MEMORANDUM

To: File Nos. S7-07-18, S7-08-18, S7-09-18

From: Eric Diamond, Senior Advisor to Chairman Jay Clayton

Re: Standards of Conduct for Investment Professionals

Date: August 7, 2018

On June 19, 2018, Chairman Jay Clayton and Lucas Moskowitz (Chief of Staff to Chairman Clayton) met with the following representatives of The Institute for the Fiduciary Standard:

- Knut A. Rostad, Institute for the Fiduciary Standard (President and Founder)
- John C. Bogle, Founder and Retired CEO of The Vanguard Group (Member of The Institute's Board of Advisors) (by phone)
- Tamar Frankel, Professor of Law at Boston University (Member of The Institute's Board of Advisors)
- Phyllis Borzi, Former Assistant Secretary for Employee Benefits Security at U.S. Department of Labor (Member of The Institute's Board of Advisors)
- Michael Zeuner, Managing Partner at WE Family Office (Member of The Institute's Board of Directors)
- James Patrick, Managing Director of Envestnet (Member of The Institute's Board of Directors)
- Bill Crager, President, Envestnet (Friend of the Institute)
- Brian Hamburger, Founder and Managing Member of the Hamburger Law Firm (Former General Counsel to the Best Practices Board)
- Paul Pagnato, Managing Director, Partner, and Founder of Pagnato-Karp (Member of The Institute's Board of Directors)
- Darren Fogarty, Master's Student at Duke University (Research Analyst, The Institute)

The meeting participants discussed, among other things, the SEC's proposed rules and interpretation relating to standards of conduct for investment professionals. The Institutes' representatives provided the attached documents.

INSTITUTE FOR
THE FIDUCIARY STANDARD

June 19th
100 F St NE, Washington, DC 20549

Securities & Exchange Commission Chairman Jay Clayton
Meeting with the Institute for the Fiduciary Standard

Knut A. Rostad, Institute for the Fiduciary Standard
President and Founder

John C. Bogle, Founder and Retired CEO of The Vanguard Group
Member of The Institute's Board of Advisors
(Will be joining by phone)

Tamar Frankel, Professor of Law at Boston University
Member of The Institute's Board of Advisors

Phyllis Borzi, Former Assistant Secretary for Employee Benefits Security at US DOL 2009-2017
Member of The Institute's Board of Advisors

Michael Zeuner, Managing Partner at WE Family Offices
Member of The Institute's Board of Directors

James Patrick, Managing Director of Envestnet
Member of The Institute's Board of Directors

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Research Analyst, the Institute

INSTITUTE FOR
THE FIDUCIARY STANDARD

June 19, 2018

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

Dear Chairman Clayton:

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

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

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

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

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

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

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

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

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

- Adopt the DOL Rule description of best interest:

  "Investment advice is in the ''Best Interest'' of the Retirement Investor when the Adviser and Financial Institution providing the advice act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party."

- This means, among other things, that the standard should not only be applied "at the time" of the recommendation, (perhaps just a few seconds). Further it means, the standard is not putting the interest of the retail customer *equivalent* to the interest of the broker, but *ahead* of the broker.

- This also means the standard is not directed to "at least some" retail customers or any unidentified "particular" retail customer

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

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

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

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

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

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

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

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

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

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

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

- Stop the worst conflicts. Eliminate egregious conflicts (sales contests, bonuses) that appear designed to impair objectivity and undermine investors' best interests.

- State material conflicts inherent harms. Start with the consensus in academic literature and on Main Street that material conflicts are inherently harmful to investors. The consequent urgency to avoid and eliminate conflicts if humanly possible is then made clear.

- State the burden to overcome conflicts and what "mitigation" means. Consistent with the inherent harms of material conflicts, state the need to overcome significant burdens to proceed with the transaction. Provide guidance on proactive disclosure, clear written informed client consent and determining fairness and reasonableness in concrete and practical terms.

- State personalized fees and expenses. Provide specific personalized fees and expenses that the broker and brokerage earns, and the customer pays, expressed in dollars, and % of AUM.

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

Sincerely,

Knut A. Rostad
Knut A. Rostad
President

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

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Comments To Chairman Jay Clayton

June 19, 2018

As a co-founder and managing partner of WE Family Offices, an independent registered investment adviser, and co-founder and board member of the Institute, thank you for meeting with us today. I am a practitioner and have worked in the securities industry since 1997, at both broker-dealers and investment advisers. I deeply understand the differences between the two business models.

I applaud the Commission for addressing retail investor confusion through the lens of different business models – broker dealers and advisers. Just as the Department of Labor's rule did, the act of proposing these rules raises awareness among the investing public that two business models and standards of conduct exist. This publicity and discussion is very beneficial.

As a registered adviser, I am pleased to see the Commission's proposal to reaffirm and clarify the fiduciary duty owed by investment advisors to their clients. Specifically, holding registered advisers to the original intent of the fiduciary duty with respect to avoiding conflicts, and not simply disclosing them, is a positive step for our industry and investors.

I also applaud the effort to raise the suitability standard that applies to broker-dealers in Regulation Best Interest. However, I do not believe the proposed best interest standard is functionally equivalent to a fiduciary standard. A closer parity would serve investors well and I hope some of the gaps between the two standards can be closed before final rules are issued; my colleagues at the Institute will provide specific suggestions before the comment period closes.

In my view, the most problematic area of the proposed rules is the Form CRS – Relationship Summary. Far from helping retail investors understand the differences between business models and then choose accordingly, the sample Form CRS in the proposed rule, blurs the distinctions and makes it appear that there are only subtle differences between advisers and broker-dealers. This is potentially misleading because the differences in alignment and motive are material: brokers agree to sell investment products on behalf of manufacturers; advisers act on behalf of their clients to buy investment products that are best for the client. This difference is profound, and when investors don't understand with crystal clarity that the person purporting to advise them is actually selling to them, bad outcomes happen.

In an advisory relationship there are only two parties – the investor and the adviser, and the adviser is bound to represent the investor's interests at all times. In a broker-dealer relationship there are three parties – the investor, the broker-dealer, and the product manufacturer whom the broker-dealer is representing. If retail investors understood this fundamental and profound difference, and if the Commission could facilitate this understanding through the creation of a Form CRS that emphasized the fundamental differences between the business models, retail investors would be well served. The Institute will also provide specific suggestions in this regard before the comment period closes.

Michael Zeuner
Managing Partner

Remarks by John C. Bogle, Founder, The Vanguard Group

For: Jay Clayton, Chairman U.S. S.E.C.

Date: June 19, 2018

I am pleased to say a few words about fiduciary duty in this meeting with the Chairman and leaders from the Institute for the Fiduciary Standard. My name is John ("Jack") Bogle. I founded the Vanguard mutual fund complex in 1974 and the first index mutual fund in 1975. Overseeing $5 trillion in assets, Vanguard is now the world's largest mutual fund manager, and index funds now drive the mutual fund industry, accounting for 43% of equity fund assets. Since 2008, investors had added $2.3 trillion to their equity index fund holdings and withdrawn $1.0 trillion from their holdings of actively managed equity funds.

I mention these massive numbers not to brag, but to make a point: Vanguard and indexing have grown because both were designed to serve investors, not fund managers, not fund distributors, and not stockbrokers. (We eliminated all sales commissions on our funds forty-plus years ago.) "Putting investors first" has been our mission from the beginning.

By way of full disclosure, I hold a strong belief that fund managers and marketers have a fiduciary duty to the investors who are their clients. So it won't surprise you to know that I applaud the principles that underlie the proposal "Best Interest" Regulation.

I've reviewed the proposal by you and your fellow commissioners and the SEC staff to harmonize the regulation of those different providers of financial services (stockbrokers and registered investment advisers) to retail investors:

- To eliminate investor confusion between the two positions.
- To substantially eliminate any mismatches between investor expectations and understanding on the one hand, and market and legal realities on the other.
- To require that investment professionals—whether advisors or brokers—follow standards of conduct that embody key fiduciary principles and not placing their interests ahead of the interests of their clients.

I salute you all for this astute statement of the need for strong and parallel regulation designed to serve investors.

I confess that I have not yet read in its entirety the Commission's 900-page memorandum describing how Regulation Best Interest will be implemented. But in my long experience as an entrepreneur and CEO, I have consistently said: "Ideas are a dime a dozen. Implementation is everything."

The implementation of the proposed regulation will face challenges from those with a vested interest in protecting their present business model. I urge the Commission to stand firm in developing regulations that eliminate or mitigate conflicts of interest wherever possible; rather than merely requiring disclosure of conflicts, brokers and advisers should provide a mandatory compliance from showing the professionals' income from all relevant sources. Investors don't need more fine print, they need hard data, and they need a fair shake.

Today we look at investment advisers and stockbrokers as different businesses. But it is no secret that they are becoming more alike as significant numbers of brokers have turned to the fee-based model over the commission-based model. I believe that trend will continue to grow, even accelerate—all the more reason to harmonize the regulation. The rise of the embryonic "Robo-advisers" will impact both brokers and advisers and the exchange-traded fund (ETF) is already embraced by elements of both camps. I'm confident that the implementation of Regulation Best Interest will not ignore these issues of tomorrow.

I applaud the Commission's attempt to ensure that the best interests of investors are not superseded by the interests of service marketers—it is the essence of fiduciary duty. The arc of fiduciary duty may be long, but it is bending in a direction that will serve the national interest and the interest of investors.

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Tamar Frankel
Professor of Law

June 22, 2018

Jay Clayton, Chairman
Offices of the Commissioners, United States Securities and Exchange Commission
100 F Street, NE, Room 10700
Washington, DC 20549

Dear Chairman Clayton:

Thank you so much for meeting with the Fiduciary Institute group and for agreeing to receive these additional written comments.

The assumption in regulating broker dealers is the recognition that most investors are not experts in securities trading and rely on brokers' advice which is, in fact, "sales talk." Sales talk is infested by conflicts. Currently, brokers' advice is legal conflicted advice.

However, one element, which investors are used to inquire and judge is the investors' cost of broker services. It is no surprise that traditionally this cost was expressed in a percentage of the traded securities prices-a full-time task, especially if the specific traded securities prices traded and timing is not clearly stated. Interestingly, when the DOL rule seemed to come closer large brokerage firms changed their information to investors from percentage to dollars. But about a week ago the Wall Street Journal noted that large brokerage firms are *considering* a move to disclosing investor cost by percentage.

Investors can compare prices and number of trading. Therefore, they can check the trading costs and ask questions to check for example "churning" of their accounts. These questions might lead to a habitual self-regulatory practice.

Another more difficult, but impo liant element in the brokers' issue is the fact that some, and it seems most, are not paid a salary. In the case of Vanguard, I understand they are. In the case of Wells Fargo bank it seems that they were fired if they failed to gain more clients (open "new accounts)." I do not suggest regulating this issue but noticing the brokers that are being paid are not as hard-pressed as those who are.

Third, it may be helpful to require brokerage firms to have supervisors over the brokers focusing on the type of "sales-advice" that the brokers are practicing. Compliance has become an acceptable legal requirement. If a legal requirement is not directly imposed an

institutional preventive requirement will be far harder to neglect. FINRA's rules are easier to enforce. In fact, a violation that ends in withdrawing the license to act as brokers and a brokerage firm might be effective and less costly to enforce than court cases.

Needless to say, I add my vote to my colleagues' presentations at the meeting.

Sincerely,

Tamar Frankel
Robert B. Kent Professor of Law
Boston University School of Law