici.org/pdf/per24-04.pdf.

[16] Rule 12b-1 fees equal to zero.

[17] We note that in any given year, the change in asset-weighted fund expense ratios reflects that: (1) expense ratios of individual funds may have fallen; 2) assets may have shifted to lower-cost funds; (3) new, lower-cost funds may have entered the market; and (4) higher-cost funds may have left the market. *See supra* note 11 (Figure 4 in Duvall and Mitler (2018) reports the breakdown of those contributing factors).

C. The SEC Should Clarify Which Fund Fees Need to be Disclosed and How

Regulation Best Interest would require that, at or before the time of a recommendation, a broker-dealer reasonably disclose to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, including all material conflicts of interest that are associated with the recommendation *i.e.*, the Disclosure Obligation).[18] The SEC explains that this requirement would obligate the broker-dealer to disclose fees and charges that apply to the customer's transactions, holdings, and accounts, including "quantitative information, such as amounts, percentages or ranges" of fees and charges.[19]

We request that the SEC confirm that the Disclosure Obligation would not require a broker-dealer to separately calculate fund-level fees and expenses, and that a broker-dealer can direct customers to the fund prospectus for detailed, standardized information about fund fees and expenses. We also recommend that the SEC not require broker-dealers to disclose fund fees and expenses on an individualized basis at the beginning of the relationship or prior to a recommendation. We explain the basis for these recommendations below.

1. Broker-Dealers Should Not Be Required to Separately Calculate Fund-Level Fees

The SEC explains that the purpose of proposed Regulation Best Interest's Disclosure Obligation is to make the customer aware of "certain key information regarding [the customer's] relationship with the broker-dealer."[20] The SEC's focus is on the scope and terms of the relationship, and the incentives the broker-dealer may have. Consistent with this focus, we request the SEC confirm that the proposed Disclosure Obligation would not require a broker-dealer to separately calculate fund fees and expenses.[21] Instead, the SEC should require the broker-dealer to disclose (1) the fees and expenses associated directly with its services, and (2) the types of fees and expenses associated with the products that it recommends. Importantly, broker-dealers already are required to disclose the fees they receive relating to the customer's investment.[22]

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[18] Proposed Rule 15l-1 a)(2)(i) under the 1934 Act.

[19] Best Interest Proposal at 21602. The SEC explains that these fees may include: commissions, mark-ups and mark-downs and sales loads, other account fees and expenses (including, for example, custodian, account maintenance and account inactivity fees), and investment fees and expenses for certain products such as mutual funds and variable annuities. Best Interest Proposal at n.193 and accompanying text.

[20] *Id.* at 21599.

[21] The SEC should revise its guidance on this issue in any release adopting a final rule. *See supra* note 19.

[22] A broker-dealer purchasing or selling fund shares for a customer is required to provide the customer with a confirmation statement that provides disclosure regarding the compensation the broker-dealer receives in connection with the transaction. *See* Rule 10b-10 under the 1934 Act. The SEC staff has deemed this obligation to be satisfied, for sales loads,

When making a recommendation of a fund, the broker-dealer should be permitted to direct customers to the fund's prospectus as the source of detailed information about fund fees and expenses.[23] The fund, not the broker-dealer, is in the best position to provide information about the fees the fund charges. Funds already are subject to comprehensive, standardized fee disclosure obligations in their prospectuses.[24] In fact, the SEC has long worked to ensure that fund information, including fees, is clear and comparable across funds. Suggesting a broker-dealer has an independent obligation to calculate and disclose fund fees could result in inconsistent disclosure, potential errors, lack of comparability among funds, and confusion for investors, and could undermine the SEC's longstanding efforts to provide investors with both specific and comparable information on fund fees.

2. *Requiring Individualized Fee Disclosure Would Present Significant Challenges*

The SEC requests comment in the Best Interest Proposal and the Disclosure Proposal regarding whether it should require broker-dealers (and, in the Disclosure Proposal, investment advisers) to provide quantitative information about fees or individualized cost disclosure. Individualized cost disclosure, especially at the outset of the customer relationship, raises significant operational burdens and compliance issues, however. With respect to funds, individualized cost disclosure simply is not necessary to provide investors with information about the amount or range of fees they will be charged when they invest.[25] We therefore recommend that the SEC not require broker-dealers or advisers to provide forward-looking estimates of actual individualized costs prior to a recommendation or at the beginning of the relationship, as applicable.

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by delivery to the customer of a prospectus that discloses "the precise amount of the sales load or other charges or a formula that would enable the customer to calculate the precise amount of those fees." *See Investment Company Institute,* SEC No-Action Letter (Apr. 18, 1979).

[23] As discussed above, investors may instead pay a commission or other sales charge directly to the broker when purchasing certain no-load share classes through the broker. *See supra* Section I.A.

[24] For closed-end funds, updated expense information is provided in a fund's semiannual and annual reports to shareholders.

[25] The SEC previously has considered, and rejected, individualized account statement cost disclosure in the context of shareholder report disclosure of mutual fund fees. The SEC instead concluded that the best way to improve shareholder understanding was to require a fee example in shareholder reports showing the expenses paid on each $1,000 invested, based both on the fund's actual operating expenses and actual return for the period and, to allow comparisons among funds, assume a return of 5 percent per year. *See Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, SEC Rel. Nos. 33-8393; 34-49333; IC-26372 (Feb. 27, 2004), *available at* https://www.sec.gov/rules/final/33-8393.htm. In addition, as explained in more detail above, average expense ratios for long-term mutual funds have fallen over time. *See* Section III.B, *supra*.

Providing individualized cost disclosure at the time of a recommendation, for example, would require broker-dealers or their associated persons to predict fees and expenses that a potential investor would pay, potentially before the person even has made an investment.[26] We understand that it would be challenging for broker-dealers and their associated persons to calculate individualized cost information on a forward-looking basis. Providing such cost information would be challenging because of, among other reasons, the uncertainty of predicting cost information on an individualized basis before the customer invests, cost variation among customers, the likely need to provide cost information for different time periods, and other complex calculations that the broker-dealer would need to make.[27] To provide accurate information, broker-dealers would need to develop centralized systematic methods to calculate the information across all services and products available on their platform, and would need to develop compliance and supervisory programs to monitor information provided to retail investors. The costs to build these capabilities, which would include both substantial upfront investments and costly ongoing maintenance, do not appear to be justified for broker-dealers generally, and clearly not with respect to recommendations of funds, given the extensive fee information already required to be disclosed in a fund's prospectus and statement of additional information.

3. *Clarify Fee Disclosure Obligations in Form CRS*

Proposed Form CRS requires broker-dealers to summarize the principal fees and expenses that retail investors will incur. The SEC proposes to prescribe language describing "transaction-based fees," or commissions, that an investor pays when buying or selling an investment. We request that the SEC revise these descriptions to make them more product agnostic and to better clarify how different types of fees would affect an investment. We also recommend that the SEC reframe Form CRS disclosure to focus investors on asking their financial professional about types and levels of fees associated with each type of account, rather than asking their financial professional to predict actual costs on a forward-looking, individualized basis during the account opening process.[28] We explain the basis for these recommendations below.

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[26] Commissioner Peirce recently suggested exploring the feasibility of providing backward-looking cost disclosure that is investor-specific. *See What's in a Name? Regulation Best Interest v. Fiduciary*, Remarks by Commissioner Hester M. Peirce at the National Association of Plan Advisors D.C. Fly-In Forum (July 24, 2018), *available at* https://www.sec.gov/news/speech/speech-peirce-072418. As noted above, funds already provide an expense example in their annual and semi-annual shareholder reports. *See supra* note 25.

[27] *Cf.* Letter to Brent J. Fields, Secretary, SEC, from Paul Schott Stevens, President and CEO, Investment Company Institute, dated May 18, 2018, at Appendix A, *available at* https://www.sec.gov/comments/s7-04-18/s70418-3669117-162439.pdf (discussing European regulators' recent transaction cost disclosure efforts as an example of the need for caution when requiring investor disclosure based on complex methodologies with subjective inputs).

[28] The SEC provides extensive investor education materials on its website, including materials on investment products, such as funds. *See, e.g., Mutual Funds, available at* https://www.investor.gov/investing-basics/investment-products/mutual-

a. Proposed mandatory language on transaction-based fees

Proposed Form CRS prescribes language that all broker-dealers would have to use to describe the types of transaction-based fees that investors may pay. The SEC indicates that it believes investors would benefit from specific examples of transaction-based fees and gives two examples of transaction-based fees—bond mark-ups/mark-downs and mutual fund sales loads. The SEC proposes requiring firms to include mutual fund sales loads as an example "because they are common indirect fees associated with investments that compensate the broker-dealer."[29]

This disclosure suggests that mutual fund sales loads are one of the most common examples of transaction fees. Yet, mutual fund sales loads are increasingly uncommon. In fact, eighty-five percent of fund shares are now sold without a sales load or Rule 12b-1 fee.[30] It therefore may be misleading or, at the very least, unnecessary to highlight mutual fund sales loads as one of the Form's two required examples of transaction-based fees. Indeed, specifically highlighting bonds and mutual funds ironically could cause investors to overlook fees on other products with potentially higher and more complex fees,[31] or suggest to investors that the costs of investing in bonds and mutual funds raise special concerns that other investment products do not.

We recommend that Form CRS instead provide a bulleted list of non-exclusive examples of transaction-based fees.[32] Providing a list with several examples would increase the likelihood that an investor will be able to recognize a transaction-based fee and request more information from his or her financial representative. A list approach also would be more product agnostic and would avoid giving investors the impression that fees on products other than bonds and mutual funds are less worthy of scrutiny. To ensure that the list of examples is relevant to the customer, the SEC could consider permitting a broker-dealer to provide examples of transaction-based fees that most commonly apply to its business and the products that it offers.

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funds#Fees. SEC educational materials could play a key role in providing investors with generic information about different types of accounts, investment products, and associated fees and expenses.

[29] Disclosure Proposal at 21433.

[30] *See* discussion of distribution trends, at Section II.B, *supra*.

[31] Private placements are one example of such a product. *See, e.g., Regulators Step Up Scrutiny of Sales of Private Stakes*, Wall Street Journal (Jul. 2, 2018), *available at* https://www.wsj.com/articles/regulators-step-up-scrutiny-of-sales-of-private-stakes-1530565028.

[32] It could also direct investors to SEC investor education materials that provide information about investment costs and fees, such as *How to Open a Brokerage Account, available at* https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-how-open-brokerage-account, and *Brokers Miscellaneous Fees, available at* https://www.sec.gov/oiea/investor-alerts-bulletins/ib_brokersmiscfees.html.

We also recommend that the SEC describe transaction-based fees consistently with a broad statement that transaction fees "increase the cost of your investment." We note that Form CRS describes a bond mark-up or mark-down as a fee that "might be part of the price you pay for the investment," while describing a mutual fund load as a fee that "reduces the value of your investment."[33] We recommend that any final Form CRS instead use consistent language.

b. Proposed requirement to state that some investments impose additional fees that will reduce the value of retail investors' investments over time

Form CRS also requires investment firms to include a statement that some investments impose additional fees that will reduce the value of retail investors' investments over time, and include examples of such investments that they offer to retail investors. The SEC contemplates mutual funds, variable annuities, and ETFs as common examples. This requirement could suggest that funds are more expensive than other investments (*i.e.*, they charge "additional" fees), which is not necessarily true. Moreover, this formulation is inconsistent with the SEC's characterization of Rule 12b-1 fees in Form N-1A, which describe these ongoing fees as fees that "increase the cost of your investment."[34]

Consistent with our recommended approach to transaction-based fee disclosure, we recommend that Form CRS instead use the following language to describe ongoing fees: "Some investments include ongoing fees that increase the cost of your investment."

c. Investor prompts to request individualized cost disclosure

Form CRS includes two separate prompts for investors to ask a broker-dealer or adviser for individualized cost information—in the "Fees and Costs" section and in the "key questions" at the end of the form. The SEC assumes that financial professionals are well positioned to provide retail investors with forward-looking estimates of actual costs during the account opening process. We question the SEC's assumption and believe that estimating individualized costs at this juncture would be difficult and burdensome, and not result in meaningful information. We do not see how financial professionals would generate accurate individualized cost disclosure during the initial meeting with a new investor, potentially before receiving complete information on the customer's investments, financial

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[33] Form N-1A, by comparison, describes a mutual fund sales load as part of the price an investor pays for the investment. *See* Form N-1A Item 12(a)(1) (A fund that sells shares subject to a front-end sales load must "explain that the term 'offering price' includes the front-end sales load.").

[34] *See* Form N-1A Item 12(b)(2) (which describes the impact of ongoing fees as increasing costs rather than reducing value: "Because these fees are paid out of the Fund's assets on an on-going basis, over time these fees will increase the cost of your investment and may cost you more than paying other types of sales charges").

circumstances, and investment objectives, and before making any recommendations of a security or investment strategy. To predict costs on a forward-looking basis, a financial professional first would need to determine an investor's risk tolerance, time horizon, and other preferences, and then forecast the types of investment products in an investor's account, as well as the likely frequency of future trading.

We strongly recommend that the SEC reframe Form CRS disclosure to focus investors on asking their financial professional about types and levels of fees associated with each type of account. This approach would be much more informative than a detailed individualized estimate of possible prospective costs that is highly likely to be inaccurate and costly to prepare. More detailed cost information would be available through the layered disclosure framework that the SEC proposes, with references and links to other disclosures where interested investors can find more information. We believe this approach would better meet the SEC's policy goal of using Form CRS to help investors decide which account type is best for their needs.

D. The SEC Should Clarify the Role of Costs in a Broker-Dealer's Recommendation

Proposed Regulation Best Interest's Care Obligation would require that a broker-dealer exercise reasonable diligence, care, skill, and prudence to have a reasonable basis to believe the recommendation is in the best interest of the customer.[35] The SEC indicated it believes that "cost (including fees, compensation and other financial incentives) associated with a recommendation would generally be an important factor."[36] The heavy emphasis on cost in the discussion of the proposed Care Obligation, however, creates uncertainty regarding how a broker-dealer should balance cost with other appropriate factors when making a recommendation. Cost is only one of many factors that may be relevant to a recommendation. To achieve the Commission's goal of preserving investor choice, it is critical that the SEC acknowledge the variety of factors that may be relevant to a recommendation, including other factors that the SEC does not discuss in the Best Interest Proposal. We therefore recommend that the SEC clarify how a broker-dealer should consider cost as part of the proposed Care Obligation, particularly regarding recommendations of funds. We discuss our specific suggestions below.

[35] Specifically, the broker-dealer would be required to: 1) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; 2) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (3) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.

[36] Best Interest Proposal at 21588.

1. *The SEC Should Confirm That a Broker-Dealer Is Not Required to Recommend the Lowest Cost Product and May Consider Subjective Factors*

We appreciate the SEC's statements that provide context for a broker-dealer's consideration of costs as part of the Care Obligation.[37] However, statements elsewhere in the Best Interest Proposal suggest cost should be the primary focus of the broker-dealer's Care Obligation. For example, the SEC explains that:

> . . . when a broker-dealer recommends a *more expensive* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that the higher cost is justified (and thus nevertheless is in the retail customer's best interest) based on other factors (*e.g.,* the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions), in light of the retail customer's investment profile.[38]

The resulting ambiguity about how a broker-dealer should consider cost may cause broker-dealers, due to liability concerns, to avoid recommending products that may be in a particular customer's best interest but have higher costs.[39]

The relationship between cost and financial incentives is also important, as the SEC recognizes. The SEC believes that, when making a recommendation, a broker-dealer should consider any financial incentives it has to recommend the security or investment strategy. The SEC explains that:

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[37] For example, the SEC notes that the Care Obligation would not require a broker-dealer "to recommend the least expensive or least remunerative security or investment strategy. . . . " and that "the cost associated with a recommendation is ordinarily only one of many factors to consider when evaluating the risks and rewards of a subject security or investment strategy involving securities." Best Interest Proposal at 21609, 21610.

[38] *Id.* at 21612. The SEC explains that the concept of a customer's investment profile is intended to be consistent with FINRA's suitability rule and would include, but would not be limited to, the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation. Proposed Rule 15l-1(b)(2) under the 1934 Act.

[39] Under ERISA, a fiduciary must recommend investments with reasonable expenses. (". . . [A]n Adviser and Financial Institution do not have to recommend the transaction that is the lowest cost or that generates the lowest fees without regard to other relevant factors." 81 Fed. Reg. 21002, 21030 (Apr. 8, 2016); *see also Hecker v. Deere & Co.,* 556 F.3d 575 (7th Cir. 2009). It also is unclear what the "lowest" cost product may be under certain circumstances, as it will depend on the other products to which it is compared, relevant holding periods, and potentially other considerations. *See, e.g., infra* note 52.

> When a broker-dealer recommends a *more remunerative* security or investment strategy over another reasonably available alternative offered by the broker-dealer, the broker-dealer would need to have a reasonable basis to believe that—putting aside the broker-dealer's financial incentives—the recommendation was in the best interest of the retail customer based on the factors noted above, in light of the retail customer's investment profile.[40]

As currently described, however, the proposed Care Obligation could discourage broker-dealers from recommending funds that are not the lowest cost, including those offered by smaller and medium-sized firms, but that may offer investors other important benefits. For example, it may be relevant for a broker-dealer, when making a recommendation to a particular retail investor, to consider not only cost and the other factors the SEC has explicitly referenced, but also more subjective factors, such as the nature and quality of a provider's services (including advantages to the investor of consolidating investments at a single firm, such as higher levels of service that may be offered), minimum initial investments, and firm reputation.[41] We request that the SEC explicitly clarify that a broker-dealer may consider such legitimate factors in meeting the proposed Care Obligation.

2. *The SEC Should Clarify the Nature of "Otherwise Identical" Securities and "Reasonably Available Alternatives"*

The SEC states that, under the proposed Care Obligation, a broker-dealer could not have a reasonable basis to believe that a recommended security is in the best interest of a retail customer if (1) it is more costly than a *reasonably available alternative* the broker-dealer offers and (2) the characteristics of the securities are *otherwise identical*.[42] The SEC explains that, if a broker-dealer recommends a more expensive security or investment strategy over another *reasonably available alternative* the broker-dealer offers, it needs to have a reasonable basis to believe the higher cost is justified and is in the customer's best interest, in light of the customer's investment profile. The SEC does not define either of the italicized terms, however. We are concerned that, in the absence of clarification, the Commission's statements in the Best Interest Proposal could result in unintended consequences for investors. We therefore make the recommendations below.

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[40] Best Interest Proposal at 21612. The SEC acknowledges, however, that "this does not mean that a broker-dealer could not recommend the more remunerative of two reasonably available alternatives, if the broker-dealer determines the products are otherwise both in the best interest of—and there is no material difference between them from the perspective of—the retail customer, in light of the retail customer's investment profile."

[41] The SEC's factors would not seem to clearly accommodate these legitimate (and common) considerations.

[42] Best Interest Proposal at 21588.

It is unclear what the SEC intends the concept of "otherwise identical securities" to mean, given it is rare that two securities would be completely identical, aside from their costs.[43] How should a broker-dealer analyze two securities for purposes of determining whether they are "otherwise identical?" For example, would this concept require a broker-dealer to recommend the lowest cost option of two S&P 500 index funds?[44] We do not believe this was the SEC's intent. Also, index funds with similar investment objectives may differ, among other things, with respect to their management, the specific indices they track, and the reputation of the fund firm.[45] Similarly, two large-cap growth funds may have comparable investment objectives and strategies, but differ in their management, performance history, and the securities they hold.

The only example the SEC provides of "identical securities" with different cost structures is different share classes of the same mutual fund.[46] This example appears to be based on the SEC's recent settled enforcement actions related to share class selection.[47] In these cases, the SEC generally alleged that an investment adviser, or dual registrant, recommended that clients invest in Class A shares[48] even after clients became eligible to invest in otherwise identical, but lower cost Class I shares of the same fund.[49] The SEC's examples in the Proposals, however, do not reflect legitimate factors a broker-dealer could consider in recommending a customer invest in one share class of a fund rather than another. We recommend that the SEC explicitly acknowledge that different share classes may be appropriate for different investors. For example, it may be relevant for a broker-dealer to consider a customer's eligibility for a share class, whether a broker-dealer has an agreement with a fund company to make a

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[43] It also is unclear what the SEC means by "cost" in this context—whether the cost of the security, the overall cost to the investor, or something else.

[44] Even individual S&P 500 index funds can differ from one another in certain respects. *See* Sean Collins, Investment Company Institute, *Are S&P 500 Index Mutual Funds Commodities?,* Perspective*,* Vol. 11, No. 3, Aug. 2005, *available at* https://www.ici.org/pdf/per11-03.pdf.

[45] Also see additional factors discussed above, *supra* note 40 and accompanying text.

[46] Best Interest Proposal at n.106.

[47] *See, e.g., In the Matter of Packerland Brokerage Services, Inc.,* Investment Advisers Act Rel. No. 4832 (Dec. 21, 2017); *In the Matter of SunTrust Investment Services, Inc.,* Investment Advisers Act Rel. No. 4769 (Sept. 14, 2017); *In the Matter of Envoy Advisory, Inc.*, Investment Advisers Act Rel. No. 4764 (Sept. 8, 2017); *In the Matter of Cadaret, Grant & Co., Inc.*, Investment Advisers Act Rel. No. 4736 (Aug. 1, 2017). In February 2018, the SEC's Division of Enforcement announced a share class disclosure initiative to encourage advisers to self-report possible securities law violations relating to their failure to make necessary disclosures regarding mutual fund share class selection. *See* SEC, Division of Enforcement, Share Class Selection Disclosure Initiative, *available at* https://www.sec.gov/enforce/announcement/scsd-initiative.

[48] Whether the Class A shares may or may not have been subject to a sales load varied in each case. But in all the recent settled cases, the fund had a Rule 12b-1 fee.

[49] The Class I, or institutional, shares, charged no sales loads or Rule 12b-1 fees and were otherwise the same.

particular share class available, an investor's expected time horizon for holding the shares,[50] share class rights and features,[51] and how the customer pays the broker-dealer for its services (*e.g.*, transaction-based fees, front-end or deferred sales loads, commissions).

The SEC also should clarify, in any final release, what it intends by the term a "reasonably available alternative." The SEC refers in the Best Interest Proposal to "reasonably available alternatives offered by the broker-dealer," but it is unclear what it means for alternatives to be "reasonably available."[52] Based on the SEC's statements in the Best Interest Proposal, we believe the SEC intends that a broker-dealer could, subject to disclosure and satisfaction of its Care Obligation and Conflict of Interest Obligations, as applicable: (i) limit its product offerings to a particular range of products (including only certain fund share classes) and (ii) make available and recommend proprietary products, either solely or in addition to third-party products.[53] In this context, we believe a "reasonably available

[50] For example, an investor that does not intend to hold shares for more than seven years may pay a lower total cost to invest by purchasing Class C shares rather than Class A shares. This would be true if the Class C shares were sold at net asset value with a total expense ratio of 1.50 percent (which includes an annual 1 percent Rule 12b-1 fee) and a contingent deferred sales load of 1 percent for one year, and the Class A shares were sold with a 5.75 percent front-end sales charge and a total expense ratio of 0.75 percent, which includes a 0.25 percent Rule 12b-1 fee. Appendix B to this letter further illustrates this point.

[51] For example, particular share classes may be subject to minimum initial and ongoing purchase requirements or may be available only to certain investors (*e.g.*, retirement plans and their participants, advisory program investors).

[52] The staff of the SEC's Division of Enforcement has stated that, for purposes of the Share Class Selection Disclosure Initiative, whether a lower-cost share class is "available" is fund specific. The staff, in its FAQs, includes a non-exhaustive list of examples as to when the staff would likely conclude that a lower-cost share class was "available" for the same fund:

- The client could have purchased a lower-cost share class for the same fund because the client's investment met the applicable investment minimum.
- There was or is language in the fund prospectus that says the fund will waive the investment minimum for a lower-cost share class for the same fund for advisory clients.
- There was or is language in the fund prospectus that says the fund may waive the investment minimum for a lower-cost share class for the same fund for advisory clients, and the adviser had no reasonable basis to believe the fund would not waive the investment minimum for a lower-cost share class for its advisory clients. An assumption by the adviser that a fund would not waive the investment minimum for his or her clients without taking steps to confirm this assumption would not constitute a reasonable basis.
- The investment adviser purchased a lower-cost share class of the same fund for other similarly-situated clients.

The staff notes that the list is intended to be non-exhaustive and there may be other circumstances when a lower-cost share class was "available" for the same fund. *See Share Class Selection Disclosure Initiative – FAQs, available at* https://www.sec.gov/enforce/educationhelpguidesfaqs/share-class-selection-disclosure-initiative-faqs.

[53] *See, e.g.,* Best Interest Proposal at 21603 ("We preliminarily believe that a material conflict of interest that generally should be disclosed would include material conflicts associated with recommending: Proprietary products . . . or limited range of products; [or] one share class versus another share class of a mutual fund . . ."); *id.* at 21609 ("Nor does Regulation

alternative" means an alternative investment offered by the broker-dealer that would also satisfy the broker-dealer's reasonable basis obligations under the proposed Care Obligation. We request that the SEC explicitly confirm this meaning.[54]

III. Conflicts of Interest

Regulation Best Interest's Conflict of Interest Obligations would require a broker-dealer firm to establish, maintain, and enforce written policies and procedures reasonably designed to:

(1) identify and at a minimum *disclose, or eliminate, all material conflicts of interest* that are associated with such recommendations; and

(2) identify and *disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives* associated with such recommendations.

The Conflict of Interest Obligations would create a broad new duty for broker-dealers to mitigate material conflicts of interest arising from financial incentives. It is unclear, however, which conflicts a broker-dealer would be required to mitigate and how. As discussed in more detail below, we recommend that the SEC clarify what is a "material conflict of interest." We also recommend that the SEC revise the proposed Conflict of Interest Obligations to require that a broker-dealer firm establish, maintain, and enforce written policies and procedures reasonably designed to (i) identify and disclose material conflicts of interest associated with a recommendation, and (ii) mitigate, or eliminate, those material conflicts of interest associated with the recommendation that create a financial incentive for the associated person of the broker-dealer to put the associated person's interests ahead of the retail customer's interests.

A. A "Material Conflict of Interest" Should Be an Objective Concept

In the Best Interest Proposal, the SEC proposes to interpret the term "material conflict of interest" to mean "a conflict of interest that a reasonable person would expect might incline a broker-dealer—

Best Interest prohibit, among others, recommendations from a limited range of products, or recommendations of proprietary products, products of affiliates, or principal transactions, provided the Care Obligation is satisfied and the associated conflicts are disclosed (and mitigated, as applicable) . . .").

[54] In certain places in the Proposal the SEC references only "reasonably available alternatives," which could suggest the broker-dealer must look to investment options beyond those it offers. We do not believe this was the SEC's intent and strongly recommend that the SEC revise these references to limit them to reasonably available alternatives *offered by the broker-dealer*. *See id.* at 21588.

consciously or unconsciously—to make a recommendation that is not disinterested."[55] While the SEC explains that it intended this interpretation to be consistent with the concept of material conflicts of interest under the Advisers Act, we believe the Commission inadvertently has proposed a standard that is subjective and inconsistent with existing Advisers Act principles.

Rather than focusing on what "a reasonable person would expect might incline a broker-dealer . . ." the standard should instead focus on the nature of an incentive and its effect on the broker-dealer's conduct. Under the federal securities laws, information is material where there is a substantial likelihood that a reasonable investor would have considered the information important.[56] Under the Advisers Act, a conflict of interest arises if an incentive exists that "might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[57] Thus, we recommend that the SEC interpret "conflict of interest" to mean "a conflict of interest that might incline a broker-dealer—consciously or subconsciously—to make a recommendation that is not disinterested."[58] Such a conflict of interest should be considered "material" if there is a substantial likelihood that a reasonable investor would consider the information important.[59] This is the same test that the SEC has recognized is applicable to materiality determinations under the Advisers Act,[60] and is consistent with long-standing interpretations of "materiality" under the federal securities laws.

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[55] *Id.* at 21602.

[56] *See SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992). *Cf. Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 445, 449 (1976).

[57] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963) (stating that the Advisers Act "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested").

[58] Note that while *Capital Gains* uses the phrase "consciously or unconsciously," the Court adopted that standard from an SEC report that discussed whether advice "might in some way be tinged with that pecuniary interest [whether consciously or] or *subconsciously* motivated . . ." *Capital Gains,* at text accompanying n.19 (emphasis added). It appears that *subconsciously* is the word the Court intended to use.

[59] *See SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992) (stating that the test for materiality established in *TSC Industries* "appears to be accepted as a general definition of materiality under the federal securities laws").

[60] *See* Amendments to Form ADV, Advisers Act Release 3060 (July 28, 2010) ("The standard of materiality under the Advisers Act is whether there is a substantial likelihood that a reasonable investor (here, client) would have considered the information important. *See S.E.C. v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992). *Cf. Basic Inc. v. Levinson*, 485 U.S. 224, 231– 232 (1988); *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 445, 449 (1976). This is a facts and circumstances test, requiring an assessment of the 'total mix of information,' in the characterization of the Supreme Court. *TSC Industries*, 426 U.S. at 449. Given that materiality depends on the factual situation, which may vary with each situation, we do not believe that it is appropriate to specifically define or provide any bright line tests for what is and is not material.").

B. Clarify Application of the Conflict of Interest Obligations

1. Distinguish Duty to Mitigate from Duty to Disclose

The Best Interest Proposal lacks clarity around what would constitute a "material conflict of interest arising from financial incentives" that a broker-dealer would have to mitigate or eliminate, as compared to a material conflict that a broker-dealer would have to disclose.[61] The SEC's examples appear to limit the concept of a "material conflict of interest arising from a financial incentive" to those faced by associated persons of a broker-dealer when making recommendations to retail customers. The SEC explains that it intended the proposed Conflict of Interest Obligations to address the same concerns regarding conflicts as the DOL fiduciary rule, but "in a less prescriptive manner . . . ."[62] As drafted, however, the SEC's proposed mitigation obligation may extend further than the requirements of the DOL fiduciary rule, with significant adverse implications for existing business practices.

We recommend that the SEC revise its proposed Conflict of Interest Obligations to require a broker-dealer firm to establish, maintain, and enforce written policies and procedures reasonably designed to (i) identify and disclose material conflicts of interest associated with a recommendation, and (ii) mitigate, or eliminate, those material conflicts of interest associated with the recommendation that create a financial incentive for the associated person of the broker-dealer to put the associated person's interests ahead of the retail customer's interests.

This approach would focus the mitigation obligation on fees, revenue, or other financial incentives that create a material conflict of interest for an associated person that may directly influence the person's recommendation. By contrast, a broker-dealer (like an investment adviser) should be permitted to address material conflicts at the *firm level* by disclosing them, and not further mitigating or eliminating such conflicts, as long as they do not otherwise result in a material financial incentive to the broker-dealer representative making the recommendation. This approach is consistent with the approach that

[61] The SEC explains that "financial incentives" may include, but are not limited to: compensation practices that the broker-dealer has established, including fees and other charges for providing services and selling products; employee compensation or employment incentives (*e.g.*, quotas, bonuses, sales contests, special awards, differential or variable compensation, incentives tied to appraisals or performance reviews); compensation practices involving third parties, including both sales compensation and compensation that does not result from sales activity, such as compensation for services provided to third parties (*e.g.*, sub-accounting or administrative services provided to a mutual fund); receipt of commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer or a third party; sales of proprietary products or services, or products of affiliates; and transactions that the broker-dealer (or an affiliate thereof) would effect in a principal capacity.

[62] Best Interest Proposal at 21622.

DOL took in its now vacated BIC exemption under the fiduciary rule[63] and appears to be consistent with the SEC's intent.[64]

Our recommended approach, consistent with SEC statements in the Best Interest Proposal, would permit a broker-dealer to recommend only proprietary products, or from a limited range of products, provided that the broker-dealer firm discloses to customers material conflicts of interest associated with such recommendations, and otherwise satisfies the Care Obligation.[65] For example, if a broker-dealer recommends both proprietary funds and third-party funds, we believe the broker-dealer should be able to address through disclosure the material conflicts that recommending proprietary funds raises. The SEC should not require the broker-dealer to take additional steps to mitigate the material conflict if there is no material financial incentive to the broker-dealer representative to recommend proprietary funds over third-party funds (*i.e*., no difference in compensation to the broker-dealer representative between proprietary and third-party funds), and no other material financial incentive exists for the representative to favor proprietary funds (*e.g*., an incentive or bonus structure incentivizing the sale of proprietary funds or a software tool provided to representatives to develop recommendations that favors proprietary funds over third-party funds the firm recommends).

2. *Omit Unworkable Examples of Mitigation or Elimination of Conflicts*

a. A fund adviser should not be required to relinquish fees for managing an affiliated fund

The SEC's suggestion that a firm may, under certain circumstances, need to relinquish fees associated with managing proprietary funds is inconsistent with proposed Regulation Best Interest, and is

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[63] The BIC exemption required that firms adopt policies and procedures to insulate broker-dealer and investment adviser representatives from incentives that would violate the DOL's best interest standard. *Best Interest Contract Exemption*, 81 Fed. Reg. 21002, 21033 (Apr. 8, 2016). The BIC exemption's policies and procedures requirement focused on mitigating conflicts at the individual representative level that could misalign the representative's interests with those of the investor (*e.g*., differential compensation).

[64] *See, e.g.,* Brett Redfearn, Director, Division of Trading and Markets, Remarks at the FINRA Annual Conference, Washington, DC (May 22, 2018), *available at* https://www.sec.gov/news/speech/redfearn-remarks-finra-annual-conference-052218 ("The Commission defined financial incentives broadly to cover a wide variety of compensation practices established by the broker-dealer, including quotas, bonuses, sales contests, special awards, differential, or special compensation, and so on. So, for example, if a broker-dealer today provides incentives to its representatives to favor one type of large cap mutual fund over another, the broker-dealer would need to mitigate that conflict, for example, by levelling the compensation for recommending similar funds so that the conflict does not taint the recommendation.")

[65] Best Interest Proposal at 21603.

unnecessary to address material conflicts of interest. The SEC states that, to eliminate material conflicts of interest:

> . . . a broker-dealer could satisfy this obligation by negating the effect of the conflict by, for example, in the case of conflicts related to affiliated mutual funds, crediting fund advisory fees against other broker-dealer charges—thus effectively eliminating the material conflict of interest.[66]

This example suggests that a firm that offers proprietary funds should consider relinquishing the advisory fees the firm or its affiliate receives for managing those funds as a means to address conflicts that selling such funds creates. This example is inconsistent with the SEC's explicit statements elsewhere in the Best Interest Proposal that Regulation Best Interest would not preclude a firm from offering proprietary products. It also is inconsistent with the explicit direction under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") that a best interest standard should not preclude the sale of only proprietary or other limited range of products.[67] The SEC should clarify in any adopting release that firms selling proprietary funds are not obligated to credit fund advisory fees against other broker-dealer charges. The ability to charge fees to manage proprietary funds is critical to preserve the ability of firms to offer both proprietary and third-party funds.

b. Do not reference a "neutral factors" approach to mitigation policies and procedures

The SEC recommends that broker-dealers reference in their policies and procedures on mitigation, among other practices:

> . . . minimizing compensation incentives for employees to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis—for example, *establishing differential compensation criteria based on neutral factors* (*e.g.,* the time and complexity of the work involved) . . .[68]

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[66] *Id.* at 21619.

[67] Section 913 of the Dodd-Frank Act 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. 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." Nor would the Advisers Act require such an approach.

[68] Best Interest Proposal at 21621 (emphasis added).

We recommend that the SEC omit from any final release any suggestion that broker-dealers should incorporate a "neutral factors" analysis into mitigation policies and procedures.

The "neutral factors" concept appears to be derived from the DOL's BIC exemption. This concept, however, caused widespread industry confusion, and led many broker-dealer firms to restrict their product offerings in ways that resulted in reduced investor choice and flexibility. The DOL's discussion of "neutral factors" in the BIC exemption release and subsequent DOL guidance did not sufficiently clarify the concept, beyond focusing on the time and complexity associated with recommending an investment. In addition to creating further confusion about what constitutes a "neutral factor," the DOL guidance[69] suggested that, based on the neutral factors analysis, compensation paid to individual representatives could not vary within "product types" or "reasonably designed investment categories," implying that all funds, for example, should be considered one product type or category. This interpretation effectively required levelized compensation across all funds offered by a broker-dealer, regardless of whether there might be valid reasons for differential payments with respect to different funds, such as increased time and complexity for a broker-dealer to recommend one fund product compared to another. By referencing the DOL's neutral factors concept, the SEC risks importing into its final rule the same confusion and marketplace disruption that resulted from the BIC exemption.

We generally support, however, the SEC's reference to a "non-exhaustive list of potential practices" broker-dealers should consider incorporating into their policies and procedures to mitigate conflicts of interest, including "minimizing compensation incentives for employees to favor one type of product over another." We believe this approach, in contrast with the more rigid "neutral factors" concept, is more consistent with the goal of permitting broker-dealers to develop policies and procedures that are tailored to their particular business models.

IV. Scope of Obligations

A. The SEC Should Clarify When Regulation Best Interest Applies to Recommendation of an Account Type

The SEC states that proposed Regulation Best Interest would not apply to a recommendation of an account type generally, unless the recommendation is tied to a securities transaction (*e.g.,* a recommendation to rollover or transfer assets from a retirement plan to an individual retirement account (IRA)).[70] The Commission requests comment on this issue, however. The standard of conduct that applies to a recommendation of an account type raises complex issues, especially for dual

[69] DOL Conflict of Interest FAQs, Part I—Exemptions at 7.

[70] Best Interest Proposal at 21595.

registrants. Given the significant implications of this choice for retail investors, we suggest that the SEC consider providing more clarity as to which standard of conduct would apply when a broker-dealer (particularly a dual registrant) recommends an account type, and when it would apply.[71] We note that this decision is relevant not only for retail investors making an initial choice of which account type may be most appropriate to execute their investment strategy, but for those investors who already hold securities in an account and receive a recommendation to convert that account to a different type of account.[72]

B. The SEC Should Use a Single Definition of "Retail" in Regulation Best Interest and Form CRS

The definition of "retail customer" under proposed Regulation Best Interest differs from the definition of "retail investor" under proposed Form CRS. The SEC requests comment on these proposed definitions. We recommend that the SEC adopt a single definition of "retail investor" for purposes of both rulemakings, limited to natural persons and with several further modifications, as described below.

The SEC proposes to define "retail customer" under Regulation Best Interest as "a person, or the legal representative of such person, who: (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (2) uses the recommendation primarily for personal, family, or household purposes." The SEC proposes to define "retail investor" under Form CRS as "a prospective or existing client or customer who is a natural person (an individual). This term includes a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust."

We recommend that the SEC adopt a single definition of "retail investor" for purposes of both proposed Regulation Best Interest and proposed Form CRS, limited to natural persons and with an exclusion for sophisticated investors. We suggest the following definition:

> "Retail investor" for purposes of Regulation Best Interest and Form CRS means a natural person, or the legal representative of such person, other than a natural person with total assets of at least $50 million. For purposes of this definition, a "legal representative" of a natural person means an executor, conservator, or a person holding a durable power of attorney for a natural person and does not include a bank, trust company, savings and loan association, credit

[71] If the SEC determines to provide further clarity on these issues, we recommend it do so through a proposed rulemaking so that the public has an opportunity to comment.

[72] For example, a retail investor who previously purchased mutual fund shares subject to a front-end load in a brokerage account may receive a recommendation to convert that account to a fee-based advisory account.

> union, broker-dealer, investment adviser, or other financial institution or regulated intermediary.

A definition limited to natural persons is more consistent with the Commission's focus in these proposals on retail investors—individuals. Using a single definition of "retail investor" in both rules also would provide important administrative efficiencies, facilitate compliance, and avoid confusion. The recommended exclusion for institutional investors is consistent with existing FINRA rules applicable to broker-dealers.[73] Including an institutional investor exclusion based on FINRA rules is important to avoid disruption to the industry.

Consistent with the SEC's approach in the Proposals, the recommended definition of "retail investor" would only be for purposes of Regulation Best Interest and Form CRS. Thus, only a recommendation of any securities transaction or investment strategy involving securities by a broker, dealer, or a natural person who is an associated person of a broker or dealer to a "retail investor" would be subject to Regulation Best Interest, and a broker-dealer or investment adviser would only have an obligation to deliver Form CRS to a prospective or existing client or customer that is a "retail investor."[74]

The SEC states in the Best Interest Proposal that the definition of "retail customer" in proposed Regulation Best Interest would include participants in ERISA-covered plans and IRAs.[75] We believe that, in addition to including participants in ERISA-covered plans and IRAs, the definition should include participants in certain non-ERISA plans as well. For this reason, we recommend that the SEC clarify that the definition of "retail investor," for purposes of Regulation Best Interest and Form CRS, includes a natural person who is: (A) a participant or a beneficiary of (1) a qualified plan as defined in Section 3(a)(12)(C) of the 1934 Act, (2) a plan that meets the requirements of Section 403(b) or Section 457 of the Internal Revenue Code, or (3) an "employee pension benefit plan" as defined in Section 3(2)(A) of ERISA (collectively, "retirement plans"), or (B) an owner of an IRA.[76] These retirement plan participants and beneficiaries, and IRA owners, would meet the definition of a "retail investor" for purposes of Regulation Best Interest only to the extent that a broker-dealer makes: (A) a

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[73] *See* FINRA Rule 2210(a)(6) (defining "retail investor"). Most broker-dealers have extensive processes, workflows, and systems designed to address requirements applicable to retail investors, under FINRA rules, while differentiating the treatment of "institutional investors" (as defined in FINRA Rule 2210(a)(4)), including certain natural persons with total assets of at least $50 million.

[74] An investment adviser would be required to deliver Form CRS to a retail investor before or at the time the firm enters into an investment advisory agreement with the retail investor. A broker-dealer would be required to deliver Form CRS to a retail investor before or at the time the retail investor first engages the firm's services. A dual registrant would be required to deliver Form CRS to a retail investor at the earlier of entering into an investment advisory agreement with the retail investor or the retail investor engaging the firm's services.

[75] Best Interest Proposal at 21598.

[76] A "retail investor" should not, in any event, include retirement plans, their sponsors or trustees, or plan fiduciaries.

recommendation of a securities transaction or investment strategy involving securities directly to the participant, beneficiary, or IRA owner with respect to securities held or to be held for such natural person's benefit by the retirement plan account or IRA and under the investment control of the participant, beneficiary, or IRA owner, or (B) a recommendation directly to the participant, beneficiary, or IRA owner as to how securities held by the plan or IRA should be invested after the securities are rolled over, transferred, or distributed from the retirement plan or IRA. A natural person would not meet the definition of "retail investor" solely because he or she is a participant or beneficiary of a retirement plan, or an owner of an IRA, for which a broker or dealer acts as a trustee or fiduciary.

Treating natural persons that are retirement plan participants, beneficiaries, or IRA owners, as "retail investors" for purposes of Regulation Best Interest is critical to achieving one of the key benefits of the SEC's best interest rulemaking—providing consistent protections to retail brokerage customers. The SEC's adoption of a strong best interest standard for broker-dealers that applies to investors in both retail and retirement accounts will provide the necessary basis for the DOL to adopt a new, streamlined prohibited transaction exemption for financial professionals that are subject to an SEC-governed standard of conduct. This result would benefit retail investors because it would subject broker-dealers to a consistent SEC-governed standard of conduct when they provide recommendations to retail investors, whether those investors are saving for retirement or other goals.

We also recommend that the SEC make explicit in the definition of "retail investor" that a "legal representative" of a natural person means an executor, conservator, or a person holding a durable power of attorney for a natural person but does not include a bank, trust company, savings and loan association, credit union, broker-dealer, investment adviser, or other financial institution or regulated intermediary. It is unnecessary to subject recommendations that a broker-dealer makes to regulated intermediaries to the Best Interest Obligation, or for such intermediaries to receive a Form CRS, as they are subject to direct legal obligations regarding their activities, and exercise independent judgment in evaluating a recommendation.[77] The SEC has provided similar clarification in other contexts. For example, it provided an exemption from the definition of "municipal advisor" where an independent registered municipal advisor represents a municipal entity, and in the context of establishing special requirements for security-based swap dealers and major security-based swap participants acting as counterparties to special entities.

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[77] *Cf.* Rule 15Ba-1(d)(3)(vi) under the 1934 Act; Rule 15Fh-5 under the 1934 Act. Moreover, in various circumstances, the staff of the SEC's Division of Investment Management has not applied certain provisions of the Advisers Act to advisers when dealing with other investment advisers or financial intermediaries like banks that are subject to fiduciary or other suitability obligations. *See, e.g.*, *BNY ConvergEx Group, LLC*, SEC No-Action Letter (Sept. 21, 2010); *Morgan, Lewis & Bockius LLP*, SEC No-Action Letter (Apr. 16, 1997); *Copeland Financial Services, Inc.*, SEC No-Action Letter (Sept. 21, 1992); *Kempner Capital Management, Inc.*, SEC No-Action Letter (Dec. 7, 1987).

Finally, we recommend that the definition of "retail investor" not include trusts, their trustees, beneficiaries, or grantors. We acknowledge that the SEC's proposed definition of "retail investor" for purposes of Form CRS would include "a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust"[78] and that the SEC interprets the proposed definition of "retail customer" for purposes of Regulation Best Interest to include trusts that represent the assets of a natural person, if the recommendation is primarily for personal, family, or household purposes.[79] We believe, however, that not including trusts in our recommended definition of "retail investor" is more consistent with the Commission's focus on natural persons. This approach also is consistent with the Commission's approach to defining the term "consumer" under SEC Regulation S-P, which provides that "[a]n individual is not your consumer solely because he or she has designated you as trustee for a trust [or] because he or she is a beneficiary of a trust for which you are a trustee."[80]

At most, if the Commission believes that the definition of "retail investor" should include certain natural persons in the trust context, it should take the view that a natural person who is a trustee, beneficiary, or a grantor of a revocable trust, should be treated as a "retail investor" for purposes of Regulation Best Interest and Form CRS only to the extent that: (i) the trust is for the benefit of one or more natural persons; and (ii) such natural person trustee, beneficiary, or grantor of a revocable trust, is authorized to direct securities transactions on behalf of the trust. A natural person trustee should not be treated as a "retail investor" for purposes of Regulation Best Interest or Form CRS if the person is serving as trustee solely in his or her capacity as a representative of a financial institution or other regulated intermediary. Treating natural person trustees, beneficiaries, and grantors in this manner would be consistent with the Commission's intent because it would ensure that those individuals who have authority to direct the investment of the trust's assets receive the protections of Regulation Best Interest and Form CRS.[81]

C. Clarify Disclosure Delivery Obligations for Funds

First, we recommend that the SEC clarify that, where an investor sends a fund firm a "check and application" that designates an intermediary of record, the designated intermediary would retain all delivery obligations for Form CRS and Regulation Best Interest disclosure. A fund should have no obligation in this situation to notify the intermediary or deliver Form CRS or Regulation Best Interest disclosure to the investor.

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[78] *See* proposed Rule 204-5(d)(2) under the Advisers Act and proposed Rule 17a-4(e)(2) under the 1934 Act.

[79] Best Interest Proposal at 21596, 21597.

[80] SEC Regulation S-P, 17 C.F.R. § 248.3(g)(1).

[81] *Cf. Money Market Reform; Amendments to Form PF*, 79 Fed. Reg. 47736, 47798 (Aug. 14, 2014) (treatment of trusts for purposes of retail money market fund definition under Rule 2a-7 under the 1940 Act).

Second, we recommend that the SEC clarify that the Form CRS delivery requirements would not apply to a fund's limited-purpose broker-dealer. Some fund complexes have a limited-purpose broker-dealer that provides discrete administrative services to fund shareholder accounts. The limited-purpose broker-dealer does not provide investment recommendations, and its function does not lend itself to regulatory requirements designed for full-service broker-dealers.

Form CRS could be construed, however, as requiring the fund's limited-purpose broker-dealer to deliver the form to an investor in certain circumstances. For example, when a fund transfer agent receives an investor's new account application (*i.e.*, "check and application") that does not designate an intermediary of record, the transfer agent may list or otherwise associate the fund's limited-purpose broker-dealer as the "default" broker-dealer for the account. The fund's limited-purpose broker-dealer also may be designated on a customer's account when an outside broker-dealer has resigned as broker-dealer of record for that account.[82]

In either of these instances, a fund's limited-purpose broker-dealer is similar to an execution-only broker-dealer in that it is not providing a recommendation to the investor and therefore would fall outside of the scope of Regulation Best Interest.[83] It is unnecessary for the fund's limited-purpose broker-dealer to deliver Form CRS in this circumstance because it is acting solely in an administrative capacity. Delivery of Form CRS in these circumstances is likely to create investor confusion. We also note that the investor already receives information on fund fees in the prospectus that is delivered at the time of the investor's initial purchase of fund shares and then typically annually thereafter. We therefore recommend that the SEC clarify that a fund's limited-purpose broker-dealer is not subject to Form CRS delivery obligations.

V. Investment Adviser Fiduciary Duty

We appreciate the SEC's intent in the Adviser Interpretation Proposal to reaffirm and clarify its views of the fiduciary duty that investment advisers owe to their clients. We agree that there are benefits to having a clear statement regarding the fiduciary duty that applies to an investment adviser, and the obligations flowing from that duty that are enforceable under Section 206(1) and (2) of the Advisers

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[82] Funds that rely on intermediaries for distribution may designate their limited-purpose broker-dealer on shareholder accounts for administrative or system-related purposes. Account holders are often encouraged, through separate mailings, messages on account statements, and electronic communications, to seek a new financial representative.

[83] The SEC asks whether it should exclude execution-only broker-dealers from the requirement to deliver Form CRS because they do not provide investment advice to their customers. Disclosure Proposal at 21455. Our request to exclude limited-purpose broker-dealers is analogous.

Act.[84] Before adopting any final interpretation, however, we urge the SEC to revise the interpretation so that it is more consistent with common law principles that historically have governed interpretation of an adviser's fiduciary duty and the contours of an investment adviser's obligations under Section 206(1) and (2). We discuss our specific suggestions below.

A. <u>SEC Should Clarify the Scope and Applicability of an Adviser's Fiduciary Duty</u>

We recommend that, in any final Adviser Interpretation, the SEC more clearly recognize that, under common law, the specific obligations that flow from an adviser's fiduciary duty depend on the scope of the relationship to which the adviser and client have agreed. The SEC acknowledges that, "[a]lthough the ability to tailor the terms means that the application of the fiduciary duty will vary with the terms of the relationship, the relationship in all cases remains that of a fiduciary to a client."[85] At other points in the Proposal, however, the SEC makes broad statements about an adviser's fiduciary duty that we believe do not accurately reflect that fiduciary obligations stemming from the duties of loyalty and care vary depending on the scope of the relationship, as agreed to with the client.[86]

The Adviser Interpretation Proposal also raises a related issue in that it appears to apply to both retail and institutional advisory relationships. The examples in the Proposal, however, focus on—and appear to derive their rationale from—retail client relationships. While we agree that many of the obligations the SEC discusses may apply to institutional client relationships, not all are relevant, and some obligations would apply in a different manner. We therefore recommend that the SEC acknowledge that how an adviser's fiduciary duty obligations apply in institutional relationships may differ. We

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[84] Courts have interpreted Section 206(1) and (2) based on common law fraud principles that have evolved over time. *See SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 191 (1963). Congress added Section 206(4) to the Advisers Act in 1960 to address the limitations of Section 206(1) and (2), including the SEC's lack of express rulemaking authority. *See* Act of Sept. 13, 1960, Pub. L. No. 86-750, 74 Stat. 885 at § 9 (codified as amended at 15 U.S.C. §§ 80b-2–80b-6, 80b-8–80b-12, 80b-17); H.R. Rep. No. 2179, 86th Cong., 2d Sess., at 7-8 (1960) ("Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud."); S.Rep. No. 1760, 86th Cong., 2d Sess. (1960) ("In order to overcome this difficulty, section 9 of the bill would amend [15 U.S.C. § 80b-6] to add a prohibition against engaging in conduct which is fraudulent, deceptive or manipulative and to authorize the Commission by rules and regulations to define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."). The SEC has adopted numerous antifraud rules under this authority (Rules 206(4)-1 through 206(4)-8 under the Advisers Act).

[85] Adviser Interpretation Proposal at 21205.

[86] *See* Restatement (Third) of Agency § 8.01 cmt. c ("Fiduciary obligation, although a general concept, is not monolithic in its operation. In particular, an agent's fiduciary duties to the principal vary depending on the parties' agreement and the scope of the parties' relationship."); *see also* Restatement (Third) of Agency § 8.08 cmt. b ("A contract may also, in appropriate circumstances, raise or lower the standard of performance expected of an agent …").

further recommend that the SEC ensure any final interpretation appropriately reflects such differences, including in any examples it provides. We describe, below, aspects of the Proposal that require clarification:

- Updated investment profile: The SEC explains that, to satisfy the duty of care, an investment adviser must make a reasonable inquiry into the client's investment profile and update it as necessary to reflect any changes in circumstances. While an adviser to an institutional client, such as a subadviser to a fund, has a duty of care to that client, the concept of a periodically updated "investment profile" may not apply in that context. Rather, a subadviser to a fund would provide advice based on the terms of the subadvisory agreement and the fund's investment objectives.

- Duty to provide advice and monitoring over the course of the relationship: The SEC asserts that an adviser's duty of care also includes the duty to provide advice and monitoring over the course of a relationship with a client. The SEC states that the monitoring duty "extends to all personalized advice [the adviser] provides the client, including an evaluation of whether a client's account or program type . . . continues to be in the client's best interest."[87] While, at one point in the Proposal, the SEC acknowledges that the extent of an adviser's advice and monitoring obligations depend on the services to which the adviser and the client agree, the discussion otherwise suggests that a monitoring obligation exists generally.[88] Given the variety of advisory relationships and models that exist, including institutional mandates that may be more limited or specific, we believe this is an overly broad statement of law. The SEC therefore should explicitly acknowledge in any final Adviser Interpretation that the extent of an adviser's advice and any duty to monitor are established by agreement between the adviser and the client.

B. Disclosure and Consent under the Advisers Act

The Commission states that an investment adviser must seek to avoid conflicts of interest with its clients and, at a minimum, make full and fair disclosure to clients of all material conflicts of interest that could affect the advisory relationship.[89] The Commission explains that "an adviser must provide the

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[87] Adviser Interpretation Proposal at 21208.

[88] *Id.* at 21207-08 ("An investment adviser's duty of care also encompasses the duty to provide advice and monitoring over the course of a relationship with a client. . . . the steps needed to fulfill this duty may be relatively circumscribed for the adviser and client that have agreed to a relationship of limited duration via contract . . . An adviser's duty to monitor extends to all personalized advice it provides the client, including an evaluation of whether a client's account or program type . . . continues to be in the client's best interest.) (internal citations omitted).

[89] Adviser Interpretation Proposal at 21208, citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

client with sufficiently specific facts so that the client is able to understand the adviser's conflicts of interest and business practices well enough to make an informed decision."[90]

While we agree with this principle in concept, we do not necessarily agree with the Commission's broad statement that "an adviser disclosing that it 'may' have a conflict is not adequate disclosure when the conflict actually exists." As courts have recognized, the appropriateness of "may" based disclosure depends on the facts and circumstances.[91] We agree that it would not be appropriate to use "may" to describe a material conflict that *always* exists. Yet, such disclosure can be an appropriate and effective means to communicate a conflict, given the varying and conditional nature of an investment adviser's practices, related conflicts of interest, and, critically, the materiality of those conflicts of interest when considering the surrounding circumstances. As such, where a practice that gives rise to a conflict of interest is conditional and not absolute, or the materiality is conditional and not absolute, the use of the word "may" is both accurate and appropriate. Moreover, courts have soundly rejected differences between "will" and "may" in the disclosure context as "semantic quibbling" and not material omissions in and of themselves.[92]

The SEC explains that a client's informed consent to an adviser's disclosure may be explicit or implicit, depending on the facts and circumstances. The Commission asserts, however, that, "it would not be consistent with an adviser's fiduciary duty to infer or accept client consent to a conflict where either (i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict, or (ii) the material facts concerning the conflict could not be fully and fairly disclosed."[93] The Commission explains that:

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[90] Adviser Interpretation Proposal at 21209.

[91] *Mendell v. Greenberg,* 927 F.2d 667, 679 (2d Cir. 1990) (even where the disclosure at issue used the word "may" instead of "will," "a reasonable investor would still have been on notice that additional [financial] incentives were most likely and should have been anticipated."); *Hoffman v. UBS-AG*, 591 F. Supp. 2d 522, 534 (S.D.N.Y. 2008) ("Defendants' prospectuses were not misleading or incomplete to the extent that they disclosed the possibility of entering into a shelf-space arrangement. . . . The language used in Defendants' prospectuses gave investors adequate notice of the possibility of shelf-space agreements, arrangements about which investors could have inquired if they felt that such agreements would compromise the service that they were receiving."). The use of "may" should not be deemed a material omission in and of itself. *See Benzon v. Morgan Stanley Distributors, Inc.*, 420 F.3d 598, 612 (6th Cir. 2005); *Lubbers v. Flagstar Bancorp Inc.*, 162 F. Supp.3d 571, 581 (E.D. Mich. 2016); *In re AIG Advisor Group Sec. Litig.*, No. 06 CV 1625 (JG), 2007 WL 1213395 at *8 & n.15 (E.D.N.Y. April 25, 2007); *In re RAC Mortgage Investment Corp. Sec. Litig.*, 765 F. Supp. 860, 864 (D. Md. 1991).

[92] See *Benzon v. Morgan Stanley Distributors, Inc.*, 420 F.3d 598, 612 (6th Cir. 2005); *Lubbers v. Flagstar Bancorp Inc.,* 162 F. Supp.3d 571, 581 (E.D. Mich. 2016); *In re AIG Advisor Group Sec. Litig.*, No. 06 CV 1625 (JG), 2007 WL 1213395 at *8 & n.15 (E.D.N.Y. April 25, 2007); *In re RAC Mortgage Investment Corp. Sec. Litig.*, 765 F. Supp. 860, 864 (D. Md. 1991).

[93] Adviser Interpretation Proposal at 21209.

> . . . in some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflict necessary to obtain informed consent and satisfy an adviser's fiduciary duty. In other cases, disclosure may not be specific enough for clients to understand whether and how the conflict will affect the advice they receive.

At another point in the proposal, the SEC asserts that "[d]isclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act."[94] These statements could suggest or be misconstrued to suggest that disclosure and informed consent are insufficient as a matter of law to satisfy an adviser's fiduciary duty of loyalty. We urge the Commission to confirm that full and fair disclosure of material conflicts and informed consent—which may be implicit or explicit, depending on the facts and circumstances—is the existing standard under common law and the Advisers Act.[95]

We appreciate that if particular disclosure, based on the facts and circumstances, is not *adequate* to convey the nature or extent of the adviser's conflict (including for the reasons the Commission provides as examples), the adviser likely would not have a basis on which to obtain informed consent from the client. In those situations, an adviser may decide to improve its disclosure so that it can obtain informed client consent or, alternatively, may choose instead to mitigate or eliminate the conflict.

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[94] *Id.* at 21208.

[95] *See SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180 (1963). The SEC's instructions to Form ADV Part II instruct an adviser completing the registration form that:

> Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them. To satisfy this obligation, you therefore may have to disclose to clients information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require. You may disclose this additional information to clients in your brochure or by some other means.

See also Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987) ("The type of disclosure required by an investment adviser who has a potential conflict of interest with a client will depend upon all the facts and circumstances. As a general matter, an adviser must disclose to clients all material facts regarding the potential conflict of interest so that the client can make an informed decision as to whether to enter into or continue an advisory relationship with the adviser or whether to take some action to protect himself against the specific conflict of interest involved.").

However, we believe it is not an accurate statement of law that "[i]n all of these cases where full and fair disclosure and informed consent is *insufficient* . . . an adviser [should] eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed."[96] Rather, consistent with common law principles and the Advisers Act, the focus in assessing the basis for a client's informed consent should be on whether the adviser's disclosure is *adequate*. Of course, an investment adviser must separately satisfy its duty of care to the client, including providing advice that is suitable for the client in accordance with the agreement between the investment adviser and the client.

C. The SEC Should Not Incorporate a "Best Interest" Standard into the Duty of Care

In a departure from the existing suitability standard under the Advisers Act, the SEC has incorporated a "best interest" standard into an investment adviser's duty of care.[97] To avoid confusion and unintended consequences, we urge the SEC to adhere in any final interpretation to the existing standard.

The SEC states that an adviser has "a duty to provide personalized advice that is suitable for and *in the best interest of* the client based on the client's investment profile."[98] The SEC explains that:

> We believe [an adviser's suitability] obligation, when combined with an adviser's fiduciary duty to act in the best interest of its client, requires an adviser to provide investment advice that is suitable for *and in the best interest of* its client.[99]

It is unclear what this standard means under the Advisers Act. The term "best interest" is not defined, for purposes of the Advisers Act, and has not, to date, been part of the articulation of an adviser's duty of care.[100] Furthermore, it is unclear how this "best interest" standard would relate to the best interest

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[96] Adviser Interpretation Proposal at 21209 (emphasis added).

[97] The SEC has stated previously that, as part of its fiduciary duty of care, an adviser has a duty to provide suitable advice to its clients. *See Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients,* 59 Fed. Reg. 13464 (March 22, 1994) (proposed rule); *see also In re George Sein Lin,* Investment Advisers Act Release No. 1174 (June 19, 1989); *In re Westmark Financial Services, et al.,* Investment Advisers Act Release No. 1117 (May 16, 1988).

[98] Adviser Interpretation Proposal at 21206 (emphasis added).

[99] *Id.* at n.26.

[100] The SEC has referenced only "best interest" with regard to an adviser's duty of loyalty. *See* Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) ("To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own."). If the SEC wishes to change the standard for an adviser's fiduciary duty of care, it would need to do so through a proposed rulemaking under Section 206(4) of the Advisers Act.

standard under proposed Regulation Best Interest, especially for investment advisers that are also registered as broker-dealers. We urge the SEC to omit references to "best interest" in describing an adviser's duty of care to avoid the ambiguity and unintended consequences that would otherwise result.

D. The SEC Should Not Propose Broker-Dealer Rules for Advisers

The SEC requests comment on incorporating certain broker-dealer obligations into the investment adviser regulatory framework: (i) licensing and continuing education requirements for personnel of SEC-registered investment advisers; (ii) delivery of account statements to clients with investment advisory accounts; and (iii) financial responsibility requirements for SEC-registered investment advisers, including fidelity bonds. The Commission believes that these are areas where the broker-dealer regulatory framework may provide investor protections that may not have counterparts in the investment adviser context. We understand that the Commission may issue proposed rules on these potential enhancements in the future.

We recommend that the SEC not pursue these areas of potential rulemaking for investment advisers. As described below, the SEC has neither articulated adequately why these potential changes would be beneficial, nor has it addressed key concerns and questions they raise.

1. The SEC Has Not Explained the Necessity of Federal Licensing and Continuing Education Requirements for Advisers

The SEC explains that the Financial Industry Regulatory Authority (FINRA) imposes registration obligations and qualification requirements on associated persons of broker-dealers, including a qualification exam and continuing education requirements. The SEC requests comment on whether personnel of SEC-registered advisers similarly should be subject to federal licensing and continuing education requirements. The SEC provides insufficient detail about how this concept would apply to advisers and their personnel.

Before the Commission explores further imposing registration, qualification, and continuing education requirements on investment adviser representatives, it should first explain why such requirements are necessary in light of current regulation under state law, what such new requirements would consist of, and how they would be administered and by whom. Also, because of the costs (to both firms and the Commission) of imposing such requirements, the Commission should determine before issuing any such proposal that any benefits it expects to flow from a new far-reaching regulatory regime for investment adviser representatives will, in fact, exceed its costs, and that such a regime is necessary to protect investors. We highlight several of these issues below.

FINRA, as the SRO for broker-dealers, has delegated authority under the 1934 Act for the registration and regulation of broker-dealers under FINRA's rules, and qualification of broker-dealer's associated

persons. Unless a waiver applies, FINRA requires all associated persons of FINRA's members (*i.e.,* all federally-registered broker-dealers) to pass a qualification examination relevant to the associated person's business. Currently, FINRA offers close to 40 different types of qualification examinations.[101] FINRA also imposes on its members' associated persons a continuing education requirement, which it revises from time to time as necessary to keep pace with changes in the industry.

Investment adviser representatives[102] also are subject to qualification and other regulatory requirements, but under state law.[103] Most states regulate investment adviser representatives and require their registration.[104] Regardless of the state, state registration as an investment adviser representative typically consists of filing a standardized Form U-4, Uniform Application for Securities Industry Registration, with the state through the Investment Adviser Registration Depository, and passing a qualification exam. In the late 1990s, the North American Securities Administrators Association (NASAA) developed a Uniform Investment Adviser Law Exam, the Series 65 exam, as the required qualification examination.[105] States began to require this examination unless an applicant could document competency through some other means.[106]

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[101] A list of these examinations is available on FINRA's website at: http://www.finra.org/industry/qualification-exams.

[102] Rule 203A-3(a)(1) under the Advisers Act defines the term "investment adviser representative" to mean, in relevant part, "only those supervised persons of a federally-registered investment adviser who are natural persons and with whom the investment adviser representatives has more than five clients who are natural persons." This rule also excludes from the definition of "supervised person" any representative who does not, on a regular basis, solicit, meet with, or otherwise communicate with clients of the investment adviser." Pursuant to these provisions, only those representatives of federally-registered advisers with a place of business in a state who have more than 5 natural person clients with whom they engage in business are subject to a state's registration requirements.

[103] There is no SRO for investment advisers. The National Securities Markets Improvement Act of 1996 (NSMIA), however, preserved the states' authority to regulate and require the registration of certain representatives of federally-registered advisers. In particular, Section 203A(b)(1)(A) of the Advisers Act preserved the states' authority to "license or register or otherwise qualify any [representative of a federally-registered investment adviser] who has a place of business in that state."

[104] Aside from most states registering investment adviser representatives, states generally prohibit investment adviser representatives from engaging in any unlawful or fraudulent practices or in any prohibited business practices as defined by state law.

[105] NASAA also developed a Series 66 examination, which was required of those persons who would be dually registered as an investment adviser representation and a broker-dealer representative. The Series 66 was required in addition to any examination FINRA required for the applicant to conduct business on behalf of a broker-dealer. The Series 65 and 66 examinations are administered through FINRA's testing centers on behalf of the states.

[106] States typically waive the examination requirement for persons holding a professional designation such as CFP, ChFC, CFA, CIC, or PFS. *See, e.g.,* Florida Rule 600.0024(d).

With respect to continuing education requirements imposed on investment adviser representatives, NASAA recently has announced that it is:

> . . . consulting with external stakeholders and conducting a nationwide survey to collect input and views on a potential continuing education requirement for investment adviser representatives. NASAA and its members are in the early phases of this initiative and are conducting this stakeholder survey to determine the next phase.[107]

Accordingly, as the Commission considers whether to pursue imposing licensing or continuing education requirements on representatives of SEC-registered advisers, we strongly recommend that it consider the regulatory requirements that already are in place under state law. The Commission should also be cognizant that the infrastructure to implement a new registration and examination regime for investment adviser representatives does not exist at the federal level. Creating such an infrastructure would raise a host of issues (including resource issues) that are beyond the scope of the Commission's current request for comment.

2. Fund Investors Already Receive Quarterly Account Statements

The SEC explains that broker-dealers generally must provide account statements to clients at least once every calendar quarter. While proposed Form CRS would provide some information to investors about the key categories of fees and expenses they should expect to pay, it would not require detailed or personalized disclosure about fees and expenses. The Commission requests comment on whether registered investment advisers should be required to provide investors with account statements to allow them to easily see and understand the fees and expenses they pay for the adviser's services. The SEC provides little detail regarding the potential content or frequency of such account statements.

Fund investors in investment advisory accounts receive at least quarterly account statements regarding their fund shares from either the broker-dealer, bank or transfer agent holding the fund shares.[108] Requiring advisers to separately provide quarterly account statements therefore would be duplicative and could lead to potential client confusion. Moreover, the purchase or sale of fund shares is generally executed through a broker-dealer or bank (typically the client's custodian), and these broker-dealers and banks must provide investors with confirmation statements.

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[107] *See* NASAA's website (http://www.nasaa.org/44344/nasaa-2018-investment-adviser-representative-continuing-education-iar-ce-survey/).

[108] *See* NASD Rule 2340.

In addition, investment advisers are themselves required to ensure their clients receive account statements in at least two instances. As the SEC notes, investment advisers to separately managed account programs relying on the 1940 Act safe harbor from being deemed investment companies must ensure each client receives a quarterly account statement containing a description of all activity in the client's account, as a condition of reliance on the safe harbor.[109] Further, as the SEC acknowledges, investment advisers with custody of client assets must have a reasonable basis to believe the "qualified custodian" that holds the assets sends an account statement to the investor at least quarterly.[110] Indeed, under the Advisers Act "custody rule," the SEC requires that, if an investment adviser separately sends statements to its clients, it must urge clients to compare the statements the adviser distributes to the statements the client receives from its qualified custodian.[111] Thus, at least in this instance, the SEC has implied that the client's custodial statements are the truest statement of a client's account.

Given the statements, confirmations, and reports that fund investors already receive or have access to, requiring advisers to send an additional account statement containing largely duplicative information would impose substantial and unnecessary burdens on advisers. In addition, from an investor experience perspective, receipt of an additional statement regarding the investor's account could create confusion regarding which statement is the true record of his or her fund holdings.

3. *Financial Responsibility Requirements Are Unnecessary for Fund Advisers*

The SEC explains that broker-dealers are subject to strict requirements regarding minimum capital and segregation of client assets under the 1934 Act. These and other broker-dealer obligations are intended to ensure that customer assets are protected and available in the event the firm fails. The SEC requests comment on whether registered investment advisers should be subject to financial responsibility requirements similar to those that apply to broker-dealers.[112] While the SEC does not provide much detail regarding how a financial responsibility requirement might apply to advisers,[113] we share, below, some general observations as to why financial responsibility requirements are unnecessary for fund advisers, given existing legal requirements.

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[109] *See* Rule 3a-4 under the 1940 Act.

[110] *See* Rule 206(4)-2(a)(3) under the Advisers Act.

[111] *See* Rule 206(4)-2(a)(2) under the Advisers Act; Item 15 of Form ADV.

[112] The Commission acknowledges that, under the Advisers Act custody rule, registered investment advisers are subject to conditions intended to protect client assets, including the requirement to maintain client assets with a "qualified custodian" and the requirement for advisers that have custody to undergo a surprise audit at least annually. *See* Rule 206(4)-2 under the Advisers Act.

[113] The request for comment asks about net capital requirements, fidelity bonds, reserve capital, minimum net worth requirements, and audited financial statements.

Custody of Assets. Most importantly, fund advisers must maintain fund portfolio assets in a custody arrangement meeting the requirements of Section 17(f) of the 1940 Act and related rules.[114]

Management and Board Oversight. A fund's investment adviser, acting as agent, manages the fund's portfolio pursuant to a written contract with the fund that is subject to oversight and annual approval by the fund's board of directors, including a majority of independent directors.[115] The adviser manages the fund in accordance with the fund's investment objectives and policies as described in its registration statement. Boards of funds, the majority of which consist of independent directors or trustees, regularly monitor the performance and activities of the fund's adviser.[116] If the fund's directors determine, in their business judgment, that the adviser does not have the financial capacity to continue to manage the fund, they may terminate the adviser's advisory contract and, with shareholder approval, contract with another, financially viable, adviser to manage the fund. Under these circumstances, due to the strict custodial and other protections under the 1940 Act and the Advisers Act, there would be no financial risk posed to the fund, the portfolio assets of which would remain protected at an eligible custodian. Further, it is important to note that an adviser does not take on the fund's investment risks.[117]

In addition, fund advisers are subject to stringent regulatory requirements under the 1940 Act and the Advisers Act, which further protect fund assets and fund investors.

Fidelity Bonding. Funds are subject to fidelity bonding requirements under the 1940 Act. The contract under which the custodian provides services to the fund limits the purposes for which money may be disbursed by the custodian.[118] Any officer or employee that has the authority to direct the disbursement of the fund's assets is required to be bonded by a fidelity insurance company against

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[114] Nearly all funds use a US bank custodian for domestic securities, although the rules under the 1940 Act permit other limited custodial arrangements. *See, e.g.,* Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self-custody subject to strict conditions); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories).

[115] *See* Section 15(c) of the 1940 Act.

[116] Independent directors make up three-quarters of boards in 84 percent of fund complexes. *See* ICI Independent Directors Council, *Overview of Fund Governance Practices, 1994–2016* (October 2017), *available at* https://www.idc.org/pdf/pub_17_fund_governance.pdf.

[117] In particular, the adviser does not own fund assets, and it may not use fund assets to benefit itself or any other client. Investment gains and losses from a fund are solely attributable to that fund, and do not flow through to the adviser.

[118] For example, the contract typically will provide for payment of fund assets against receipt of portfolio securities purchased (*i.e.*, delivery versus payment), payment of fund expenses for services received, and payment of redemption proceeds for shares redeemed. Payment of fund assets for these purposes must be approved by officers or employees of the adviser specifically named in the custodial contract to approve disbursement of money.

larceny and embezzlement.[119]

Prohibited Transactions. The 1940 Act broadly prohibits transactions between a fund and its affiliated persons, including its adviser, which would generally preclude purchases and sales of securities and other property between a fund and its adviser,[120] and the adviser borrowing money from, or loaning money to, the fund.[121] The 1940 Act also prohibits joint transactions, in which the fund and the affiliate are acting together in any transaction that is "joint" in nature.[122]

Audited Financial Statements. Funds are required, under the 1940 Act, to deliver annual reports to shareholders containing financial statements that are prepared in accordance with Generally Accepted Accounting Principles (GAAP) and audited by an independent public accountant.[123] That independent public accountant must be registered with the Public Company Accounting Oversight Board. Among other things, the audit provides assurance that the fund's assets exist, that the fund has clear title to the assets, that the assets are valued consistent with GAAP, and that the NAV per share is properly stated.[124]

Controls Over Financial Reporting. Funds also are subject to requirements under the 1940 Act regarding internal controls over their financial reporting[125] and certification of the accuracy of the fund's financial statements and internal controls quarterly as required by the Sarbanes-Oxley Act of 2002 and SEC rules.[126]

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[119] *See* Section 17(g) of the 1940 Act and Rule 17g-1 thereunder. Such fidelity bonds must be approved annually by the fund's board of directors, including a majority of the independent directors.

[120] *See* Section 17(a)(1) and (2) of the 1940 Act.

[121] *See* Section 17(a)(3) and (4) of the 1940 Act.

[122] *See* Section 17(d) of the 1940 Act. Requirements with respect to compliance programs provide a further layer of protection against misappropriation of client assets. *See* Rule 38a-1 under the 1940 Act and Rule 206(4)-7 under the Advisers Act.

[123] *See* Rule 30e-1 under the 1940 Act, Item 27(b) of Form N-1A, and Item 24(4) of Form N-2.

[124] The SEC also requires the delivery of semi-annual reports to shareholders containing unaudited financial statements. *See* Rule 30e-1 under the 1940 Act, Item 27(c) of Form N-1A, and Item 24(5) of Form N-2. These annual and semi-annual reports, which include a schedule of the fund's investments, financial statements, and other information, must be transmitted to shareholders and filed with the SEC not more than 60 days after period end. *See* Rules 30e-1 and 30b2-1 under the 1940 Act.

[125] *See* Rule 30a-3 under the 1940 Act. Funds must file annually with the SEC a report prepared by the registered fund's independent public accountant on the fund's system of internal accounting controls. *See* Item 77B of SEC Form N-SAR.

[126] *See* Rule 30a-2 under the 1940 Act, SEC Form N-CSR, and SEC Form N-Q.

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We hope that our comments are helpful to the Commission and staff as they further refine their approach to standards of conduct for broker-dealers and advisers. We would be glad to answer any questions or provide further assistance. Please feel free to contact me at [redacted], Susan Olson at ([redacted], or Sarah Bessin at [redacted].

Sincerely,

Paul Schott Stevens
President and CEO
Investment Company Institute

cc: The Honorable Jay Clayton
The Honorable Kara M. Stein
The Honorable Robert J. Jackson, Jr.
The Honorable Hester M. Peirce
Dalia O. Blass, Director, Division of Investment Management
Brett Redfearn, Director, Division of Trading and Markets
Securities and Exchange Commission

The Honorable Preston Rutledge, Assistant Secretary of Labor
Timothy D. Hauser, Deputy Assistant Secretary for Program Operations
Joe Canary, Director, Office of Regulations and Interpretations
Employee Benefits Security Administration
Department of Labor

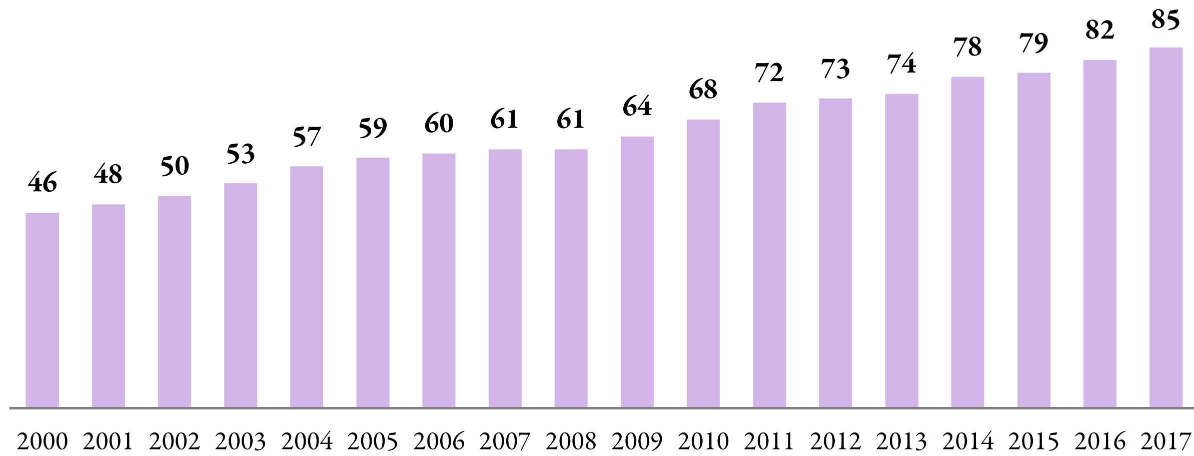
Appendix A

Figure A1
Total Net Assets of Long-Term Mutual Funds Are Concentrated in No-Load Share Classes
Percentage of long-term mutual fund total net assets, 2007–2017

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Load	**31**	**30**	**28**	**26**	**24**	**23**	**21**	**20**	**19**	**17**	**15**
Front-end[1]	25	24	22	21	20	18	17	16	15	14	13
Back-end[2]	2	2	1	1	1	(*)	(*)	(*)	(*)	(*)	(*)
Level[3]	4	4	4	4	4	4	4	4	3	3	2
Other[4]	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)
Unclassified[5]	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)
No-load[6]	**51**	**53**	**54**	**56**	**58**	**60**	**62**	**64**	**65**	**67**	**70**
Retail	35	34	34	34	33	33	34	35	36	36	36
Institutional	17	19	20	22	25	27	28	28	29	31	34
Variable annuities	**15**	**15**	**15**	**14**	**14**	**13**	**13**	**13**	**12**	**12**	**11**
"R" share classes[7]	**2**	**3**	**3**	**3**	**3**	**3**	**4**	**4**	**4**	**4**	**4**
Memo:											
Long-term mutual fund total net assets (billions of dollars)	**$8,914**	**$5,788**	**$7,797**	**$9,030**	**$8,942**	**$10,361**	**$12,331**	**$13,149**	**$12,897**	**$13,616**	**$15,899**

[1] Front-end load > 1 percent. Primarily includes Class A shares; includes sales where front-end loads are waived.
[2] Front-end load = 0 percent and contingent deferred sales load (CDSL) > 2 percent. Primarily includes Class B shares.
[3] Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and Rule 12b-1 fee > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.
[4] This category contains all other load share classes not classified as front-end load, back-end load, or level load.
[5] This category contains load share classes with missing load fee data.
[6] Front-end load = 0 percent, CDSL = 0 percent, and Rule 12b-1 fee ≤ 0.25 percent.
[7] "R" shares include assets in any share class that ICI designates as a "retirement share class." These share classes are sold predominantly to employer-sponsored retirement plans. However, other share classes—including retail and institutional share classes—also contain investments made through 401(k) plans or IRAs.
(*) = data round to 0
Note: Components may not add to 100 percent because of rounding. Data exclude mutual funds that invest primarily in other mutual funds.
Sources: Investment Company Institute, Lipper, and Morningstar

Figure A2
The Majority of Long-Term Mutual Fund Gross Sales Went to No-Load Mutual Funds Without Rule 12b-1 Fees[1]
Percentage of long-term mutual fund gross sales,[2] 2000–2017

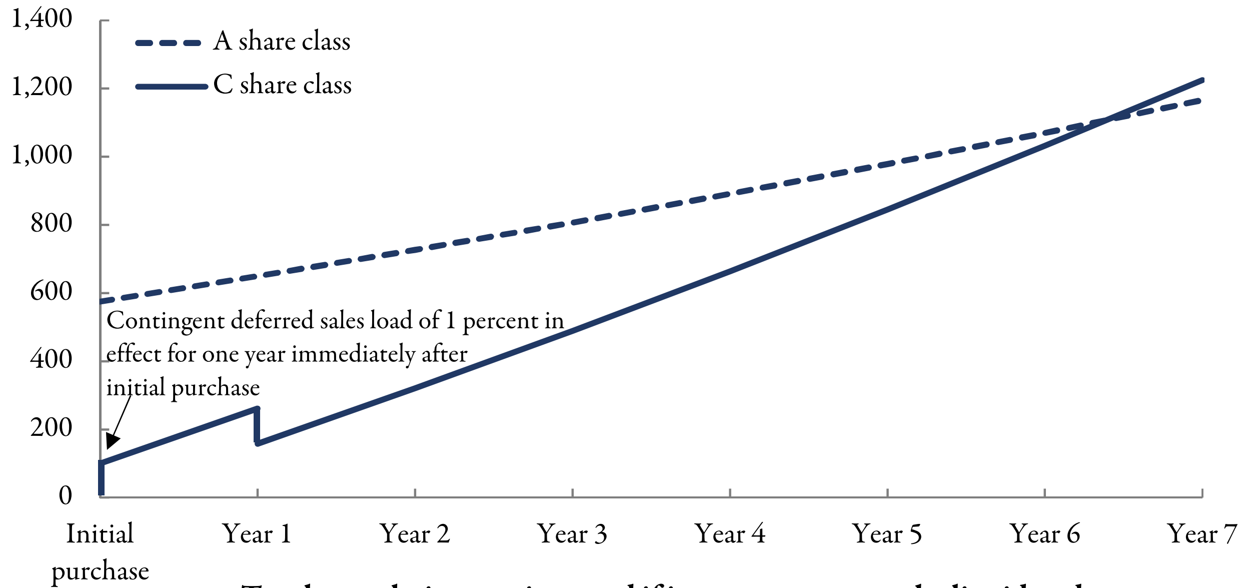


[1] Rule 12b-1 fee = 0.
[2] Long-term mutual fund data exclude mutual funds available as investment choices in variable annuities, mutual funds that ICI designates as "retirement share classes," and mutual funds that invest primarily in other mutual funds.
Sources: Investment Company Institute, Lipper, and Morningstar

Appendix B

For Some Holding Periods, C Share Classes Can Be Less Costly Despite Having Typically Higher Expense Ratios

Total expenses paid in dollars



Note: Data are tabulated using a generic open-end mutual fund with A and C share classes. The A share class has a total expense ratio of 0.75 percent (which includes a 0.25 percent Rule 12b-1 fee) with a 5.75 percent maximum front-end load, and the C share class has an expense ratio of 1.50 percent (which includes a 1 percent Rule 12b-1 fee) and a contingent deferred sales load of 1 percent for one year. Calculations assume an initial investment of $10,000, a 5 percent annual return, and that share classes are not purchased through a platform that waives front-end loads, contingent deferred sales loads, and/or Rule 12b-1 fees.

Sources: Investment Company Institute