Multiple Long-Term Catalysts for the SEC's Regulation Best Interest, Form CRS & Potential Investment Adviser Interpretations

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I. Scope of Outline

A. This outline reviews the long-running and continually evolving history over the appropriate standard of care for broker-dealers and investments advisers under the federal securities laws.

1. Following the SEC's report to Congress under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or "DFA") of its Study Regarding a Harmonized Standard of Care for Broker-Dealers and Investment Advisers in January 2012, the SEC published a Request for Data and Information (RFDI) in March 2013 that elicits input on the costs and burdens of several hypothetical approaches to harmonizing the standards of care governing broker-dealers and investment advisers.[1]

This outline segment provides context within which to evaluate the SEC's 2018 Best Interest Initiatives in in view of the many stages of the regulatory examination of broker-dealer and investment adviser standards of care.

B. Many catalysts for change have contributed to this latest regulatory development, including regulatory solutions galvanized by profound economic turmoil, and competing industry and regulatory initiatives

1. The outline segment reviews these agents for change that ultimately led to a congressionally mandated SEC study on a harmonized broker-dealer and investment adviser standard of care in the Dodd-Frank Act.

2. The outline segment also charts regulatory and industry positions, addresses various regulatory and legislative solutions that functioned as substantive preludes

[1] The RFI follows years of administrative rulemaking on this issue and litigation about it. *See*, Wilkerson*; The Status of Broker-Dealers Engaged in Investment Advisory Functions: Muddy Waters Slowly Clearing,* ALI-ABA Conference on Life Insurance Company Products: Current Securities and Tax Issues (2007) link.

to the Dodd-Frank Act ("DFA"), and provides a framework of statutory and regulatory background.

3. With these regulatory antecedents at hand, the scope of regulation over broker-dealers and investment advisers involved in their respective functions can be evaluated and prognosticated.

II. Chronological & Historic Developments Contributing to Change

A. Tully Report

1. On April 10, 1995, a broad-based Committee on Compensation Practices (formed at the request of SEC Chairman Arthur Levitt in response to concerns about actual and potential conflicts of interest in the retail brokerage industry) issued a report[2] that found that although the existing commission-based compensation system worked remarkably well for most investors, regrettably conflicts of interest persisted and were underscored by widely publicized incidents where brokerage-dealers and their representatives damaged the interests of their clients.

2. The Committee identified corrective "best practices" that focused on compensation policies designed to align the interest of three parties in the relationship (the client, the registered representative, and the broker-dealer) and encouraged long-term relationships among them, such as asset-management accounts, incentive compensation and wrap fees. Ultimately, the advent of asset-management arrangements contributed to a migration of traditional broker-dealer functions into overlapping investment advisory roles.

B. Rule 202(a)(11)-1 Saga

1. Under this 2005 rule, a broker-dealer providing advice that is solely incidental to its brokerage services was excluded from the Advisers Act even if it charged an asset-based or fixed fee rather than a commission, markup or mark-down, so long as it made certain disclosures about the nature of its services.

2. The rule provided guidance about when a broker-dealer is providing advice that is not solely incidental to the conduct of its business, and tried to provide a Solomon-like solution to evolving broker-dealer functions that increasingly bled into investment advisory activities following the Tully Report.

3. See Release No. IA-3110 (Nov. 19, 2010) at http://sec.gov/rules/proposed/2010/ia-3110.pdf

C. Financial Planning Association (FPA) Lawsuit on Rule 202(a)(11)-1

1. The FPA sued the SEC to overturn Rule 202(a)(11)-1, arguing that: Rule 202(a)(11)-1 was arbitrary and capricious; it created a legally unsupportable double standard among investment advisers and certain broker-dealers; and,

[2] *See* http://www.sec.gov/news/studies/bkrcomp.txt

involved an "improper re-write" of the Advisers Act, where the rule was tantamount to legislation which contradicts the text and purpose of the Act itself.

D. The U.S Court of Appeals for the DC Circuit issued a decision in 2007 rejecting the rule and explained that "in light of the context in which Congress drafted subsections (C) and (F), we conclude that, as indicated by the structure of §202(a)(11) and the problems Congress addressed in the IAA, as well as the other indicators of Congress' intent, under Chevron step one, the text of (C) and (F) is unambiguous, and that, therefore, the SEC has exceeded its authority in promulgating the final rule." *See Financial Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

E. RAND Report

1. A 2008 report commissioned by the SEC, compared how the different regulatory systems that apply to broker-dealers and investment advisers affect investors, and found that "over the past two decades, broker-dealers have begun to drift subtly into a domain of activities that (at least under the regulatory regime) have historically been the province of investment advisers." *See* Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, RAND Report: Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, 14 (Jan. 3, 2008) [RAND Report].

F. CFP Board of Standards Fiduciary Duty Initiatives

1. The Certified Financial Planner Board of Standards, Inc. (CFP Board) adopted updated Standards of Professional Conduct[3] establishing ethical practices for CFP professionals that become effective July 1, 2008 and clarified the scope of fiduciary duty standards for individuals holding the CFP designation.

2. The CFP Board believed that its revised requirements regarding the duty of care a certificant owed to clients were consistent with Rule 202(a) (11)-1 and other investment advisory requirements under the Advisers Act.

G. Financial Planning Coalition[4] (FPC)

1. Financial Planning Coalition supported the creation of a professional oversight board for financial planners and advisers that would establish baseline

[3] http://www.cfp.net/docs/for-cfp-pros---professional-standards-enforcement/2010standards.pdf?sfvrsn=2
[4] The Financial Planning Coalition is comprised of Certified Financial Planner Board of Standards (CFP Board), the Financial Planning Association® (FPA®), and the National Association of Personal Financial Advisors (NAPFA).

competency standards for financial planners and require adherence to a stringent fiduciary standard of care.

2. Recommended applying principles-based regulation to *individuals* providing comprehensive financial planning services or holding themselves out as financial planners, but not to the firms that employ them.

3. FPC Reaction[5] to Legislative Proposals

a) Concerned that that certain provisions of the Investor Protection Act may facilitate a watered down fiduciary duty standard.

Concerned that when describing standards of conduct, the phrase "when providing personalized investment advice" might be used to argue that "hat switching" by brokers is allowed. By "hat switching" FPC references the "common practice" where the same financial intermediary provides investment advice under a fiduciary duty and then executes the recommended transactions under a "lower" suitability obligation.

b) All investors receiving personalized investment advice should benefit from the protections of the Advisers Act fiduciary duty.

H. The "Madoff Opportunity"[6]-A Lightning Rod for Regulatory and Legislative Action.

1. Practitioners have observed that one of the collateral consequences of the Bernad Madoff scandal[7] "is a general recognition that the current bifurcated approach to regulating financial professionals who give investment advice—specifically, broker-dealers and investment advisers—may not be serving the best interests of investors."[8]

2. Commentators explain that although "both give investment advice to investors, broker-dealers and investment advisers remain subject to regulatory requirements that differ in many respects, are administered by different regulatory bodies, and may leave investor protection gaps (as well as create "regulatory arbitrage" opportunities)."[9]

3. The Madoff scandal's devastating effects "have clearly focused attention on the need for long-overdue reform of the regulation of investment professionals who

[5] http://www.fpanet.org/docs/assets/JointLetter102609-2.pdf
[6] *See* Lemke and Stone, The Madoff "Opportunity" Harmonizing the Overarching Standard of Care for Financial Professionals Who Give Investment Advice, 13 Wall Street Lawyer 6 (June 2009) at 1.
[7] On December 11, 2008, the Securities and Exchange Commission (SEC) charged Bernard L. Madoff (Madoff) with securities fraud for a multi-billion dollar Ponzi scheme that he perpetrated on advisory clients of his firm. The complaint charged Madoff with violations of the anti-fraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. In addition, the U.S. Attorney's Office in the Southern District of New York also indicted Madoff for criminal offenses on the same date. On March 12, 2009, Madoff pled guilty to all charges and on June 29, 2009, federal District Judge Denny Chin sentenced Madoff to serve 150 years in prison, which was the maximum sentence allowed.
[8] *Id.* at I
[9] *Id.* at 1

give advice, the broker-dealer and investment adviser industries, as well as SEC Chairman Mary Schapiro, FINRA CEO Richard Ketchum, and many others."[10]

I. The SEC's Financial Literacy Study[11]

1. Dodd-Frank Act Section 917(a)(1) directed the SEC to conduct a study to identify the existing level of financial literacy among investors, including subgroups of investors identified by the SEC.

2. Findings in SEC Financial Literacy Report (August 2012)

a) Retail investors lack basic financial literacy. Certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the average general population.;

b) Timing of Disclosure:

(1) *Generally, retail investors prefer to receive disclosures before making a decision on whether to engage a financial intermediary or purchase an investment product or service;*

c) Content of Disclosure:

(1) *Regarding financial intermediaries, investors consider information about fees, disciplinary history, investment strategy, conflicts of interest to be absolutely essential; and,*

(2) *Regarding investment product disclosures, investors favor summary documents containing key information about the investment product.*

d) Format of Disclosure:

(1) *Investor preferences are mixed with respect to the method of delivery. Some investors prefer to receive certain documents in hard-copy, while others favor online disclosure;*

(2) *Investors prefer that disclosures be written in clear, concise, understandable language, using bullet points, tables, charts, and/or graphs;*

(3) *Investors favor "layered" disclosure and, wherever possible, the use of a summary document containing key information about an investment product or service;*

[10] *Id* at 2.
[11] Staff of the Securities and Exchange Commission, Study Regarding Financial Literacy Among Investors (Pursuant to Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act), August 2012. http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf

(4) Useful, Understandable and Relevant Information Preferred

(a) Retail investors find the following information to be useful and relevant before engaging a financial intermediary:

(i) Fees/expenses/compensation;

(ii) Investment performance/track record;

(iii) Investment strategy;

(iv) Disciplinary history;

(v) The identity of the firm and the scope of services offered; and

(vi) Sources and amount of compensation to the financial intermediary.

(b) Retail investors find the following information to be useful and relevant before purchasing an investment product:

(i) Fees and expenses;

(ii) Investment performance;

(iii) Principal risks; and,

(iv) Investment objective.

(5) Methods to Increase the Transparency of Expenses

(a) Provide both a narrative explanation of fees and compensation and a fee table;

(b) Present the fee and compensation information in table format only, in table format with examples, in a bulleted format with examples, or in bulleted format only;

(c) Simplify the wording of the expense disclosure and make the expense disclosure briefer and less detailed;

(d) For trade confirmations, disclose the composition of a financial intermediary's total compensation, including types of compensation; and

(e) For a potential point-of-sale disclosure, explain how the financial intermediary is paid in connection with the client's account.

(6) Methods to Increase the Transparency of Conflicts of Interest

(a) Provide specific examples that demonstrate how a potential conflict of interest would operate in relation to the specific advice furnished to the client;

(b) Present the conflicts of interest disclosure in a bulleted format or in a summary table format;

(c) Make the conflicts of interest disclosure more specific, even if it results in a lengthier disclosure document;

(d) Make the conflicts of interest disclosure brief and more general, with more specific information available upon request;

(e) Disclose whether a financial intermediary (the individual representative)

(i) stands to profit if a client invests in certain types of products;

(ii) whether the financial intermediary would earn more for selling certain specific products instead of other comparable products; and,

(iii) whether the financial intermediary might benefit from selling financial products issued by an affiliated company.

(7) The Most Effective Existing Private and Public Efforts to Educate Investors.

(a) Based on the feedback of commenters, the staff identified the most effective existing public and private investor education efforts as including programs that are research-based, that are goal oriented and emphasize important investor education concepts, and that are easily accessible, delivered efficiently, and relevant to their target audience.

(8) Strategy to Increase the Financial Literacy of Investors--develop programs:

(a) Targeting specific groups including young investors, lump sum payout recipients, investment trustees, the military, underserved populations, and the elderly;

(b) Promoting the importance of checking the background of investment professionals;

(c) Promoting Investor.gov as the primary federal government resource for investing information; and

(d) Promoting awareness of the fees and costs of investing.

3. The SEC's Investor Advisory Committee

a) In 2009 the SEC established an Investor Advisory Committee[12], which was charged with developing analysis and recommendations about a harmonized standard of care for broker-dealers and investment advisers following the SEC's Study under Section 913 of the Dodd-Frank Act.

b) At a meeting in October 2013, the Advisory Committee considered significant recommendations for a broker-dealer Standard of Conduct.

III. Congressional Directive to Conduct a Study on a Harmonized Standard of Care

A. Section 913 of the Dodd-Frank Act required that the SEC, before engaging in any decision to advance rulemaking with respect to a new standard of care, conduct a Study to evaluate, among other things, the effectiveness of existing legal or regulatory standards of care for BDs, IAs and their associated persons providing personalized investment advice and recommendations about securities to retail customers imposed by the SEC and a national securities association, and other Federal and State legal or regulatory standards.

B. The Study specified fourteen separate required considerations to be addressed. Those required Study considerations include "the effectiveness of existing legal or regulatory standards" and "whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards," and even "the potential impact of eliminating the broker dealer exclusion from the definition of 'investment adviser' under section 202(a)(11)(C) of the Advisers Act.

C. Other required Study considerations include the SEC's review of:

1. The specific instances related to the provision of personalized investment advice about securities in which the regulation and oversight of investment advisers provide greater protection to retail customers than the regulation and oversight of broker dealers;

2. The potential impact on retail customers, including the potential impact on the range of products and services offered by broker dealers if the Advisers Act

[12] http://sec.gov/spotlight/investoradvisorycommittee.shtml

standard and/or other requirements are applied to broker dealers and their associated persons;

3. The varying level of services provided by brokers, dealers and investment advisers and their associated persons and the varying scope and terms of retail customer relationships among them;

4. The potential impact on retail customers that could result from changes in regulatory requirements or legal standards of care, including protection from fraud, access to investment advice, and recommendations about securities to retail customers, or the availability of such advice and recommendations;

5. The potential additional costs and expenses to retail customers regarding their investment decisions; and

6. The potential additional costs and expenses to brokers, dealers and investment advisers resulting from potential changes in the regulatory requirements or legal standards.

D. In sum, Section 913 required not only an investigation of whether a new or different standard of care will enhance investor protection, but also an evaluation of the potential consequences, intended and unintended, on retail customers, as well as the BDs and IAs who provide them with personalized investment advice about securities.

IV. SEC Report on a "Harmonized" Standard of Care

A. Request for Public Input

1. In fulfillment of Section 913 of the DFA, on July 27, 2010 the SEC invited comment[13] on a study to evaluate:

a) The effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and persons associated with them when providing personalized investment advice and recommendations about securities to retail investors; and,

b) Whether there are gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for these intermediaries.

2. The SEC was required to submit a study report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives no later than 6 months after the July 15, 2010 enactment of the Dodd-Frank Act.

B. Recommendations in the SEC Study Report

1. In January 2012, the SEC released its study on broker-dealers and investment advisers, as required by Section 913 of the Dodd-Frank Act. The study

[13] *See* Release No. IA-3058 (July 27, 2010) at http://www.sec.gov/rules/other/2010/34-62577.pdf

recommended that the SEC “adopt and implement, with appropriate guidance, the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers." According to the study, the standard should be "no less stringent than currently applied to investment advisers under [the] Advisers Act."

2. The study also recommended “that when broker-dealers and investment advisers are performing the same or substantially similar functions, the SEC should consider whether to harmonize the regulatory protections applicable to such functions. Such harmonization should take into account the best elements of each regime and provide meaningful investor protection." The study observed that the "staff's recommendations were guided by an effort to establish a uniform standard that provides for the integrity of personalized investment advice given to retail investors.

3. Consistent with Congress‘s grant of authority in Section 913, the study recommended the consideration of rulemakings that would uniformly apply a fiduciary standard no less stringent than currently applied to investment advisers under Advisers Act Sections 206 (1) and (2) to both broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.

4. The study addressed the following items, most of which comport with ACLI’s recommended position:

- **Standard of Conduct**. The study recommends a uniform fiduciary standard of conduct should provide that all brokers, dealers, and investment advisers shall act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice, when providing personalized investment advice about securities to retail customers. The report recommends that the SEC should engage in rulemaking or issue interpretive guidance addressing the components of the uniform fiduciary standard concerning the duties of loyalty and care. In doing so, the report advises that the SEC should identify specific examples of common conflicts of interest to provide a smooth transition to the new standard by broker-dealers as well as consistent interpretations by broker-dealers and investment advisers.

- **Duty of Loyalty**. A uniform standard of conduct will obligate both investment advisers and broker-dealers to eliminate or disclose conflicts of interest. The report recommends that the SEC should prohibit certain conflicts and require uniform, simple and clear disclosures to retail investors about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest.

- **Duty of Care**. The report recommends that the SEC should consider specifying uniform standards for the duty of care owed to retail investors, through rulemaking or interpretive guidance. According to the report, minimum baseline professionalism standards could include, for example,

specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor.

- **Personalized Investment Advice About Securities**. The report recommends that the SEC should engage in rulemaking or issue interpretive guidance to explain what it means to provide personalized investment advice about securities.

- **Principal Trading**. The report recommends that the SEC should address through interpretive guidance or rulemaking how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading.

- **Harmonization of Regulation**. The report observes that a harmonization of regulation, where harmonization adds meaningful investor protection, would offer several advantages, including providing retail investors the same or substantially similar protections when obtaining the same or substantially similar services from investment advisers and broker-dealers.

- **Costs of New Regulatory Compliance**. The report acknowledges that changes in legal or regulatory standards concerning personalized investment advice to retail investors could lead to increased costs for investors, investment advisers, broker-dealers, and their associated persons. The report considers a number of potential costs, expenses and impacts of various potential regulatory changes.

- **Broker-Dealer Exclusion from the Definition of Investment Adviser**. Section 913 of the Dodd-Frank Act required the SEC to consider the potential impact of (i) eliminating the broker-dealer exclusion from the definition of investment adviser in the Advisers Act; and (ii) applying the duty of care and other requirements of the Advisers Act to broker-dealers. The report indicates that these alternatives would not provide the SEC with a flexible, practical approach to addressing what standard should apply to broker-dealers and investment advisers when they are performing the same functions for retail investors.

- **Costs of New Regulatory Compliance**. The report acknowledges that changes in legal or regulatory standards concerning personalized investment advice to retail investors could lead to increased costs for investors, investment advisers, broker-dealers, and their associated persons. The report considers a number of potential costs, expenses and impacts of various potential regulatory changes.

C. Other Related Report from Federal Agency

1. In January 2011, the GAO issued its Report [14] to Congress under the Dodd-Frank Act concerning the consistency of Investment Adviser and Financial Planner Regulation under state and federal law. ACLI and company representatives met with a team of GAO representatives several times, explaining that investment

[14] http://www.gao.gov/new.items/d11235.pdf

advisers and financial planners were extensively regulated under state insurance and securities laws, and federal securities laws.

2. The GAO report concluded that relatively little needed revision under state and federal laws, and took note of the SEC's DFA Study on the IA-BD Standard of Care. The GAO report suggested that state insurance departments confirm that regulations are uniformly implemented across jurisdictions, and recommended state regulatory study of the extent to which consumers understood the different capacities under which insurance agents can operate when providing sales advice and investment advisory services.

3. In November 2011, the NAIC developed a charge to conduct a consumer survey to implement the GAO recommendations. Several of the questions were drawn from a similar survey conducted by the RAND Corporation for the SEC preliminary to its rule proposals on the intersection of broker-dealer and investment advisory activity [Rule 202(a)(11)-1]. ACLI helped frame the NAIC project in a constructive manner and explained the extensive, preexisting regulatory tools at insurance commissioners' disposal to address the investment advisory activities of insurance agents.

V. Summary of the SEC's 2013 Request for Data and Information (RFDI)

A. The RFDI[15] requests for information on the current market for investment advice to establish a baseline for consideration of regulatory changes, an outline of, and requests for comment on, possible regulatory approaches for a uniform fiduciary standard and alternatives, and requests for comment on other potential areas for regulatory harmonization for broker-dealers and investment advisers.

B. It is important to note that The Dodd-Frank Act does not require the SEC to engage in rulemaking on a harmonized standard of care, and the SEC has not formally indicated whether it intends to adopt rules, although the SEC has generally indicated that it intends at least to propose rules.

C. To establish a baseline for comparison, the RFDI seeks information about for any proposed regulatory changes, the SEC requested data and information regarding the current regulatory structure of broker-dealers and investment advisers. The SEC also

[15] http://www.sec.gov/rules/other/2013/34-69013.pdf

requested data and information comparing broker-dealer and investment adviser capacities regarding the following topics:

1. Characteristics and perceptions of retail customers who invest using firms in each capacity;

2. Types and availability of services provided to retail customers under each capacity;

3. The extent to which different rules apply to the same or similar activities and the impact on retail customers;

4. Types of securities offered or recommended, security selections, principal trading with retail customers, analysis of customer returns, and nature, magnitude, and disclosure of conflicts of interest;

5. Costs to firms and to customers associated with providing/receiving investment advice;

6. Ability of retail customers to bring claims against firms as well as the costs and results; differences in state laws contributing to differences in advice to customers; and

7. The extent to which retail customers are confused about the regulatory status of the two capacities.

D. The RFDI release described a series of non-exclusive assumptions about potential alternative approaches to establishing a uniform fiduciary standard of conduct for broker-dealers and investment advisers. Through this process, the SEC hopes to elicit feedback on the benefits and burdens of the various alternatives.

1. Assumptions about a Possible Uniform Fiduciary Standard

a) "Personalized investment advice about securities" would include a "recommendation" as interpreted under existing broker-dealer regulation and any actions or communications that would be considered investment advice about securities under the Advisers Act (generally not "impersonal investment advice" or general educational tools);

b) The term "retail customer" would have the same meaning as in the Dodd-Frank Act;

c) Any action would apply to all SEC-registered broker-dealers and SEC-registered investment advisers;

d) The uniform standard would accommodate different business models and fee structures (brokers could receive commissions, no asset-based fee requirement, principal trades allowed with disclosure);

e) The uniform standard would generally not require either broker-dealers or investment advisers to (i) have a continuing duty of care or loyalty after

providing advice about securities or (ii) provide services beyond those contractually agreed upon with the retail customer;

f) Offering or recommending only proprietary products or a limited range of products would not by itself constitute a violation of the fiduciary standard;

g) Advisers Act Sections 206(3) and 206(4) and related rules would continue to apply to investment advisers but not to broker-dealers; and

h) Existing law and guidance would continue to apply to broker-dealers.

2. While these assumptions provide guidance on possible future SEC rulemaking, the SEC repeatedly emphasized that these assumptions do not suggest the SEC's policy view or the ultimate direction of possible SEC action. The SEC also noted that commenters are free to provide information using alternatives or assumptions that are different from these assumptions.

E. Potential Uniform Fiduciary Standard

1. The RFDI release notes that the SEC's Report under Section 913 of the DFA on a harmonized standard of care contained recommendations that the SEC should adopt rules that provide for a uniform standard of conduct for all broker-dealers and investment advisers that provide advice about securities in the retail marketplace.

2. The SEC staff further recommended that these rules (or related interpretive guidance) should address the two key components of a uniform fiduciary standard: the duty of loyalty and the duty of care.

3. For purposes of considering these recommendations, the SEC is seeking information on the costs and benefits of implementing a uniform fiduciary standard that would include a duty of loyalty element and a duty of care element.

4. The SEC release states that commenters should assume that the SEC would provide detail or guidance that the duty of loyalty element would:

a) Require disclosure of all material conflicts of interest; require disclosure in a "general relationship guide" (similar to Form ADV Part 2A) to be delivered at the beginning of a retail customer relationship;

b) Require oral or written disclosure at the time advice is given of any material changes to existing conflicts of interest or new conflicts of interest;

c) Not require broker-dealers to conduct transaction-by transaction disclosure and consent for principal trading as required of investment advisers under Advisers Act Section 206(3); and,

d) Prohibit the receipt or payment of non-cash compensation in connection with the provision of personalized advice about the purchase of securities (no trips, prizes, sales contests).

5. In addition to the requirements of the duty of loyalty, the SEC stated that commenters should assume that the duty of care would impose certain minimum professional obligations upon broker-dealers and investment advisers.

6. The RDFI release advised commenters to assume that the duty of care would include:

a) Suitability requirements, including having a reasonable basis to believe that securities and investment strategy recommendations are suitable for (i) at least some customers and (ii) the specific customer to whom the recommendation was made;

b) Product-specific disclosure, due diligence, and suitability requirements for certain product recommendations, such as penny stocks, options, debt securities and bond funds, municipal securities, mutual fund share classes, hedge funds, and structured products;

c) A best execution duty; and,

d) A requirement that compensation must be fair and reasonable, taking into consideration all relevant circumstances.

VI. Summary of the SEC Chairman's 2017 Request for Information (CRFI) about a Standard of Conduct for Broker-Dealers and Investment Advisers

A. In June 2017, SEC Chair Jay Clayton published a request for information about standards governing broker-dealers and investment advisers, in light of the Department of Labor's conflict of interest rule ("fiduciary rule").

1. The request observed that the Department of Labor's Conflict of Interest Rule (i) may have significant effects on retail investors and entities regulated by the SEC, (ii) may have broader effects on U.S. capital markets, and (iii) invokes matters within the SEC's mission of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation.

2. The Chair's request noted that clarity, consistency and coordination among regulators are essential elements of effective oversight and regulation. The Chair's publication explained that "significant developments in the marketplace since the SEC last solicited information from the public in 2013 include financial innovations, changes to investment adviser and broker-dealer business models, and regulatory developments," such as the DOL's adoption of its fiduciary rule.

3. The informational request also observed that an updated assessment of the current regulatory framework, the current state of the market for retail investment advice, and market trends is important to the SEC's ability to evaluate the range

of potential regulatory actions. The Request elicited feedback on 50 short questions as a guide to the development of a uniform best interest standard.

B. ACLI's Securities Regulation Committee and Distribution Committee developed policy to guide ACLI's responsive submission on these matters, dated October 3, 2017.

1. In its letter, ACLI explained that life insurers agree with the Chairman's observation that the Department of Labor's Conflict of Interest Rule (i) may have significant effects on retail investors and entities regulated by the SEC, (ii) may have broader effects on U.S. capital markets, and (iii) invokes matters within the SEC's mission of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation.

2. ACLI supported the Chairman's statement that clarity, consistency and coordination among regulators are essential elements of effective oversight and regulation.

3. ACLI commended the mutual coordination expressed by SEC Chair Clayton and DOL Secretary Acosta to develop a best interest standard. ACLI encouraged the SEC's continued outreach to state regulators and the National Association of Insurance Commissioners (NAIC) as partners in the development of a best interest standard.

4. ACLI agreed that "significant developments in the marketplace since the SEC last solicited information from the public in 2013 include financial innovations, changes to investment adviser and broker-dealer business models, and regulatory developments," such as the DOL's adoption of its Conflict of Interest Rule (the "Fiduciary Rule" or the "Rule") in 2016.

5. ACLI concured with the CRFI that "an updated assessment of the current regulatory framework, the current state of the market for retail investment advice, and market trends is important to the SEC's ability to evaluate the range of potential regulatory actions." The SEC's regulatory framework assessment should include the comprehensive network of state insurance regulation.

C. ACLI's submission also noted:

1. To meet their financial and retirement security needs, retirement savers deserve standards ensuring continued access to a wide variety of retirement products, retirement savings information and related financial guidance from financial professionals acting in their best interest.

2. ACLI supports appropriately tailored uniform standards requiring all financial sales professionals to act in the best interest of their customers.

3. The SEC's depth and decades of experience concerning the regulation of investment advisers and broker-dealers provides an excellent foundation for developing a constructive best interest standard that can be uniformly applied across all regulatory platforms, including state insurance regulations. In this way

consumers will enjoy a consistent level of protection and will be able to obtain access to a wide range of retirement products and advice.

4. Regulatory circumstances have evolved since the adoption of the Fiduciary, with the SEC and state insurance regulators fully engaged in working toward a uniform "best interest" standard of care.

5. DOL's commendable proposal to postpone the effectiveness of the Fiduciary Rule for 18 months provides a significant opportunity for careful further input and analysis, and reconsideration of the Fiduciary Rule's approach. Joint collaborative efforts between the SEC, FINRA, DOL and state insurance regulators will generate a uniform best interest standard across all regulatory platforms that properly protects consumers while advancing financial and retirement security.

6. It is constructive to review existing regulatory systems, identify areas in need of improvement, and examine the economic impact of potential modifications. Conscientious evaluation of the many different business models operating in this space will contribute to efficient, effective regulation.

VII. 2018 SEC Best Interest Initiatives & Interpretations

A. The SEC's three related initiatives on Regulation Best Interest, Form CRS Relationship Summary, and Investment Adviser Standards of Conduct and Interpretations appeared in the Federal Register on May 9, 2018, and contained a comment deadline of August 7, 2018.

B. Statements of SEC Commissioners

1. SEC Chairman Clayton's Statement at the Open Meeting on Standards of Conduct for Investment Professionals

2. Commissioner Kara M. Stein's Statement on the Proposals, with specific additional questions for commenters

3. Commissioner Michael Piwowar's Statement on the Proposals

4. Commissioner Robert J. Jackson Jr.'s Statement on the Proposals

5. Commissioner Hester M. Peirce's Statement on the Proposals

6. SEC Press Release on the Commission Action Taken April 18, 2018

C. Overview of Proposed Regulation Best Interest

1. Proposed Reg. BI would establish a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. The proposed standard of conduct is to act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the

retail customer. This obligation shall be satisfied under Reg. BI if the broker-dealer or a natural person who is an associated person of a broker-dealer:

a) Before or at the time of such recommendation reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the recommendation;

b) In making the recommendation, exercises reasonable diligence, care, skill, and prudence;

c) Establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and,

d) 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.

D. ACLI Principles Measured Against the SEC's Initiatives

1. ACLI's Board developed seven core principles for guidance on regulatory developments involving a standard of care at DOL, SEC, NAIC and the states. The Board's principles were successfully reflected in the SEC's actions, and the SEC initiatives specifically referenced ACLI input in several significant instances.

2. A chart summarizes how the Board's seven principles were echoed in the SEC's initiatives

3. ACLI Policy Positions Before Regulators

a) SEC: ACLI has actively participated in a dialog with the Securities and Exchange Commission since 2007 about appropriate standards of conduct for broker-dealers and investment advisers including:

(1) ACLI's October 3, 2017 Submission in response to SEC Chairman's Request for Information on Standards of Conduct for Investment Advisers and Broker-Dealers;

1. ACLI's July 5, 2013 Submission in response to the SEC's Request for Data and Information on Brokers, Dealers and Investment Advisers;

2. ACLI's August 30, 2010 Submission in response to the SEC's request for information on its Study on the Responsibilities of Brokers, Dealers, and Investment Advisers in fulfillment of Section 913 of the Dodd-Frank Act; and

3. ACLI's December 13, 2007 Submission in response to the RAND Study on Broker-Dealer and Investment Advisory Issues.

b) DOL

(1) ACLI Written Submissions to DOL

(a) Comment Letter to DOL on Conflict of Interest Rule (7/21/15)

(b) Supplemental Letter on DOL Conflict of Interest Rule (9/24/15)

(2) ACLI Hearing Testimony on Fiduciary Rule

(a) Written Testimony on Conflict of Interest Rule

(b) Written Testimony about Cost Benefit Analysis of Rule

c) NAIC:

(1) ACLI Letter on Best Interest Standard of Care (1.23.18)

(2) ACLI Letter to Standard of Care Working Group (6.15.18)

VIII. The SEC's Position on Robo-Advisers [Investment Management Guidance Update No. 2017-02 Concerning Robo-Advisers][16] (February 23, 2017).

A. The SEC guidance highlights essential regulatory issues and disclosure for robo-advisers.

1. The SEC's 2017 advisory recognizes that there are many aspects about robo-advisory relationships and mechanics that are complex and need careful disclosure.

2. In interesting contrast, the Department of Labor's Fiduciary Rule suggested that robo-advisers minimize the need for complex advice.[17] It is challenging to reconcile that the Fiduciary Rule would have steered consumers to robo-advice that the SEC believes need extensive disclosure, while DOL concluded that disclosure is inadequate in governing conflicts and that consumers lack the basic financial literacy to comprehend complex transactions.[18]

B. The SEC's Advisory explains the Staff of the Division of Investment Management, in coordination with the Staff of the Office of Compliance Inspections and Examinations, has been monitoring and engaging with robo-advisers to evaluate how these advisers meet

[16] *See* https://www.sec.gov/investment/im-guidance-2017-02.pdf .
[17] *See* final Fiduciary Rule Regulatory Impact Analysis at 181.
[18] *See* final Fiduciary Rule Regulatory Impact Analysis at 109, 145, 187.

their obligations under the Investment Advisers Act of 1940 (the "Advisers Act"), given the unique challenges and opportunities presented by these programs.[19]

C. The guidance focuses on robo-advisers that provide services directly to clients over the internet. The SEC also noted that its guidance may also be helpful for other types of robo-advisers and other registered investment advisers.

D. The SEC's guidance focuses on three distinct areas and provides suggestions on how robo-advisers may address them.

1. **The Substance and Presentation of Disclosures to Clients about the Robo-Adviser and the Investment Advisory Services It Offers.**

a) The SEC explains that as a fiduciary, an investment adviser has a duty to make full and fair disclosure of all material facts to, and to employ reasonable care to avoid misleading clients, and advises.

b) The information provided must be sufficiently specific so that a client is able to understand the investment adviser's business practices and conflicts of interests.

c) The information must be presented in a manner that clients are likely to read (if in writing) and understand.

d) To address potential gaps in a client's understanding of how a robo-adviser provides its investment advice, the robo-adviser should disclose, in addition to other required information, information regarding its business practices and related risks.

e) The SEC highlighted risks inherent in the use of an algorithm to manage client accounts, including that among other things:

(1) Robo-advisers might halt trading or take other temporary defensive measures in stressed market conditions;

(2) Robo-advice might rebalance client accounts without regard to market conditions or on a more frequent basis than clients might expect; and,

(3) Changes to algorithmic code after inception of the relationship may materially affect customer portfolios.

[19] *See* https://www.sec.gov/investment/im-guidance-2017-02.pdf

2. **Suitability of Robo-Advice**.

a) The SEC's Guidance emphasizes that an investment adviser's fiduciary duty includes an obligation to act in the best interests of its clients and to provide only suitable investment advice.

b) The SEC's Guidance also explains that consistent with these obligations, an investment adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives.

(1) *See Status of Investment Advisory Programs under the Investment Company Act of 1940*, Investment Company Act Release No. 22579 (Mar. 24, 1997) at text accompanying n.32 ["Investment advisers under the Advisers Act owe their clients the duty to provide only suitable investment advice, whether the advice is provided to clients through an investment advisory program.

(2) To fulfill this suitability obligation, an investment adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives." ("Rule 3a-4 Adopting Release"), citing to *Suitability of Investment Advice Provided by Investment Advisers*, Advisers Act Release No. 1406 (Mar. 16, 1994) [proposing a rule under Section 206(4) of the Advisers Act that would expressly require advisers to give clients only suitable advice; the rule would have codified existing suitability obligations of advisers].

c) The SEC explains that robo-advisers need questionnaires eliciting sufficient information to allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that client based on their financial situation and investment objectives;

d) The SEC observed that some robo-adviser's questionnaires are not designed to provide a client with the opportunity to give additional information or context concerning the client's selected responses.

e) In addition, the SEC noted that robo-advisers may not be designed so that advisory personnel may ask follow-up or clarifying questions about a client's responses, address inconsistencies in client responses, or provide a client with help when filling out the questionnaire.

f) The SEC Guidance instructs that given this limited interaction, when considering whether its questionnaire is designed to elicit sufficient

information to support its suitability obligation, a robo-adviser may wish to consider factors such as:

(1) Whether the questions elicit sufficient information to allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that client based on his or her financial situation and investment objectives;

(2) Whether the questions in the questionnaire are sufficiently clear and/or whether the questionnaire is designed to provide additional clarification or examples to clients when necessary (e.g., through the use of design features, such as tool-tips or popup boxes); and

(3) Whether steps have been taken to address inconsistent client responses, such as: Incorporating into the questionnaire design features to alert a client when his or her responses appear internally inconsistent and suggest that the client may wish to reconsider such responses; or

(4) Implementing systems to automatically flag apparently inconsistent information provided by a client for review or follow-up by the robo-adviser;

3. **Compliance Practices for Robo-Advisers**

a) The Advisory recommends adoption and implementation of effective compliance programs that are reasonably designed to address issues uniquely germane to providing automated advice.

b) The Advisory notes that Rule 206(4)-7 under the Advisers Act requires each registered investment adviser to establish an internal compliance program that addresses the adviser's performance of its fiduciary and substantive obligations under that Act.

c) To comply with the rule, the SEC explains that a registered investment adviser must adopt, implement, and annually review written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and the rules thereunder, and that take into consideration the nature of the firm's operations and the risk exposures created by such operations.

d) In developing its compliance program, the SEC observes that a robo-adviser should be mindful of the unique aspects of its business model.

(1) For example, a robo-adviser's reliance on algorithms, the limited, if any, human interaction with clients, and the provision of advisory services over the internet may create or accentuate risk exposures for the robo-adviser that should be addressed through written policies and procedures.

(2) In addition to adopting and implementing written policies and procedures that address issues relevant to traditional investment advisers, robo-advisers should consider whether to adopt and implement written policies and procedures that address areas such as:

(a) The development, testing, and backtesting of the algorithmic code and the post implementation monitoring of its performance;

(b) The questionnaire eliciting sufficient information to allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that client based on his or her financial situation and investment objectives;

(c) The disclosure to clients of changes to the algorithmic code that may materially affect their portfolios;

(d) The appropriate oversight of any third party that develops, owns, or manages the algorithmic code or software modules utilized by the robo-adviser;

(e) The prevention and detection of, and response to, cybersecurity threats;

(f) The use of social and other forms of electronic media about the marketing of advisory services (e.g., websites; Twitter; compensation of bloggers to publicize services; "refer-a-friend" programs); and,

(g) The protection of client accounts and key advisory systems.

E. The SEC cautions that robo-advisers should consider whether the organization and operation of their programs raise any issues under the other federal securities laws, including the Investment Company Act of 1940 (the "Investment Company Act"), and in particular Rule 3a-4 under that Act.

1. To the extent that a robo-adviser believes that its organization and operation raise unique facts or circumstances not addressed by Rule 3a-4[20], the SEC suggests that such advisers may wish to consider contacting the Staff for further guidance.

[20] Rule 3 a-4 Provides a conditional, nonexclusive safe harbor from the definition of investment company for programs that provide discretionary investment advisory services to clients. *See* https://www.ecfr.gov/cgi-bin/text-idx?SID=b074cc7170d03485cbf86bcc934011b8&mc=true&node=se17.4.270_13a_64&rgn=div8