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By electronic mail to rule-comments@sec.gov

Brent J. Fields
Secretary
U.S. Securities Exchange Commission
100 F. Street NE
Washington, DC 20549-1090

Re: Supplemental Comment Letter to NASAA's 2018 Consolidated Comments to SEC Proposed Rulemakings: Regulation Best Interest (File No. S7-07-18), Form CRS Relationship Summary, Amendments to Form ADV, Required Disclosures, and Restrictions on the Use of Certain Names or Titles (File No. S7-08-18), and Standards of Conduct for Investment Advisers (File No. S7-09-18)

Dear Mr. Fields,

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am submitting the following supplemental comments to further expand on our letters of August 7 and 23, 2018, in response to the above-referenced proposals ("Proposed Reg BI").[2] This letter further expands on our suggestion that the Securities and Exchange Commission ("SEC" or the "Commission") reform its interpretive guidance of proposed rule 240.15*l*-1 to support a robust interpretation and implementation consistent with the rule's intended investor protection purpose; highlights practices by broker-dealers that we believe would be consistent with a best interest standard and those that would not; and urges the Commission to adopt a final rule accompanied by an adopting release that articulate meaningful disclosure, care, and conflict obligations. We also address the advocacy by industry groups in support of disclosure as sufficient mitigation for conflicts and other problematic practices and we urge the Commission to reject this approach. We close with a discussion of the investment adviser's fiduciary duty standard and how, despite public remarks by Commission officials, the standard should ensure that investors interests are put first.

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as a forum for these regulators to work with each other to protect investors at the grassroots level and promote fair and open capital markets.

[2] All references to the Comment Letters on Proposed Rules on Regulation Best Interest referenced in this supplemental comment letter refer to the above-referenced proposals.

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I. The Commission Should Revise the Interpretive Guidance Issued with the Proposed Reg BI Release to Champion (and Not Subvert) Investors' Best Interests

Industry groups have seized upon the SEC's emphasis to "preserve – to the extent possible – investor choice and access to existing products, services, service providers, and payment options" as an invitation to continue business as usual, subverting the Commission's goal of championing the best interests of retail clients. In their comment letters, associations representing companies that manufacture and sell products that pose perennial problems for retail investors lamented the sales decline attributed to the Department of Labor's rule ("DOL Rule") imposing a real fiduciary duty for retirement accounts. For instance, in its comment letter to the Commission the American Council of Life Insurers noted how "[v]ariable annuity sales declined 21 percent in 2016 (from $133 billion in 2015 to $104.7 billion)."[3] Similarly, sales of non-traded REITS also experienced significant declines, reportedly $9.6 billion (46.4%) between 2013 and 2015.[4] Organizational and offering expenses (as high as 15%) for these products also fell, reduced by more than half in some circumstances, as the market scrambled to discontinue or reform products the sales of which could not be justified under a rigorous fiduciary standard.

Fearing the adverse impact to the company bottom line, associations representing the financial services industry fought tooth and nail to overturn the DOL fiduciary duty rule. Fresh off their victory, many of the DOL Rule opponents have now submitted laudatory comments in response to Proposed Reg BI.[5] Given the significant resources expended by these groups in opposition to the Department of Labor's effort to address the abuses associated with conflicted advice, the Commission must ask why the sudden about face in light of the agency's efforts to address the very same practices targeted by the DOL Rule.

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[3] American Council of Life Insurers, Comment Letter on Proposed Rule on Regulation Best Interest (August 3, 2018) at 6, https://www.sec.gov/comments/s7-07-18/s70718-4173937-172339.pdf (hereafter "ACLI").

[4] Bruce Kelly, Are Nontraded REIT Sales Back From the Dead?, InvestmentNews (July 12, 2018, 4:37 PM), https://www.investmentnews.com/article/20180712/FREE/180719961/are-nontraded-reit-sales-back-from-the-dead.

[5] ACLI at 3 ("Reg BI is a largely sensible, principles-based rule governing broker-dealer conduct . . . [and] is vastly superior to the prescriptive, and now vacated DOL Fiduciary Rule and its BIC exemption"); State Farm Mutual Automobile Insurance Company, Comment Letter on Proposed Rule on Regulation Best Interest (August 6, 2018) at 2, https://www.sec.gov/comments/s7-09-18/s70918-4171029-172089.pdf (hereafter "State Farm") ("State Farm supports the Commission's principles-based approach to the standard of conduct, rather than mandating prescriptive requirements for broker-dealers when making recommendations to retail clients"); National Association of Insurance and Financial Advisors, Comment Letter on Proposed Rule on Regulation Best Interest (August 2, 2018) at 1, 14, https://www.sec.gov/comments/s7-07-18/s70718-4171820-172314.pdf (hereafter "NIAFA"); Insured Retirement Institute, Comment Letter on Proposed Rule on Regulation Best Interest (August 7, 2018) at 2, https://www.sec.gov/comments/s7-07-18/s70718-4185630-172656.pdf (hereafter "IRI"); Financial Services Institute, Comment Letter on Proposed Rule on Regulation Best Interest (August 7, 2018) at 2-3 https://www.sec.gov/comments/s7-07-18/s70718-4181966-172528.pdf (hereafter "FSI"); Institute for Portfolio Alternatives, Comment Letter on Proposed Rule on Regulation Best Interest (August 7, 2018) at 1-2, https://www.sec.gov/comments/s7-07-18/s70718-4184408-172586.pdf (hereafter "IPA").

The answer lies within the comment file itself. Quoting the Commission's Reg BI proposing release ("proposing release"), industry associations report they are "happy and pleased to see" their perceived ability to exploit harmful conflicts that the DOL Rule would have eliminated or constrained will not be curbed by the SEC's Proposed Reg BI. This is not an encouraging reaction to a rule designed to significantly reduce, if not outright eliminate, conflicted advice for retail investors.

While NASAA does have concerns with the guidance in the proposing release as noted in our earlier comment letter, we do not read proposed *rule* 15*l*-1 the way that DOL Rule opponents do. These groups point to the Commission's "interpretive nuances" as confirmation that pretty much anything and everything will be considered "acting in the client's best interest" – where disclosure occurs. To these industry groups, no abusive product or practice appears to be off limits. In the industry's view, not even conflict-ridden sales practices involving cash and non-cash prizes are being taken off the table as they conjure up carve-outs for "product-neutral" rewards (as if it matters which high-commission product a broker pulls off the shelf to meet a production target or qualify for some type of cash or noncash award).[6]

Should the Commission vote to adopt a final rule, the Commission must shift the focus from caveats to substance. The text of the rule can and should be interpreted by the Commission in the adopting release to require meaningful reform that benefits all investors. The Commission should not emphasize how industry can continue business as usual and yet comply with the rule. That is the wrong message to send if the goal here is to enact a standard that eliminates and mitigates conflicts such that investors get the maximum benefit of every dime they save and invest.

In NASAA's initial comment letter, we highlighted portions of the proposing release that we believed would be used by industry to continue harmful practices experienced under the existing suitability standard. Those beliefs were well-founded as industry comment letters attest.[7] As NASAA explained, the only way for the Commission to fix this problem is to strike

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[6] ACLI at 17 ("Reg. BI should not burden or preclude the operation of compensation arrangements and business models, including non-cash compensation arrangements, such as producer meetings that are educational or that reward production. Disclosure about compensation arrangements and structures is appropriate and superior to limiting different business models."); IRI at 11 ("[A]s long as they are not tied to the volume or amount of sales of any particular product, there is simply no reason to be concerned that these incentives would influence the specific recommendations to be made by the financial professional."); FSI at 8-9 ("product agnostic incentives . . . are permissible"); IPA at 6-7 ("we believe that trips (including those with a business and/or education component), bonuses, or sales contests based on product-agnostic measures such as overall asset growth or gross revenue would not raise these concerns"); Securities Industry and Financial Markets Association, Comment Letter on Proposed Rule on Regulation Best Interest (August 7, 2018) at 29 https://www.sec.gov/comments/s7-07-18/s70718-4185817-172705.pdf (hereafter "SIFMA"); Center for Capital Markets Competitiveness, Comment Letter on Proposed Rule on Regulation Best Interest (August 7, 2018) at 17-19, https://www.sec.gov/comments/s7-07-18/s70718-4184381-172572.pdf (hereafter "Chamber") (presuming the Commission does not intend to capture bonuses for "representatives who meet overall assets under management or revenue targets that are not tied to particular investment products.").

[7] E.g., State Farm at 7 (arguing that investors do not desire a change in the broker-dealer business model and that the "suitability process has proven sound by protecting customers and providing them with valued education and options.").

or reform the offending portions of the proposing release and clarify that implementation of a final rule will not mean business as usual for broker-dealers. In meetings with Commissioners and staff on the rulemaking team as part of the comment process, NASAA was asked to supplement its initial comment letter with additional suggestions to address the guidance and implementation of the rule. In this regard, NASAA has two important suggestions for the Commission on those fronts: (1) should the Commission adopt a final rule, use language in the adopting release that better reflects a robust best interest standard; and (2) provide clear illustrations to demonstrate how Reg BI will address and resolve the issues of conflicted advice.

A. The Adopting Release Must Not Undermine the Rule

Proposed Reg B I is centered on the notion that broker-dealers will only make recommendations that are in the best interest of the retail client and that such recommendations will be made without placing the financial or other interest of the broker-dealer ahead of the interests of the retail client. That is what the text of the rule says. Yet, the Commission's guidance in the proposing release states that "best" does not actually mean "the best" and that broker-dealers should disclose on the Form CRS when they are placing their financial self-interests ahead of their clients'.[8] Similarly, the Commission's guidance and remarks by its leadership state that "cost is a more important factor" under best interest than it is under suitability, but that is not what the text of the rule says.[9] The word "cost" does not even appear in the proposed rule.[10] These types of conflicts and tensions between the text of Reg BI and the proposing release must be reconciled in the adopting release such that the Commission sets forth a rule that is designed and implemented to work for investors' best interests.

When the Commission states in the Reg BI proposal, repeatedly, that the new standard of conduct would not require broker-dealers to eliminate any conflicts, neutralize compensation, or even generally recommend lower cost, less remunerative, or less risky products to retail investors, broker-dealers naturally feel no pressure to do so.[11] When the Commission states that

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[8] 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 (to be codified at 17 C.F.R. Parts 240, 249, 275, and 279) at 21431 ("In addition, each firm would include the incentives it and its financial professionals have to put their own interests ahead of their retail investors' interests based on the account fee structure, and would state that depending on an investor's investment strategy, retail investors may prefer paying a different type of fee in certain specified circumstances.")(Internal citations omitted).

[9] *See* Dalia Blass, Director, Div. of Inv. Mgmt., SEC, Remarks at the PLI Investment Management Institute 2018 (April 30, 2018) ("How is Reg. BI different from existing suitability standards for broker-dealers in FINRA rules? Reg. BI incorporates, but goes beyond suitability, in that it covers disclosure, care, and conflict obligations. The care obligation, for example, would, for the first time, explicitly impose a best interest standard for recommendations. These obligations are key enhancements that cannot be satisfied by disclosure alone, that place greater emphasis on the importance of costs and financial incentives, and that could be directly enforced by the Commission.") Full remarks at https://www.sec.gov/news/speech/blass-remarks-pli-investment-management-institute-2018.

[10] Industry groups interpret this guidance to mean cost cannot be "the predominant motivating factor," suggesting firms could recommend the highest cost product within a certain asset class if, for example, a client was interested in one particular asset class. *See* FSI at 4; IPA at 4. Costs should not be gamed this way.

[11] ACLI at 10-11 (applauding Commission guidance that broker-dealers do not owe continuing duties and are not required to eliminate any particular conflicts, particularly those present in products that involve higher risks and costs like variable annuities) (emphasis in original); NAIFA at 20 (asking the Commission to "[a]void negatively

broker-dealers can concentrate sales in high-commission products, the Commission should expect broker-dealers will do exactly that.[12] These are the very practices the rule should be designed to stop, but yet the Commission declares that the rule is not in fact intended to do so. As the Commission knows, one of the largest broker-dealers in the country has in fact responded to Proposed Reg BI by once again returning to commission-based retirement accounts after banishing them initially to conform to the now-defunct DOL Rule.[13]

Thus, when the Commission states that broker-dealers can engage in all of the worst sales practices combined by selling a limited suite of only high-cost, highly remunerative, and illiquid products – all under the guise of acting in a client's best interest – the Commission is all but encouraging broker-dealers to do just that.[14] NASAA does not believe that is the Commission's intent, but if the Commission wants these harmful practices to stop, it must say so both in the rule and in the adopting release.

B. The Commission Should Provide Examples of Practices Both Consistent and Inconsistent with the Conduct Standard

Proposed Reg BI consists of a disclosure obligation, a care obligation, and a two-pronged conflict of interest obligation.[15] Although not defined in the proposed rule, the standard as described is meant to raise the current suitability standard applicable to broker-dealers by "requiring that recommendations to retail investors be in the best interest of those retail investors, without putting the financial interest of the broker-dealer ahead of the retail customer."[16]

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singling out certain products (e.g., variable annuities) and/or business models (e.g., offering proprietary products), which may inadvertently give the impression that these products/models require increased scrutiny in the form of heightened disclosures, explanation and/or conflict mitigation measures.").

[12] IPA at 2 (applauding the Commission's "non-biased approach that does not favor a shift away from commission-based brokerage services . . .").

[13] Greg Iacurci, Merrill Lynch Reverses Policy on Banning IRA Commissions Following Death of DOL Fiduciary Rule, InvestmentNews (August 30, 2018, 10:15 AM), https://www.investmentnews.com/article/20180830/FREE/180839999/merrill-lynch-reverses-policy-on-banning-ira-commissions-following; Lisa Beilfuss, Merrill Lynch to Resume Charging Commissions on Retirement Accounts, The Wall Street Journal (August 30, 2018 10:15 AM), https://www.wsj.com/articles/merrill-lynch-to-resume-charging-commissions-on-retirement-accounts-1535638500 ("Observers say the SEC's version would be less restrictive on brokers, emphasizing disclosures of conflicts of interest.").

[14] *E.g.*, State Farm at 9 (requesting codification of the statements set forth in the speech of Brett Redfearn, Trading and Markets Division Director, that brokers need not analyze all potential alternatives or default to recommending the least expensive or least remunerative security); NAIFA at 14 (expressing support for Commission interpretation that broker-dealers need not identify "*the* best" or "*the* lowest cost product") (emphasis in original).

[15] Regulation Best Interest, 83 Fed. Reg. 21574 (proposed May 9, 2018) (to be codified at 17 C.F.R. 240) at 21587.

[16] Jay Clayton, Chairman, SEC, Address at Temple University: The Evolving Market for Retail Investment Services and Forward-Looking Regulation – Adding Clarity and Investor Protection while Ensuring Access and Choice (May 2, 2018). Full remarks at https://www.sec.gov/news/speech/speech-clayton-2018-05-02 (hereafter "Clayton Address").

As stated in our prior letters, NASAA supports the work of the Commission and other agencies to raise the standard of care for broker-dealers. However, any such attempt should do so in a way that aligns the rhetoric of the standard with results for investors. Should this investor-first rule be finalized, broker-dealers will no doubt undertake marketing campaigns heralding their obligation to act in the "best interest" of clients when recommending securities. It is, therefore, imperative that any such best interest standard be true to its label. We believe one way to do this is to include in the adopting release examples of practices and conduct that the standard demands of broker-dealers and conversely examples of practices and conduct that would be inconsistent with the standard. This exercise is important as it will bring more clarity to investors, regulators, and the industry. There are inherent limitations on such an exercise and the examples we set forth below should not be interpreted as the definitive list of regulatory "dos and don'ts." There will be practices not discussed in our letter that, when viewed in light of all the facts and circumstances, prove to be inconsistent with the "best interest" standard.

Notably, many of the practices below would be expressly curtailed or prohibited by regulations enforced or pending in other countries, including the Canadian "Best Interest" analog.[17]

- Application of Proposed Reg BI to Sales contests. Programs that combine incentives – cash and non-cash, product-specific and product-neutral – with sales targets or goals should be banned.[18]

- Application of Proposed Reg BI to IPO allocations. Allocations of IPOs should be handled like other recommendations under the best interest conduct standard. As we pointed out in our letter of August 23, allocations should not favor certain clients over others.

- Application of Proposed Reg BI to firms that sell from a limited menu. Conflicts of interest deriving from the lack of an open product architecture are a significant concern for NASAA. As noted in our August 23 comment letter, we strongly disagree with the Commission's proposed implementation of the conduct standard such that it would have no impact on such practices. This appears to be the case even where such products have a history of being unsuitable or otherwise problematic. For instance, real estate investments, and oil and gas offerings have been listed in the top 5 most reported

[17] *See* CSA Notice and Request for Comment, Proposed Amendments to Registration Requirements, Exemptions and Ongoing Registrant Obligations, Reforms to Enhance the Client-Registrant Relationship (June 21, 2018), http://www.osc.gov.on.ca/documents/en/Securities-Category3/rule_20180621_31-103_client-focused-reforms.pdf; FINRA, Report on Conflicts of Interest (October 2013) app. 1, at 39, https://www.finra.org/sites/default/files/Industry/p359971.pdf (noting that with respect to Australia, Canada, and the European Union, regulators have concluded that some conflicts stemming from compensation practices cannot be cured through disclosure and have therefore prohibited practices such as third party commissions or inducements to firms from product issuers and manufacturers.).

[18] Industry comments are uniform in their attempts to salvage sales contests. *E.g.*, ACLI at 17; State Farm at 11.

products and schemes in NASAA's annual enforcement reports (2014, 2015, and 2016)[19] with investments in private placements frequently making an appearance in the same list. They also earn a disproportionately high place on FINRA's list of products giving rise to customer complaint arbitration. Prudence requires due consideration of competing asset classes.

- Revenue sharing under Proposed Reg BI. Arrangements where product manufacturers share revenue for distribution of their investment products raise similar concerns as sales contests. That is, firms and associated persons are incentivized to sell what might be more costly, poorer performing products as a result of higher payouts to the firm. If not outright prohibited, such revenue sharing arrangements must be closely scrutinized for compliance with the best interest conduct standard.

- Treatment of retirement account rollovers under Proposed Reg BI. Firms and their associated persons have strong incentives to recommend rolling over a retirement account to an IRA. However, certain investors may be better off leaving their 401(k)s with former employers as these accounts may offer investors access to funds that charge lower fees than similar retail accounts.[20]

- Conflict mitigation and disclosure under Proposed Reg BI. A firm should not be permitted to build a compliance structure around disclosure of conflicts and the Commission deem such disclosure compliance as sufficient "mitigation."[21]

- Recommendations regarding products and account type under Proposed Reg BI. Making a recommendation without a thorough examination of a customer's profile and the cost, liquidity, risk, and complexity of the product and/or strategy should be prohibited. Further, Proposed Reg BI must apply to the type of account that is being recommended as such recommendation is part of an investor's overall investment strategy.

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[19] NASAA Enforcement Report, 2014 Report on 2013 Data (October 2014), at 8, http://www.nasaa.org/wp-content/uploads/2011/08/2014-Enforcement-Report-on-2013-Data_110414.pdf; NASAA Enforcement Report, 2015 Report on 2014 Data (September 2015), at 8, http://www.nasaa.org/wp-content/uploads/2011/08/2015-Enforcement-Report-on-2014-Data_FINAL.pdf; NASAA 2016 Enforcement Report, Based on 2015 Data (Fall 2016), at 5, http://www.nasaa.org/wp-content/uploads/2016/09/2016-Enforcement-Report-Based-on-2015-Data_online.pdf.

[20] The Commission should reject the argument advanced by industry that disclosure is a sufficient mitigation strategy in this instance. IRI at 11 ("Assuming the client is clearly made aware of these facts, we see no additional steps the firm or the financial professional could take to minimize the impact of the conflict. In these cases, disclosure alone should be sufficient."). Conflict avoidance is clearly the preferred course for the retail investor in these situations. *See* North American Securities Administrators Association, Inc., Comment Letter on Proposed Rule on Regulation Best Interest (August 23, 2018) at 18-19, https://www.sec.gov/comments/s7-07-18/s70718-4259557-173080.pdf.

[21] *E.g.*, SIFMA at 24-26 (disclosure is sufficient for all material conflicts); IRI at 10-11 (disclosure is sufficient for firm-level conflicts). Other industry actors go further and urge the Commission to simply drop the term "mitigation" from the rule entirely. ACLI at 14 ("ACLI's members developed a consensus that 'mitigate' should be dropped from the regulation and financial incentive conflicts should be treated like any other."). The Commission should reject those efforts as well as the suggestion by all of the foregoing to prioritize disclosure and mitigation over conflict avoidance. *See*, *e.g.*, State Farm at 4.

The following practices by broker-dealers and their associated persons would be consistent with a conduct standard that requires the broker-dealer to act in a client's best interest.

- Providing regular training programs and providing other resources to salespersons to make sure they have timely information on competing asset classes and the wide range of products available to meet clients' investment needs.

- Providing resources and sufficient testing to satisfy themselves that financial advisors understand the products they are offering and that the financial advisor can readily explain the products to clients.

- Applying the standard to the type of account that is recommended as such is part of the overall investment strategy.

- Implementation of policies, procedures, and practices designed to enforce the standard and implementing steps necessary to assess and surveil for compliance with the policies, procedures, and practices.

- Comprehensively assessing the costs of the products being recommended including the impact of those costs on the investor's return.

- Disclosing the costs of transactions on a transaction-by-transaction basis in a simple, straightforward way before the transaction is executed.

- Avoiding recommendation of high cost investments and those that involve some form of fee splitting or sharing where there are less expensive and equally performing products available.

- Developing and instituting product neutral grids to reduce preferences for one product over another.[22]

- Avoiding compensation schemes that incentivize firms and their associated persons to favor one product over another.

[22] The Commission should reject the recommendation advanced by industry that the concept of "differential compensation criteria based on neutral factors" be omitted in the final rule. IRI at 14-15. The commission should further reject industry assertions that product agnostic sales competitions and incentives should be permitted under the final rule. FSI at 8-9; IPA at 6-7.

II. The Commission Should Implement Robust Disclosure, Care, and Conflict Obligations

While industry associations appear fairly content with the Commission's "interpretive nuance," some are less comfortable with various aspects of the rule text as well as the portions of the Commission's guidance that would support a stronger, stricter reading of that text.[23] Collectively, they urge the Commission to make Rule 15*l*-1 a safe harbor;[24] to drop the term "prudence" from the rule;[25] and strike references to *Capital Gains* disclosure requirements so as to limit the scope of their obligation to financial incentives only rather than all material conflicts as required of investment advisers.[26] They want the Commission to steer clear of level compensation and affirmatively take conflict avoidance off the table.[27] We urge the Commission to reject these efforts. Moreover, as explained in our initial comment letter, we recommend that the Commission strengthen the rule in certain areas, including extension of these obligations to all investors.[28]

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[23] *E.g.*, State Farm at 10 (discouraging Commission reliance on differential compensation as conflict mitigation strategy in deference to disclosure); IRI at 3, 14-15 (asking the Commission to "avoid terminology derived from the DOL Rule (such as 'differential compensation criteria based on neutral factors') in the discussion of conflict mitigation techniques"); IPA at 6 (arguing that "basing product compensation on 'neutral factors' or 'time and complexity' are not feasible" and would discourage firms from offering products steeped with financial incentives); Chamber at 19 (also arguing that "basing product compensation on 'neutral factors' or 'time and complexity' [is] not feasible . . .").

[24] State Farm at 3, 6; IPA at 3 (proposing a safe harbor where a firm delivers Form CRS and adopts written conflict disclosure and mitigation policies and procedures).

[25] State Farm at 3, 8 (arguing that prudence conveys "a meaningful departure from existing standards of conduct," tacit acknowledgement of its opposition to meaningful reform); IPA at 5 (also suggesting Commission "remove the term 'prudence'"); Chamber at 11-12 (arguing that use of "prudence" is unnecessary and would cause confusion).

[26] SIFMA at 4, 16-18 (finding no distinction between financial and non-financial incentives and urging Commission to mandate disclosure of "material" conflicts in line with *Basic v. Levinson* instead of disclosure of "all conflicts" in line with *Capital Gains*, arguing the latter "could result in excessive disclosure that would overwhelm investors"); *accord* Chamber at 15-17 (stating it is "not appropriate and not practical" to apply the *Capital Gains* approach to conflict disclosure on broker-dealers); IRI at 7-9 (urging the Commission to abandon *Capital Gains* formulation of "materiality" in deference to more generic *Basic v. Levinson* formulation): State Farm at 3, 9-10 (urging the Commission to get rid of the "general conflict" category and restrict conflict management to only financial incentives); IPA at 6 (advocating for interpretation of materiality in line with *Basic v. Levinson* and eliminating references to "additional, potentially confusing and conflicting terms . . .").

[27] SIFMA provides an enlightening discussion along these lines, wanting to clarify that the strong financial incentives at play in high-cost product sales are permitted with disclosure. Otherwise, it would not be possible, for "an associated person . . . who specializes in REITs or sovereign debt . . . [to] recommend[] particular REITs or sovereign debt securities to a customer, without considering less expensive securities outside of those sectors that are also offered by the broker-dealer." SIFMA at 26 n.48. Chamber and IPA also raise this issue, wanting to be explicitly sure that brokers will not limit access to high-cost, highly remunerative products like non-traded REITs. Chamber at 19; IPA at 4.

[28] NASAA is comfortable with the Commission giving institutional investors the ability to opt out of these elevated conduct standards in the unlikely event an investor does not wish to have its best interests served.

A. Disclosure Obligation

Personalized point-of-sale disclosure is essential to the efficacy of Proposed Reg BI. NASAA recommended that the Commission require broker-dealers and their associated persons identify *which* standard of care, *which* fees,[29] and *which* conflicts – among all of those noted in the firm's enterprise-wide disclosures on Form CRS (if adopted) – are present in the specific recommendation being made to the client.[30] For recordkeeping and supervisory purposes, this disclosure must be written. NASAA believes that digital communications are sufficient in the form of simultaneous text messages or emails (all retained by the firm). Same-day confirmation letters sent by regular mail should be reserved for clients that have no digital devices with messaging or email functions.

B. Remedies for Breach

In its initial comment letter, NASAA urged the Commission to clarify the rights and remedies of aggrieved investors for breaches of the new conduct standard. NASAA expressed concern that the Commission's language in the proposing release that no new private rights of action or new rights of rescission were created by the proposed rule would be invoked by the industry as a wholesale defense against private recourse. That is precisely what appears in the comment file as industry construes this guidance as limiting recourse to Commission enforcement only:

> State Farm supports the SEC's conclusion that Regulation Best Interest does not create a new private right of action. In light of the complexity and novelty of the obligations and requirements set forth in Regulation Best Interest, the SEC, rather than a state or federal court, is best positioned to interpret and develop a body of precedent relative to the interpretation and application of Regulation Best Interest.[31]

NASAA understands it is the Commission's intention for investors to be able to pursue alleged breaches of the standard of conduct in arbitration akin to current practice involving alleged

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[29] In Form CRS, the Commission encourages investors to ask firms to "do the math" for them when it comes to fees and cost. Certain industry groups do not want investors to ask that question, *see, e.g.*, Chamber at 24, but it is one of the most basic decision making questions possible, the answer of which should be plainly disclosed at point of sale.

[30] Industry is opposed to this disclosure, stating it would be "unworkable" and "costly." *See* SIFMA at 5, 20-21; IPA at 7-9; Chamber at 21-22. Wall Street firms experienced record profits last year and paid out significant bonuses, the highest seen since the peak of compensation observed just prior to the 2008 financial crisis. Given the billions that investors purportedly lose to conflicted advice, substantial investment is possible and justified in this area. *See* Clare Dickinson, Wall Street Bonuses Soar to Highest Level Since 2006, Financial News (March 27, 2018, 9:59 AM), https://www.fnlondon.com/articles/wall-street-bonuses-soar-to-highest-level-since-2006-20180327.

[31] State Farm at 11; *see also* NAIFA at 3 (supporting Reg BI as it "[u]tilizes existing federal enforcement mechanisms, rather than the private plaintiffs' bar and state courts to enforce and interpret the new regime"); ACLI at 9 ("Life insurers strongly concur with the SEC's clear statement that Reg. BI does not create private rights of action or rescission rights. This policy properly reflects the statutory foundation of the Exchange Act as it applies to recommendations to retail customers about the purchase of a security, in contrast with the judicially created fiduciary duty governing activity under the Investment Advisers Act."); Chamber at 13 (asking the Commission to include a disclaimer that "no private right of action is created" directly in the rule).

suitability violations. It is imperative that the Commission clarify these rights and remedies in the adopting release.

III. Further Examples of the Application of a Best Interest Standard to Various Scenarios and Practices

To better illustrate how the standard would apply and strengthen investor protection we would encourage the Commission to set out clear examples of the types of practices the rule would prohibit or the additional steps a firm must take to comply. To help illustrate the point we have used the scenarios posed in the SIFMA comment letter[32] and provided our explanation as to how we believe the best interest standard should be applied. These examples are not exhaustive and changing one or more of the facts in a scenario would likely change how the standard applies.

1. *Unsolicited Transaction – Brokerage Account – Example 1: Lucy directs her broker to purchase 100 shares of ABC in her transactional account. The broker believes that ABC is overpriced and does not recommend this transaction. Broker purchases ABC at Lucy's request and marks the transaction "unsolicited." Client receives a confirmation of the transaction.*

   Unsolicited Transaction – Brokerage Account – Example 2: Jose, an 89-year-old, directs his broker to sell and reinvest 100% of his assets in XYZ, a highly volatile investment. The broker does not recommend this transaction and communicates that to Jose when he or she receives the order. Broker purchases XYZ and marks the transaction "unsolicited." Client receives a confirmation of the transaction.

   Application of Reg BI per SIFMA: Proposed Reg BI does not apply to self-directed or otherwise unsolicited transactions by a customer who may otherwise receive other recommendations from the broker-dealer. Proposed Reg BI also does not require the broker-dealer to refuse to accept a customer's order that is contrary to the broker-dealer's recommendation. Consistent with current practice, the broker's marking the order as "unsolicited," which will appear on the client's confirmation, will adequately document that Proposed Reg BI was not triggered.

   Application of Reg BI per NASAA: Both Proposed Reg BI and the fiduciary duty create an expectation that a financial professional offering personalized advice – regardless of their registration as an associated person of a broker-dealer or investment adviser – will do right by their customers. The hypotheticals assume no advice is given (so that neither Proposed Reg BI nor fiduciary duty applies) but does not elaborate on the nature of the relationship between the representative and the clients. Assuming Lucy and Jose are both working with execution-only broker-dealers and associated persons that have never marketed or held themselves out otherwise to these clients, the broker would need only

[32] *See* SIFMA at 32-35.

communicate the known downside risks posed in the hypotheticals and proceed with each order as directed by the client. Further, if the Broker reasonably believes that Jose is at risk of financial exploitation – given the combination of advanced age and high-risk request – the broker should follow the firm's policies and procedures for reporting and disbursement holds in cases of suspected financial exploitation.

2. *Solicited Transaction – Brokerage Account: Broker calls Jon and recommends purchasing 500 shares of ABC in Jon's brokerage account. Jon agrees and the purchase is marked "solicited." Jon receives a confirmation.*

Application of Reg BI per SIFMA: Under Proposed Reg BI, the broker's obligations in satisfying the best interest standard include meeting the Disclosure, Care, and Conflict of Interest Obligations. With regard to the customer-specific Care Obligation, the broker must have reasonably believed that the purchase of ABC was in Jon's best interest, after weighing all the applicable factors, which may include costs, the product'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. There would be no ongoing duty to monitor the performance of the account. The broker also must have exercised reasonable diligence, care, skill, and prudence. This encompasses reasonable basis suitability, customer specific suitability, and quantitative suitability. Under Proposed Reg BI, cost and associated financial incentives are important factors to consider when making a recommendation.

Application of Reg BI per NASAA: Under Proposed Reg BI, the broker must meet the Disclosure, Care, and Conflict of Interest Obligations, which require the broker to place the client's interests ahead of the firm's and that of its associated persons. A commission is a common financial incentive that would be permitted where the product recommendation is based on the selfless, reasonable belief that the product is in Jon's best interest accounting for the compensation (in whatever form) inuring to the firm and broker. The broker absolutely must (not may) weigh cost, amongst all applicable factors and must have exercised reasonable diligence, care, skill, and prudence. If ABC is on the high end of the cost and risk spectrum for comparably performing products, it would very likely be in Jon's best interest to purchase something else. There is not enough information in the hypothetical, however, to know the answer. But assuming ABC is the right choice and assuming further that the broker has not held himself out as Jon's trusted adviser over the course of their professional relationship such that a de facto fiduciary relationship has developed, the broker would have no ongoing duty to monitor the ABC shares moving forward.

3. *Transactions – Recommendation to Open a Fee-based Account: A financial adviser of a dually registered broker-dealer and investment adviser, wearing her "adviser hat," recommends that Lucy open a fee-based account, which offers specific asset classes or multi-asset class diversified portfolios to provide broad diversification for her portfolio.*

   Application of Reg BI per SIFMA: Proposed Reg BI would not apply here even if the recommendation to open the fee-based account constitutes a recommendation of an investment strategy involving securities. But the Proposed Form CRS disclosure requirements would apply, under which Form CRS must be given to the customer at or before the opening of the account.

   Application of Reg BI per NASAA: Proposed Reg BI would not apply here even though the recommendation to open the fee-based account is a recommendation of an investment strategy involving securities. Reg BI does not apply because the Advisers' Act fiduciary duty standard applies instead. The financial adviser needs to evaluate other competing account types and determine whether the fee-based account proposed here will best serve Lucy's interests. It is entirely possible that a commission-based brokerage account would be a better and more cost-effective fit. There is not enough information in the hypothetical to determine whether the "financial adviser's" advice complies with the fiduciary duty standard.

4. *Principal Trading: The Smiths are interested in purchasing certain corporate bonds. The firm has a deep inventory of corporate bonds, and the broker recommends a bond that would be filled from the firm's inventory.*

   Application of Reg BI per SIFMA: Under Proposed Reg BI, principal trading is not prohibited. The broker may have to disclose the conflicts surrounding principal trading before or at the time the recommendation is made, given that this might be a material conflict of interest.[33] Although the use of disclosures in account opening agreements is allowed and may be sufficient, the broker may determine that more specific disclosures regarding capacity would be appropriate closer to the time of the recommendation. The capacity disclosure may also be provided on a post-recommendation basis in the customer confirmation that is required by Exchange Act Rule 10b-10.

   Application of Reg BI per NASAA: Under Proposed Reg BI, principal trading is not prohibited. However, the broker will need to consider alternative bonds and investments in other asset classes to determine whether the corporate bonds best serve the Smith's needs, ever mindful of the conflict presented by selling from firm inventory. Is the corporate bond cheaper than other suitable alternatives? Is it a prudent recommendation that strikes the proper balance between risk and reward for these investors while meeting their unique liquidity needs? As in the first hypothetical, the firm will need to satisfy all of the disclosure, care, and conflict resolution obligations set forth in the rule. In the

[33] For example, depending on the trade size and markup, it may not be a material conflict.

event those duties are fulfilled, the broker should provide written disclosure of its principal capacity conflict to the Smiths and obtain their consent prior to the purchase as advisers are so required.

5. *Initial Public Offering ("IPO"): Broker recommends that the Smiths purchase shares in ABC's IPO. The firm or its affiliate is the underwriter.*

Application of Reg BI per SIFMA: Under Proposed Reg BI, the broker must satisfy the Care Obligation before recommending participation in the IPO. In connection with recommending the IPO, the broker would need to disclose that the firm or its affiliate is an underwriter or other distribution participant, given that this could be a material conflict. This disclosure would need to be made in writing prior to or at the time of the recommendation, provided that the firm may satisfy this obligation by delivering a preliminary prospectus or final prospectus for SEC registered offerings. The prospectus would address, inter alia, underwriter compensation, underwriter material conflicts, and dealer selling concessions. For exempt offerings or securities, this obligation may be satisfied by providing offering documentation that addresses these aspects. In the alternative, the firm may satisfy its obligations by providing a standalone written disclosure concerning its or its affiliate's involvement in the distribution that is provided to the customer prior to the time of the recommendation, which may, but is not required to, accompany the offering document for the securities. If the SEC views this communication as a prospectus, an exemption or other guidance should be provided by the SEC to permit firms to use such communications in furtherance of Proposed Reg BI compliance.

Application of Reg BI per NASAA: Under Proposed Reg BI, the broker must satisfy the Care, Conflict, and Disclosure Obligations before making the recommendation, which requires specific due diligence into the propriety of recommending the ABC IPO to the Smiths, including all material facts, risks, costs, and conflicts of interest, that are associated with the recommendation. The broker is required to mitigate any financial incentives that are involved in the sale of IPO stock (preferably the broker would take steps to eliminate such conflicts) and disclose all other material conflicts. In addition to the disclosure and prospectus delivery obligations indicated to the left, the firm will need to have policies and procedures in place to ensure that IPO opportunities are allocated properly so that the Smiths and other clients are all treated in good faith with fair dealing.

6. *Holistic Review of "Client Relationship": As a result of several months of market volatility, Lucy and Jon ask their financial adviser (who is an employee of a dually registered investment adviser and broker-dealer) to meet with them to provide a review of the overall performance of all of the family's accounts held at the firm. The financial adviser responds and provides the Smiths with a review of the fee-based as well as other accounts including transactional brokerage and self-directed accounts.*

Application of Reg BI per SIFMA: Whether or not the financial adviser must comply with Proposed Reg BI depends on the capacity in which she is acting (i.e., on behalf of the broker-dealer or investment adviser). If the financial adviser is acting on behalf of the broker-dealer, Proposed Reg BI would only apply if she makes a recommendation of a securities transaction or investment strategy involving a security in the course of the holistic review (and not to the review itself).

Application of Reg BI per NASAA: This is a great example where, given the multiplicity of accounts and desire for an update on their family portfolio as a whole, Lucy and Jon have probably entrusted their entire financial well-being to one financial professional. If that is correct, a de facto fiduciary relationship has likely developed such that neither Lucy nor Jon believe that their financial adviser is looking out for their best interests in some of the accounts, but not in others. The fact that the current suitability regime allows that to happen is precisely why investors are so confused today. A full fiduciary duty should be imposed on the financial adviser as to all accounts in this case, commensurate with the special confidence, fidelity, and trust undoubtedly reposed in that professional by Lucy and Jon. Such an approach would also preempt the regulatory arbitrage present in the approach advocated by SIFMA.

7. *Sale of Proprietary Products: A dual-hatted representative recommends a variety of mutual funds managed by an affiliate to Lucy and Jon for their fee-based advisory accounts and brokerage accounts. There are a variety of similarly performing mutual funds available. While the mutual funds managed by an affiliate have similar fees to the client, they will generate higher overall revenue to the firm. The dual-hatted representative believes that these mutual funds managed by an affiliate are appropriate for the Smiths given multiple factors including performance.*

Application of Reg BI per SIFMA: To the extent the representative is acting on behalf of the broker-dealer in providing the recommendation, Proposed Reg BI would apply. Under Proposed Reg BI, the customer must receive a disclosure, in writing, regarding material conflicts of interest relating to the recommendation including the manner and capacity in which the representative will be acting, such that the customer understands the standard of conduct that applies to those recommendations.

With regard to the Care Obligation, "best interest" does not necessarily mean "best price" or lowest cost option. As such, a broker-dealer can recommend a security that is more expensive, or more remunerative to the firm, if it is in the best interest of the customer. That determination can be made by weighing costs, the product'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. This good faith determination by a broker-dealer is sufficient to satisfy the Care Obligation under Proposed Reg BI.

Application of Reg BI per NASAA: As noted in response to scenario number 4 above, Lucy and Jon probably believe their representative is acting as their fiduciary on all accounts and the standard of conduct should conform to that reasonable expectation. Whether it is the fiduciary or the best interest standard that applies, however, the representative should recommend the mutual fund that is in the couple's best interest as that is the standard under the rule and not one that is just "appropriate."

While performance and fees are reportedly "similar," it would not be in the couple's best interest to purchase the affiliate's product if competing products are nonetheless cheaper and/or perform better. It is also important to know whether the representative would receive additional compensation, cash (such as a bonus) or otherwise, as a result of the additional revenue generated from sales of the affiliate's product. In that case, there would be both firm and individual financial incentives at play. The firm and representative would need to have a compelling good faith argument that the affiliate's product is the better option if they want to recommend it, disclosing all conflicts in writing so that the couple understands how their interests stack up against those of the firm and representative.

8. *Allocation of Investment Opportunities: A broker has a group of clients with similar accounts and investment objectives who also have multiple accounts with the firm. The broker frequently shares investment ideas that he or she presents to some of these clients. The broker does not present these ideas to all clients in each instance or at the same time.*

   Application of Reg BI per SIFMA: Proposed Reg BI does not require brokers to provide recommendations to all clients. However, to the extent a broker does provide such recommendations, the Disclosure, Care, and Conflict of Interest Obligations would apply.

   Application of Reg BI per NASAA: The broker's standard of conduct should conform to the reasonable expectations of his clients based on the facts and circumstances surrounding those client relationships. Whether it is the fiduciary or the best interest standard that applies, the firm should have policies and procedures in place to ensure that investment opportunities are properly allocated in good faith with fair dealing so that no clients are favored to the detriment of others.

9. *Model Portfolio and Asset Allocation: Jane is online and sees that she can self-identify her investment objective or risk tolerance (such as conservative/aggressive/moderate) and view a model portfolio with preset asset allocation and a basket of mutual funds and/or ETFs that she can purchase and manage on her own. Assume that the allocation tool would be excluded from FINRA's suitability rule because it does not include a recommendation of a particular security or securities and meets the other factors in Supplementary Material .03.*

Application of Reg BI per SIFMA: FINRA Supplementary Material .03 to Rule 2111 provides certain categories of "investment strategies involving a security or securities" that are excluded from suitability requirements, provided they meet certain conditions. If a communication meets the conditions in these exemptions and therefore is not covered by Rule 2111, we believe the communication similarly would not be covered by Proposed Reg BI.

Application of Reg BI per NASAA: As the allocation tool is taking information from Jane to match her with a basket of preselected investment opportunities (to the exclusion of other products), the online platform is making a recommendation to Jane. As such, the best interest obligations under Proposed Reg BI would apply.

Several of the hypotheticals posed above involve "dual-hatted professionals." We observed from the comment file that certain segments of the industry, primarily those linked with the insurance sector, are opposed to the title restrictions so they may continue to market salespersons as trusted advisers.[34] Industry claims that "[r]equiring a "dual-hatted" person to switch back and forth between titles based on whether he or she is making a recommendation through the broker-dealer or providing investment advice through the investment adviser would increase investor confusion for retail investors."[35] If they truly want to use one title – that of advis_r with either an "e" or an "o" – and truly want to eliminate investor confusion, then they should simply submit to the fiduciary duty standard of care.[36] Accordingly, NASAA agrees with the Commission that title restrictions are one of the few ways investors will be able to discern which standard of conduct applies to the transaction at hand.

We offer the following two additional scenarios to help demonstrate the application of the Proposed Reg BI standard to certain investment products including those that are typically high cost, complex, or illiquid.

10. *<u>Sale of Highly Illiquid, High-Commission Product to Elderly Investors</u> – Broker recommends that Jose, a 79-year old retired teacher with a liquid net worth of $200,000, invest $29,700 in a non-traded REIT, which gives Jose 270 shares at $10/share after deducting an 8% commission paid up front as well as a 1.5% dealer-manager fee, and a 0.5% advisor fee. This fee structure constitutes the maximum fees of this type allowed to be charged under applicable regulations and shows Jose with a starting account balance of $27,000.*

[34] NAIFA at 1, 3.

[35] State Farm at 16; *see also* SIFMA at 24.

[36] State Farm at 5 (urging the interpretation that dual-hatted persons be able to use "adviser" or "advisor" label "in all interactions with retail investors irrespective of whether such Dual-Hatted Professional is providing investment advisory or brokerage services to a particular retail investor in a particular interaction.").

Jose is given the offering documents, which disclose the following risk factors:

- No public market currently exists for shares of our common stock.
- We may pay distributions from financing activities, which may include borrowings in anticipation of future cash flows or the net proceeds of our offerings (which may constitute a return of capital).
- This is an initial public offering; we have little operating history.
- This is a "best efforts" offering. If we are unable to raise substantial funds in this offering, we may not be able to invest in a diverse portfolio of real estate and real estate-related investments, and the value of your investment may fluctuate more widely with the performance of specific investments.
- We are a "blind pool" because we have not identified any properties to acquire with the net proceeds from this offering.
- Investors in this offering will experience immediate dilution in their investment primarily because (i) we pay upfront fees in connection with the sale of our shares that reduce the proceeds to us.
- There are substantial conflicts of interest among us and our sponsor, advisor, affiliated property manager, transfer agent and dealer manager.
- Our advisor may face conflicts of interest relating to the purchase of properties and such conflicts may not be resolved in our favor, which could adversely affect our investment opportunities.
- We have no employees and must depend on our advisor to select investments and conduct our operations, and there is no guarantee that our advisor will devote adequate time or resources to us.
- We will pay substantial fees and expenses to our advisor, its affiliates and participating broker-dealers, which will reduce cash available for investment and distribution.
- We may incur substantial debt, which could hinder our ability to pay distributions to our stockholders or could decrease the value of your investment.
- Our board of directors may change any of our investment objectives without your consent.

This offering is 206 pages prior to the financial statements, subscription agreements, prior performance tables, which research indicates that Jose will not read. The offering is extraordinarily complex with 18 different potential forms of compensation paid out during the offering, operation and conclusion (merger, listing or dissolution) of the issuer. This does not include various other forms of restricted shares or options to insiders.

Application of Reg BI. The broker could recommend a less complicated *listed* REIT at $10/share for a $7.00 commission. With the same $29,700 purchase, Jose would: (a) maximize his investing dollars by starting with $29,693 instead of $27,000 in his opening balance plus receive distributions from earnings rather offering proceeds or financing; (b) substantially reduce his risk by investing in a trust that has historical operations with financials and properties to review as well as analyst coverage; (c) give himself much needed liquidity and flexibility in the event medical needs arise; and (d) have a clearer understanding where his money is going and a significantly smaller number of conflicts to parse through.

In the unlikely event alternative products ever did represent the best asset class for Jose's $29,700, it would still not be in his best interest to purchase a non-traded alternative product.

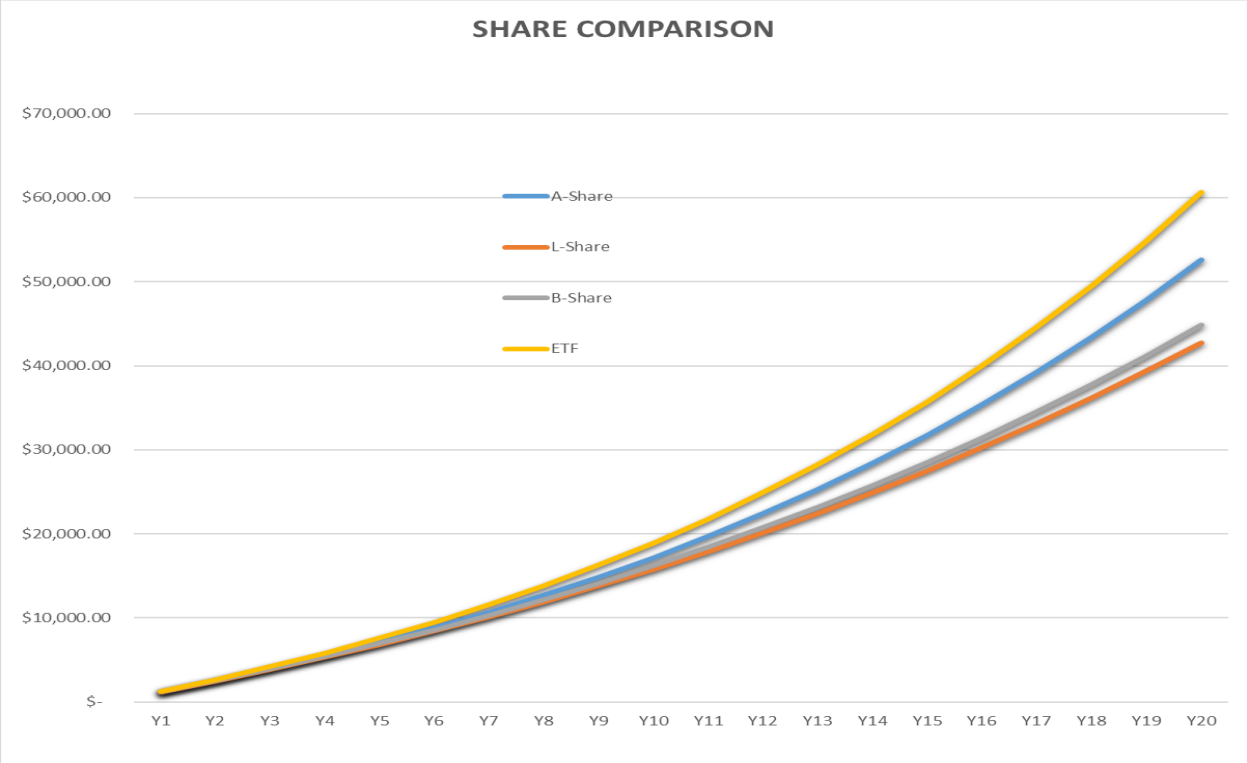
Under these facts and with this product, it is hard to see how the broker could satisfy his care, disclosure, and conflict obligations under Proposed Reg BI. This non-traded REIT, like other such investments, is expensive, illiquid, and highly complex. The fact that there are other more liquid, less costly and less complex investments available to investors regardless of age make it very unlikely, in our view, that this product could ever be sold to an investor like Jose under the Proposed Reg BI standard.

11. *Developing a Recommendation: Comparing Product Costs. Lucy and John explain to their broker that they are searching for an investment to help fund John's retirement at age 67. John is self-employed and, at 47 years old, has an investment time horizon of about 20 years. John has done some homework on investments and is considering investing in a variable annuity, mutual funds, or ETFs. The primary objective of the investment is growth. Lucy and John ask their broker for his recommendation.*

Application of Reg BI. When formulating a recommendation for Lucy and John, among the factors the broker must consider are the costs associated with each investment and the impact of those costs on the anticipated return. All investments come with costs, but the severity of the deleterious effects of these costs on an investor's return vary from product to product.[37] It is not sufficient, for purposes of a conduct standard that is meant to strengthen investor protection, for the broker to simply disclose the costs for each product in a simple, easy to read format. Rather, the conduct standard must demand of the broker that he carefully evaluate each product, including its costs and the impact of those costs

[37] The Commission has also taken steps to call attention to the impact of fees on the growth of an investor's account. *See*, Investor Bulletin: How Fees and Expenses Affect your Investment Portfolio (February 2014), SEC Pub. No. 164, https://www.sec.gov/investor/alerts/ib_fees_expenses.pdf; Updated Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio (September 8, 2016), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-how-fees-expenses-affect.

on investment returns, when formulating his recommendation for Lucy and John. It could well be that in conducting such an analysis the broker concludes that the lowest cost product will serve the best interest of Lucy and John but that may not always be the case. At a minimum, though, it is incumbent upon the broker to weigh the costs and the impact on returns as illustrated in the chart below and factor in these data points when making the recommendation. And to the extent the broker selects a more expensive product the broker must clearly set forth his rationale as to why the product is in the best interest of the client. The same analysis would similarly be required for other aspects of the recommended product including complexity and liquidity.



This chart compares costs for an L-share variable annuity, B-share variable annuity, A-share mutual fund, and an ETF. The assumptions for this cost comparison are as follows: $1,200 annual investment; an average transaction cost where applicable (mutual fund and ETF); annual expenses; and an average compounding rate of return of 8%.

IV. The Commission Should Enforce Conduct Standards, Including an Investment Adviser's Fiduciary Duty, Beyond Disclosure to the Fullest Extent Permitted by Law

Much has been made about the "best interest" standard of care as proposed by the Commission in relation to the fiduciary standard applicable to investment advisers. The Commission describes the investment adviser fiduciary duty as one that "[f]ollows the contours of the relationship between the adviser and its clients, and the adviser and its client may shape that relationship through contract when the client receives full and fair disclosure and provides

informed consent."[38] Chairman Clayton has similarly characterized the duty as one that is disclosure-centric ("The IA duty of loyalty requires full and fair disclosure of conflicts and client consent. It does not require or guarantee conflict-free advice and does not prohibit IAs from making fees in addition to advisory fees.").[39] The proper emphasis, however, should not be on disclosure but rather on the conduct.

In *SEC v Capital Gains*, the Supreme Court observed that "The Advisers Act thus 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 include an investment adviser – either consciously or unconsciously – to render advice which is not disinterested." The Court's framing of the duty echoes an intent to first and foremost eliminate those conflicts that might lead to disinterested advice. Such an approach is consistent with the duty of loyalty inherent in the fiduciary duty an investment adviser owes her clients. It may well be that the Commission has fostered an interpretation of the investment adviser fiduciary standard that relies too heavily on disclosure. Indeed, such an approach seems consistent with recent characterizations by SEC officials of the Investment Advisers Act standard. What is missing from the proposal and statements by SEC officials is a recognition that disclosure cannot and should not be characterized as sufficient to satisfy an adviser's fiduciary duty and more especially the adviser's duty of loyalty. Disclosure of conflicts aside, an adviser's duty is to act in the best interest of his or her client. The analysis does not and should not stop once the question of whether disclosure of the conflict has been made to the investor.

The *Capital Gains* decision aligns squarely with the Commission's early guidance following the passage of the Advisers Act, which made clear the Commission's view that an adviser's fiduciary duty should prevent conflicts that would erode a client's trust and confidence.

> The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice "in almost every instance." This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only such recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a

[38] 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) (to be codified at 17 C.F.R. 275) at 21205.

[39] *See* Clayton Address, *supra* note 16.

> fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients.
>
> ***Since loyalty to his trust is the first duty which a fiduciary owes to his principal, it is the general rule that a fiduciary must not put himself into a position where his own interests may come in conflict with those of his principal. To prevent any conflict and the possible subordination of this duty to act solely for the benefit of his principal, a fiduciary at common law is forbidden to deal as an adverse party with his principal.***

In re Arleen Hughes, Exchange Act Release No. 4048, 27 SEC 629, 1948 WL 29537, *11-12 (Feb. 18, 1948) (emphasis added).

State securities regulators have also taken an expansive view of the fiduciary obligations of state-registered investment advisers, typified by an expectation of undivided loyalty where the adviser acts primarily for the benefit of its clients.[40] Some states also extend these fiduciary

[40] *E.g.*, *In re Brewer*, 2010 Ala. Sec. LEXIS 50, *9-10 (Ala. Sec. Comm'n Aug. 26, 2010) ("An investment adviser is a fiduciary and has a duty to act primarily for the benefit of its clients."); *In re Godbole*, 2014 Cal. Sec. LEXIS 5, *13-14 (Cal. Dep't of Corps. Mar. 6, 2014) ("The adviser has a fiduciary duty to put the interests of the client investor ahead of his own. He is prohibited from self-dealing, misrepresentation, fraud, undisclosed conflicts of interest, manipulation or any action or course of conduct not in the best interest of the client."); *In re Marvin*, 2007 Colo. Sec. LEXIS 32, *9-10 (Colo. Dep't of Reg. Agencies Oct. 19, 2007) (noting adviser fiduciary duty includes obligation to disclose "any material conflict of interest relating to the adviser or any of its employees which could reasonably be expected to impair the rendering of unbiased and objective advice."); *In re Russell*, 2009 Colo. Sec. LEXIS 50, *6-7 (Colo. Dep't of Reg. Agencies Aug. 21, 2009) ("As a fiduciary, an investment adviser owes his clients more than honesty and good faith alone. Rather, an investment adviser has an affirmative duty of utmost good faith to act solely in the best interest of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the client's. The adviser's conduct will be measured against a higher standard of conduct than that used for mere commercial transactions." (citing *In re Arleen W. Hughes*, Exchange Act Release No. 4048, 27 SEC 629, 1948 WL 29537, *6-7 (Feb. 18, 1948)); *In re Acri*, 2014 Il. Sec. LEXIS 71, *25-26 (Ill. Sec. Dep't Jul. 1, 2014) ("As an investment adviser representative, Respondent has a fiduciary duty, owes his clients undivided loyalty, and may not engage in activity that conflicts with a client's interest without the client's consent."); *In re Langhofer*, 2008 Kan. Sec. LEXIS 93, *3 (Kan. Off. of Sec. Comm'r Nov. 18, 2008) ("As an investment adviser representative in Kansas, Respondent Langhofer owed a fiduciary duty to place his clients' interests above his own."); *In re Overstake Asset Mgmt, LLC*, 2016 Kan. Sec. LEXIS 4, *6 (Kan. Off. of Sec. Comm'r June 23, 2016) (by "holding the TBT fund [an inverse leveraged ETF] for extended periods despite warnings contained in the prospectus, James R. Overstake breached his fiduciary duty to clients."); *In re Scurlock*, 2016 Ky. Sec. LEXIS 6, *11-12 (Ky. Dep't of Fin. Inst. Sept. 9, 2016) (breach of fiduciary duty to fail to "disclose to clients in writing the amount of the finder's fee" or "the amount of any commission to be received for executing transactions pursuant to advice given."); *In re Freedom Wealth Advisors, LLC*, 2017 Maine Sec. LEXIS 4, *12 (Maine Dep't of Prof'l & Fin. Reg. Apr. 27, 2017) (breach of fiduciary duty to "Includ[e] language in the Summary Sheet that disclaimed their fiduciary responsibility for determining the suitability of the non-traditional investments they were recommending to their clients."); *In re Allsource Financial Management, LLC*, 2015 Md. Sec. LEXIS 14, *1 (Md. Att'y Gen. June 17, 2015) ("Respondents' practice of not providing pro rata refunds does not serve the best interests of their clients and breaches the fiduciary duty owed to their advisory clients."); *In re Everest Investment Advisors, Inc.*, 2015 Md. Sec. LEXIS 15, *1 (Md. Att'y Gen., Sec. Div. June 17, 2015), 2015 Md. Sec. LEXIS 15, *26-27 (Md. Att'y Gen. June 17, 2015) ("Respondents breached their fiduciary duty to clients by, among other things, forcing them to sign the financial planning agreement that imposed a fee that was not demonstratively related to advisory services rendered and acted as a penalty for terminating the advisory relationship."); *In re Askins*, 2006 Md. Sec. LEXIS 51, *6-8 (Md. Att'y Gen. Apr. 25, 2006) ("An investment

obligations beyond investment advisers to brokers, especially in dual-hatted scenarios. *E.g.*, *Burns v. Prudential Secs., Inc.*, 167 Ohio App. 3d 809, 828 (Ohio. Ct. App. 2006) ("Ohio has an expansive view of the relationship between a broker and a client that is regarded by the courts as a fiduciary one that implies trust and confidence "); *In re North Atlantic Secs.*, LLC, 2011 Maine Sec. LEXIS 14, *12,*29 (Feb. 2, 2011) ("Respondents' attempt to hide behind the fact the transfers were sent to Delmore *before* being transferred to Respondents or used for their benefit is for naught. Broker-dealers and their agents, while not held to the same fiduciary standard as investment advisers, are held to a high standard of conduct. In considering conduct that may be viewed as antithetical to the interests of investors and potentially dishonest, regulators take a broad view. Dell'Olio managed all of these transfers as Ms. Demers' broker and investment adviser, a role for which he owed her a fiduciary duty to act in her best interest over and above his own.").[41] This is so even where brokers are handling nondiscretionary accounts.

> While financial advisors generally have increased duties when managing discretionary accounts, even a broker handling a nondiscretionary account owes its client basic fiduciary duties, including but not limited to: (1) the duty to recommend an investment only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (2) the duty to inform clients of the material risks involved in the investment decision; (3) the duty to not misrepresent any fact material to the transaction; and (4) the duty to transact business only after receiving prior authorization from the client.

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adviser representative ("IAR") faces even more stringent requirements. . . These restrictions on an IAR's activities are appropriate because an IAR has fiduciary responsibilities to its investment advisory clients that may conflict with its fiduciary responsibilities as an executor of an estate, trustee of a trust and officer or director of a charitable organization."); *In re Elite Investment Advisors, LLC*, 2016 Mo. Sec. LEXIS 75, *17-18 (Mo. Sec. Comm'n Dec. 22, 2016) (breach of fiduciary duty to charge excessive management fees and invest "all client assets in the same or similar investments regardless of a particular client's investment profile or risk tolerance."); *In re Mitchell*, 2010 Mo. Sec. LEXIS 59, *17-18 (Mo. Sec. Comm'n Dec. 30, 2010) (breach of fiduciary duty to fail to offer alternative that would have allowed client to avoid surrender penalties); *In re TriCor Advisory Services, LLC*, 2013 Nev. Sec. LEXIS 37, *4-5 (Nev. Sec'y of State Jan. 31, 2013) ("An Investment Adviser is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own."); *In re Ameriprise Fin., Inc.*, 2007 N.H. Sec. LEXIS 2, *8-9 (Oct. 22, 2007) (breach of fiduciary duty for adviser to allow "a culture where compliance officers were ignored, and bullied when their opinions conflicted with those of management."); *In re American Express Fin. Advisors, Inc.*, 2005 N.H. Sec. LEXIS 2, *13-14 (Feb. 17, 20015) ("Travel, expense reimbursements, and attendance by advisors at special events were awarded to top producers. As a result of this scheme and course of conduct, the Respondent's primary loyalty and fiduciary responsibility to its advisory clients was breached in favor of the profit making motives of the Respondent. E-mails obtained by the Bureau during this investigation identify the true motives of the Respondent."); *In re Pantenburg*, 2012 Oh. Sec. LEXIS 26, *27-30 (Ohio Dep't of Com. Nov. 30, 2012) ("As a trusted fiduciary and advisor to Mr. Stamm, Respondent had a duty to protect his client's funds and inform his interest in the subsequent purchase of MAS stock."); *In re Maynard*, 2004 Vt. Sec. LEXIS 6, *51-52 (Feb. 4, 2014) ("Mr. Maynard had a fiduciary duty to the LIMCO investors to keep them informed of what was happening to their investments and how their money was being spent."); *In re Fuqua*, 2009 West Vir. Sec. LEXIS 60, *14-15 ("Fuqua and KHF Advisors were fiduciaries of their investment advisory clients. As such, they owed their clients a duty of honesty, undivided loyalty, fair-dealing and full disclosure.").

Burns, 167 Ohio App.3d at 828 (citing *Leib v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978)). The Commission has also recognized the public policy rationale in extending these elevated obligations to broker-dealers where "they have by a course of conduct placed themselves in a position of trust and confidence as to their customers." *In re Arleen Hughes*, Exchange Act Release No. 4048, 27 SEC 629, at *19.

Cognizant of the cachet associated with fiduciary status, industry participants have sought to market themselves as fiduciaries. In a recent North Carolina administrative action, the state securities regulator took action against a company registered as both an investment adviser and insurance firm for marketing that tended to mislead investors into believing that the insurance side was acting in a fiduciary capacity.

> RMFAG touted the investment adviser fiduciary standard and, when doing so, implied that RMFI was held to the fiduciary standard and that other financial professionals could not be trusted because those professionals were not held to the same standard. For example: In seminar presentation materials, RMFAG showed prospective clients a picture of a pyramid. The pyramid was divided into three levels that represented different duties of care to prospective clients. At the top of the pyramid was the word "Fiduciaries. " At the bottom of the pyramid were the words "Life Ins. Agents and Annuity Sales People." The presenter did not associate RMFI or its representatives with the insurance agents at the bottom of the pyramid. The slide that followed the pyramid slide described above read: "4 out of 5 investors believe their financial professional is a fiduciary. The truth: RIAs make up only about 25% of the industry." The slide failed to explain that RMFI was an insurance agency (not an investment adviser), and therefore not required to act as fiduciary under North Carolina law.

In re Raymond Marx Financial Advisory Group, Inc., 2018 N. Car. Sec. LEXIS 18, *1 (NC Dep't Sec. of State Oct. 2, 2018). In that case, the company used the investment adviser business to act as a solicitor for the insurance business as well as a third-party RIA where clients would be offered one or more of the insurance products that RMFI was incentivized to sell. The agency held that these practices breached the investment adviser's "duty to act primarily for the benefit" of its clients." *Id.*

Like the Commission, states generally rely on *Capital Gains* as support for these broad fiduciary obligations. *In re VI Capital Mgmt*, 2018 Wa. Sec. LEXIS 1, *2 (Wash. Dep't Fin. Inst. Mar. 4, 2018) ("Investment advisers have a fiduciary duty to their clients that requires them to subordinate their own interests to those of their clients. . . . An investment adviser must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss." (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963)); *In re McGee*, 2013 S. Car. Sec. LEXIS 35, *5-6 (SC Att'y Gen. June 10, 2013) ("26. In order to satisfy his fiduciary duty to his clients, McGee is required to put his clients' interests above his own, to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser to render advice which was not disinterested, and employ utmost

good faith and full and fair disclosure of all material facts as well as an affirmative [*6] obligation to employ reasonable care to avoid misleading.“) (also citing *Capital Gains*).

The Commission itself has recognized that disclosure may not be sufficient in certain situations. For example, excessive advisory fees and compulsory arbitration clauses cannot be mitigated through disclosure. 1 Investment Advisers: Law & Compliance § 8.03 (2018) (citing *Shareholder Servs. Corp.*, SEC No Action Letter,1989 SEC No-Act. LEXIS 159 (Feb. 3, 1989); *H&H Invs.*, SEC No-Action Letter, [1981–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,060, 1981 SEC No-Act. LEXIS 4124 (Sept. 17, 1981); *In re Roman S. Gorski*, Inv. Adv. Act Rel. No. 214, 1967 SEC LEXIS 926 (Dec. 22, 1967)).

The Commission should make clear in the final release that the Advisers' Act fiduciary duty is not simply one that can be met through the disclosure of conflicts of interest. This approach does a disservice to investors. Further, it serves a narrative that the proposed best interest standard is more robust than the Advisers' Act standard and this narrative, frankly, fails to advance the goal of strengthening investor protection. Rather, to the extent the Advisers' Act standard has weaknesses the Commission should address such weaknesses and the same can be said for the proposed best interest standard for broker-dealers. This business model neutral approach is a win-win for investors.

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Thank you for considering our additional comments. Please contact NASAA's executive director Joseph Brady at jb@nasaa.org should you have any questions about our comments.

Sincerely,

Michael Pieciak
NASAA President
Commissioner, Vermont Department of Financial Regulation