August 8, 2018

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

VIA ELECTRONIC MAIL
rule-comments@sec.gov

Subject: Proposed Rule: Regulation Best Interest; File Number S7-07-18

Dear Mr. Fields:

The Coalition of Mutual Fund Investors ("CMFI")[1] appreciates the opportunity to submit comments on Regulation Best Interest, the rule proposal by the Securities and Exchange Commission ("SEC") to improve the standard of conduct for broker-dealers when making a recommendation of any transaction or investment strategy involving securities to a retail customer.[2]

The SEC is to be commended for its overall goal of improving the standard of conduct for broker-dealers from the existing suitability standard. However, the Commission's proposal—outlined in more than 1,000 pages of regulatory verbiage—is only going to confuse further the average individual investor, especially regarding their choices between a broker-dealer and a registered investment adviser. And the proposed "best interest" standard of conduct for broker-dealers is not rigorous enough to protect individual investors who are seeking investment advice.

For some reason, the SEC avoided the simplest answer to this problem, which is to use more fully the excellent regulatory framework of the Investment Advisers Act of 1940 ("Advisers Act").

The Investment Advisers Act

The Advisers Act defines an "investment adviser" as:

[1] The Coalition of Mutual Fund Investors ("CMFI") is an Internet-based shareholder advocacy organization established to represent the interests of individual mutual fund investors. More information about CMFI can be obtained at www.investorscoalition.com.

[2] Regulation Best Interest, 83 Fed. Reg. 21,574 (May 9, 2018) (hereinafter "Regulation Best Interest"). *See also* Form CRS Relationship Summary, 83 Fed. Reg. 21,416 (May 9, 2018); and Proposed Commission Interpretation Regarding Standards of Conduct for Investment Advisers, 83 Fed. Reg. 21,203 (May 9, 2018).

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> [A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[3]

Under the Advisers Act, a registered investment adviser has a fiduciary responsibility to his or her clients. This fiduciary standard is based on equitable common law principles and it applies to the entire client relationship. The fiduciary standard includes an "affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his [or her] clients.'"[4]

This fiduciary standard also includes the duties of loyalty and care. The duty of loyalty requires an investment adviser to serve the best interests of its clients and not subordinate the client's interests to his or her interests.[5] The duty of care includes a requirement that the adviser "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information." [6]

<u>The Broker-Dealer Exclusion to the Advisers Act</u>

The Advisers Act expressly excludes from the definition of investment adviser any broker-dealer: (1) whose performance of its investment advisory services is "solely incidental" to the conduct of its business as a broker or a dealer; and (2) who receives no "special compensation" for its investment advisory services.[7] Both of these elements must be satisfied by a broker-dealer relying on this exclusion.

The 1940 House and Senate Committee Reports to the Advisers Act explained that the definition of investment adviser was "so defined as specifically to exclude ... brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions)."[8]

Even though the business model of the typical broker-dealer primarily involves transaction-based compensation structures, the SEC in 2005 adopted a final rule under the

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[3] 15 U.S.C. § 80b-2(11).

[4] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). *See also Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17 (1979) ("[T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

[5] *See, e.g.*, Proxy Voting by Investment Advisers, 68 Fed. Reg. 6,585 (Feb. 7, 2003).

[6] *See, e.g.*, Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982, at 43,012 (July 22, 2010).

[7] 15 U.S.C. § 80b-2(11)(C).

[8] S. Rep. No. 76-1775, at 22 (1940); and H.R. Rep. No. 76-2639, at 28 (1940).

Advisers Act to permit broker-dealers to offer "fee-based brokerage accounts" and maintain an exemption from the fiduciary requirements of the Advisers Act.[9]

The Financial Planning Association challenged this final rule and, in 2007, the D.C. Circuit Court of Appeals vacated the SEC's rule on the grounds that the Commission did not have the authority to exclude broker-dealers offering fee-based brokerage accounts from the definition of "investment adviser" in the Advisers Act.[10]

A Simple Solution When Providing Personalized Investment Advice About Securities

If the SEC wants to provide appropriate investor protections to retail investors, it should follow the requirements of the Investment Advisers Act and subject broker-dealers to the Advisers Act when they are providing personalized investment advice about securities on an ongoing basis. Broker-dealers providing these services on an ongoing basis should not be able to continue to rely on the broker-dealer exclusion to the Advisers Act.

The term "solely incidental" should be interpreted narrowly and only include personalized investment advice that is one-time, temporary, or limited in time or scope. One example could be a one-time recommendation involving the rollover of a retirement plan account into a brokerage account. Another example could be to provide personalized investment advice involving only a very small percentage of the total brokerage transactions executed each calendar year. These types of interactions could be considered "solely incidental" under the Advisers Act.

The term "special compensation" should include all asset-based compensation and third-party fees from mutual funds and their advisers. These fees are distinguishable from transaction-based compensation structures, such as sales loads and commissions, or mark-ups or mark-downs, for individual transactions.[11]

The SEC's proposed rule will permit broker-dealers to continue to provide personalized investment advice about securities on an ongoing basis without registering as investment advisers and assuming the fiduciary obligations that follow under the Advisers Act. Allowing this overlap in advisory services is going to be even more confusing to investors, especially when the SEC also proposes to require broker-dealers to adopt a "best interest" standard that is only defined vaguely in the proposed rule.

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[9] Certain Broker-Dealers Deemed Not To Be Investment Advisers, 70 Fed. Reg. 20,424 (Apr. 19, 2005).
[10] *Financial Planning Association v. SEC*, 482 F.3d 481, 488 ("By seeking to exempt broker-dealers beyond those who receive only brokerage commissions for investment advice, the SEC has promulgated a final rule that is in direct conflict with both the statutory text and the Committee Reports."). *See also* Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers, at footnote 56, January 2011.
[11] These asset-based and third-party fees should include 12b-1 fees, sub-accounting fees, and revenue-sharing payments.

The SEC's best interest standard, as proposed, is one in name only, as it can be complied with under almost any set of circumstances, including where significant conflicts of interest exist and where third-party fees are being paid to broker-dealers for the express purpose of creating financial incentives to sell certain products to individual investors.

The most significant of these loopholes can be found in proposed Rule 240.15l-1(a)(2)(ii)(A), where the broker-dealer best interest standard can be satisfied if the broker-dealer (1) understands the risks and rewards associated with a particular investment recommendation; and (2) has a "reasonable basis to believe that the recommendation could be in the best interest of *at least some retail customers*." (emphasis added).[12] This standard of conduct stands in stark contrast to the fiduciary obligations of a registered investment adviser, which require the duties of loyalty and care to each individual client and apply to the entire advisory relationship.

Conclusion

Instead of relying on more investor disclosures and a modestly enhanced standard of conduct for broker-dealers, the SEC should utilize the Advisers Act framework and require all broker-dealers to register as investment advisers if they: (1) provide personalized investment advice about securities to retail investors on an ongoing basis; or (2) receive asset-based compensation or third-party fees from mutual funds and/or their advisers. Approaching this problem based on *function*, instead of current business models, is going to be the only effective way to improve the current system and provide the level of protection that individual investors deserve.

Please feel free to contact me with any questions, or if you need additional information about CMFI's views on this rulemaking. My direct dial is [redacted], and my email address is [redacted].

Sincerely,

Niels Holch
Executive Director
Coalition of Mutual Fund Investors

cc: The Honorable Jay Clayton
The Honorable Kara M. Stein
The Honorable Robert J. Jackson, Jr.
The Honorable Hester M. Peirce

[12] *Regulation Best Interest* at 21,575.

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