Statement for the Record of Paul Schott Stevens
President and CEO of the Investment Company Institute

Hearing on "Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight"

Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services

United States House of Representatives

September 13, 2011

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S.-registered investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs) (collectively, "registered funds").[1] I very much appreciate the opportunity to submit this statement in connection with the Subcommittee's hearing on the regulation and oversight of broker-dealers and investment advisers.

The fund industry has a significant interest in the subject of this hearing. Investors in more than 30 million U.S. households own registered funds purchased through or with the help of financial professionals such as broker-dealers and investment advisers.[2] The strength of the regulatory regime that applies to those financial professionals, the standard of care applicable to each, and the effectiveness of the system of oversight are issues of great importance to these millions of investors.

This statement describes ICI's positions on three issues: (1) the appropriate standard of care applicable to broker-dealers when providing personalized investment advice about securities to retail customers, which was the subject of the study mandated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"); (2) ways to provide enhanced examination resources for investment advisers, which was the subject of the study mandated by Section 914 of the Dodd-Frank Act; and (3) the need for improved product-neutral point-of-sale disclosure by financial intermediaries of all types.

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[1] ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of registered funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.9 trillion and serve over 90 million shareholders.

[2] *See 2011 Investment Company Fact Book*, available at http://www.icifactbook.org, at Chapter 6, Figures 6.1 and 6.7.

Section 913 and Fiduciary Duties

The SEC staff delivered its study mandated by Section 913 to Congress in January.[3] It recommended, among other things, that the SEC exercise its discretionary rulemaking authority to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when they are providing personalized investment advice about securities to retail investors. Importantly, the study recommended that the uniform standard of conduct be "no less stringent" than the fiduciary duty that applies to investment advisers today. Our positions on the recommendations in the 913 Study and the timing of implementing rulemaking are set forth below.

Recommendations in the 913 Study

ICI agrees with the basic recommendations in the 913 Study. We, too, believe that the SEC should establish a fiduciary standard for broker-dealers that provide personalized advice or recommendations about securities to retail customers. When acting in this capacity, a broker-dealer is performing substantially the same function as an adviser, and the legal distinctions between the two are often unclear and largely irrelevant to investors.[4] And if the conduct is substantially the same, the same standard should apply. In both contexts, the customer deserves a strong, fiduciary standard of care that puts his or her interests above those of the intermediary. As SEC Chairman Mary L. Schapiro recently stated, it is "difficult to justify why there should be different rules and standards of conduct for the two roles—especially when the same or substantially similar services are being provided. Investment professionals' first duty must be to their clients."[5]

We also agree with the 913 Study's recommended approach to implementation—namely, that the SEC would adopt rules establishing the new uniform fiduciary standard for advisers and broker-dealers as an "overlay" to supplement, and not supplant, the existing investment adviser and broker-dealer regimes. We support that approach because it would preserve the strong fiduciary standard that applies to investment advisers, along with existing precedent, while applying the same high standard to both advisers and brokers when they are providing substantially similar services to retail clients.

In crafting such rules, the SEC must take care to apply the fiduciary standard to broker-dealers in a way that will not chill legitimate practices. For example, broker-dealers should be permitted, consistent with a fiduciary duty, to:

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[3] Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers* (January 2011), available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf ("913 Study").

[4] *See* LRN-RAND Center for Corporate Ethics, Law, and Governance, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (March 2008).

[5] Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission, Testimony on "Enhanced Oversight After the Financial Crisis: The Wall Street Reform Act at One Year" Before the United States Senate Committee on Banking, Housing and Urban Affairs (July 21, 2011), available at http://www.sec.gov/news/testimony/2011/ts072111mls.htm#P39_10026.

- Maintain a commission-based business that does not involve the provision of personalized advice. Simply selling an investment product should not be a fiduciary act.

- Limit the scope, nature, and anticipated duration of the relationship with the customer. An adviser's fiduciary duty is not unlimited in scope; a broker's should not be either.

- Sell proprietary investment products. Both advisers and brokers must be able to disclose any material limitations on the range of investment products about which they advise clients, and whether similar products are available outside that range.

- Offer the use of financial calculators or similar investment tools for general informational purposes without, in most instances, taking on fiduciary status (although we recognize that the use of these types of tools may, in some circumstances, entail the provision of personalized advice).

- Execute unsolicited trades without taking on fiduciary status.

- Service orphaned accounts without taking on fiduciary status.

- Engage in trading as principal, subject to appropriate limitations, disclosure, and customer consent.

We recognize that this last point on principal trading is one of the more difficult areas that the SEC will need to address through its rulemaking. There is the potential for self-dealing when any fiduciary—whether a broker-dealer or adviser—acts as principal in transactions with customers. The SEC must address this potential conflict, but also must recognize that dealer activities like trading as principal have the potential to benefit customers through enhanced liquidity, expanded investment choices, and better execution of trades. As a model, the SEC could look to Section 206(3) of the Investment Advisers Act of 1940 ("Advisers Act"), which governs principal and agency cross-trades between advisers and their clients.[6] It should recognize, however, that imposing all of the requirements of that section, including trade-by-trade disclosure and customer consent, may not be warranted for broker-dealers, particularly given demonstrated difficulties that advisers have faced in complying with this regime.[7]

There is one final element of the 913 Study that we would like to highlight for the Subcommittee. In several places, the 913 Study states that the SEC staff has taken the position that a

[6] Section 206(3) makes it unlawful for an adviser, acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to the transaction. *See* pages 24–27 of the 913 Study for a more complete description of Section 206(3).

[7] We would encourage the SEC to use this opportunity also to revisit its interpretations under Section 206(3) for registered investment advisers.

person's receipt of transaction-based compensation (i.e., commissions) is a hallmark of broker-dealer activity, and that investment advisers receiving transaction-based compensation would need to consider whether they are obligated to register as broker-dealers under Section 15 of the Securities Exchange Act of 1934.[8] As the standard of care for broker-dealers and advisers is harmonized, the label applied to the type of compensation they receive should no longer be relevant. Advisers and broker-dealers providing personalized investment advice or recommendations should equally be permitted to receive—and share—both asset-based fees and commissions.

Rulemaking Necessary to Implement the 913 Study's Recommendations

The Subcommittee has asked witnesses for their views on whether the SEC should move forward with this rulemaking, and, more specifically, whether SEC action could create potential problems in light of the standard of care rulemaking proposed by the Department of Labor. We believe it is important for the SEC to move forward with this rulemaking. It has a number of initiatives on its agenda that are related to the sale of fund shares, including changes to the rule governing distribution fees (Rule 12b-1) and point-of-sale disclosure (discussed below). In order to address most thoughtfully the entire range of distribution-related issues facing it, we believe the SEC first ought to resolve the debate over the appropriate standard of care applicable to broker-dealers, and then address point-of-sale disclosure, confirmation disclosure, and Rule 12b-1.

With respect to DOL's rulemaking, it is important to understand that DOL and the SEC proceed from different statutory frameworks. While there are similarities in ERISA and the securities laws about the general obligations that attach to fiduciaries, there are also important differences. For example, an ERISA fiduciary is subject to strict prohibited transaction rules that apply only to ERISA fiduciaries. Because of these rules, compensation arrangements that are common and legal from the SEC's perspective could become illegal, absent an exemption, if a person or firm is deemed an ERISA fiduciary.

The separate debates at DOL and the SEC need not pose a regulatory conflict. Indeed, in both contexts, the Institute supports assuring that individual investors are protected by an appropriate legal duty *when receiving personalized investment advice*, as long as that duty is crafted such that it does not chill legitimate practices and investors do not lose access to the investment products and services that meet their needs. That said, the ongoing debates are an example of the potential for regulatory hodgepodge, and it is important that neither regulator act in a vacuum.

[8] *See* 913 Study at n.164, Section II.B.2, and n.514. The SEC elsewhere has sought comment on whether the opposite is also true—whether a broker-dealer's receipt of ongoing compensation such as 12b-1 fees might require it to register as an investment adviser. *See Mutual Fund Distribution Fees; Confirmations*, SEC Release Nos. 33-9128; 34-62544; IC-29367 (July 21, 2010), at 124–25.

The Future of Adviser Oversight

ICI and its members strongly support a vigilant and effective examination program for investment advisers. The trust that over 90 million investors place in registered funds is in no small part due to the rigorous regime under which funds and their advisers operate. As required by Section 914 of the Dodd-Frank Act, earlier this year the SEC staff undertook a study considering the need to enhance investment adviser examinations.[9] The staff concluded that "the Commission likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency."[10] The study recommended that Congress consider several potential options to strengthen the SEC's examination program. We provide our perspectives on these options below.

The SEC Should Remain the Primary Regulator for Investment Advisers to Registered Funds and Their Affiliates

We believe it is imperative that the SEC continue to serve as the primary regulator for investment advisers that advise registered funds, in light of the size and importance of these funds. In addition to being regulated under the Advisers Act, advisers to registered funds must comply with the Investment Company Act of 1940 ("Investment Company Act") and its rules, which—along with a robust body of formal and informal staff guidance—create a comprehensive framework governing all aspects of the registered fund business. Consistent with this, in its examinations of registered fund complexes, the SEC staff typically reviews not only the registered funds, but all of their service providers, including advisers, principal underwriters, administrators, and transfer agents. In addition, the SEC's examination staff and its rulemaking staff have a close working relationship that fosters the application of existing rules and the development of new ones. The SEC benefits from having its examination staff "on the ground" and reporting back on potential concerns or rulemaking suggestions, while SEC examiners benefit from the guidance of the rulemaking staff and knowledge of its policies and objectives.[11] While not immune from problems, this regulatory framework has proven to be extraordinarily successful in safeguarding the interests of some 90 million investors while also allowing for the growth of a competitive and innovative industry that today boasts nearly $13.6 trillion in assets

[9] Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, *Study on Enhancing Investment Adviser Examinations* (January 2011), available at http://www.sec.gov/news/studies/2011/914studyfinal.pdf ("914 Study").

[10] *Id.* at 3.

[11] Indeed, Section 965 of the Dodd-Frank Act requires compliance examiners to be placed in the Divisions of Investment Management and Trading and Markets, likely to further facilitate this important relationship.

under management.[12] It also has provided the SEC with 70 years' worth of irreplaceable institutional knowledge, experience, and continuity.

We appreciate that the SEC has concerns about whether its resources are, or in the future will be, sufficient to allow it to fulfill adequately its regulatory obligations to oversee all registered investment advisers under its jurisdiction. We believe this is a particular risk with respect to smaller investment advisers due to the "risk-based" approach the SEC staff takes when allocating examination resources. Under this risk-based approach, the staff focuses its examination resources on those advisers that, among other things, have greater assets under management, and thus could harm more investors in the event of poor internal controls or malfeasance.[13] As a result, registered fund complexes tend to have more frequent examinations than smaller advisory firms. We believe that efforts to reform the examination program should focus primarily on efforts to fill this gap in oversight. We believe these concerns could be addressed by either of two primary options the SEC staff presented in the 914 Study.[14]

SROs for Registered Investment Advisers

One option the SEC staff recommended that Congress consider is authorizing one or more self-regulatory organizations (SROs) to examine SEC-registered investment advisers, subject to SEC oversight. We previously have expressed some concerns with delegation of SEC oversight of all registered investment advisers to one or more SROs,[15] but in recognition of the importance of ensuring that smaller, retail-facing advisers are subject to meaningful oversight, have given much thought to a middle ground. In our view, requiring registered funds and their affiliates to remain subject to SEC oversight,[16] with other registered investment advisers to be overseen by an SRO, provides a reasonable

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[12] Source: ICI data. As of June 30, 2011, mutual funds had $12.228 trillion in assets, ETFs had $1,077.3 trillion in assets, and closed-end funds had $241 billion in assets. As of December 31, 2010 (the most recent data available), UITs had $50.1 billion in assets.

[13] *See, e.g.,* United States Securities and Exchange Commission, 2004-2009 Strategic Plan, at 32, available at http://www.sec.gov/about/secstratplan0409.pdf ("The SEC will fully implement a risk-based methodology for selecting and setting examination and inspection cycles for investment advisers and funds. Larger or higher risk entities will be examined more frequently to ensure that the agency quickly identifies problems before they affect large pools of savings."); *see also* Remarks at the IA Watch Annual IA Compliance Best Practices Seminar by Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission (March 21, 2011), available at http://www.sec.gov/news/speech/2011/spch032111cvd.htm.

[14] We believe that the third option discussed in the 914 Study, that of having an SRO with responsibility only for "dually registered" entities (those registered as both advisers and broker-dealers), has less merit. Many financial services complexes have one or more advisers that are dually registered, and other advisers that are not. Under this approach, advisers within the same complex would be subject to differing regulatory oversight and interpretations.

[15] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated October 25, 2010, available at http://www.sec.gov/comments/df-title-ix/enhancing-ia-examinations/enhancingiaexaminations-6.pdf.

[16] As discussed below, there may be other entities that similarly should remain with the SEC.

way to fill the gap in oversight, while preserving the robust examination program the SEC currently follows for registered funds and their affiliates.

This option must be carefully designed to avoid duplicative regulation. This could be accomplished, in part, by ensuring that fund advisers and other institutional advisers that already are subject to substantial SEC regulation, along with their affiliates, remain under SEC oversight. In addition to fund advisers, institutional advisers that could remain subject to SEC examination might include those that advise private funds, ERISA plans, collective trust funds, endowments, foundations, non-U.S. clients, and other institutional clients. Under this option, we would recommend that if 90 percent or more of the assets under management of a registered investment adviser were attributable to such institutional clients, the adviser would remain subject to SEC oversight. In addition, we would recommend that other registered investment advisers under common control with the adviser remain subject to SEC oversight, in order to avoid the inconsistencies that would result if commonly controlled advisers were subject to examination by two different regulators. For example, advisory complexes frequently use one trading desk for all their affiliates' trading activity, and often have common compliance policies, procedures and personnel. Having advisers potentially subject to different interpretations that could affect these and other areas likely would create confusion and the potential for inadvertent compliance violations. Having the SEC continue to focus on this segment of the advisory industry would preserve its institutional knowledge for those firms currently receiving examination attention. An SRO would have responsibility for those entities that rarely, if ever, receive a regulator visit.

Imposing User Fees on SEC-Registered Investment Advisers

Another option the SEC staff outlined would involve requiring SEC-registered investment advisers to pay user fees to the SEC to fund the cost of their examinations. We believe this also may be a viable option to address the SEC's resource concerns. Under this approach, all registered investment advisers would remain subject to examination by their primary regulator, the SEC. User fees could be assessed based on objective factors, established by SEC rulemaking, such as the number and types of clients an investment adviser has and the amount of its assets under management.

This regime must, however, distinguish between those entities that currently pay fees for their regulation and those that do not. For fund complexes, the calculation of assets under management should exclude assets managed in registered funds. These funds already pay asset-based registration fees pursuant to the Investment Company Act. We note that the existing examination process for registered fund complexes which includes, as discussed above, a review of a fund's advisers and other service providers, is already far more rigorous than that of other products and services offered by registered investment advisers. We are not aware of any recent criticism of the SEC in this respect.

We would be pleased to work with the Subcommittee to further develop either of these concepts, particularly as they might apply to registered funds.

"Point-of-Sale" and Other Disclosure Initiatives Relating to Potential Intermediary Conflicts

Although we understand that today's hearing will focus on the studies mandated by Sections 913 and 914, we would encourage the Subcommittee to consider a broader, related issue—the pressing need for better product-neutral "point-of-sale" disclosure by both broker-dealers and investment advisers.

The SEC is studying new point-of-sale disclosure rules pursuant to mandates in the Dodd-Frank Act.[17] At the same time, FINRA is considering imposing new revenue sharing disclosure rules on broker-dealers that sell registered funds,[18] while also contemplating a broader conflicts disclosure document that brokers could provide customers at the beginning of their relationship.[19] While we strongly support many of these initiatives in concept, we question those that single out registered funds.

ICI has long supported enhanced disclosure to help investors assess and evaluate a broker's recommendations.[20] Certain compensation structures have the potential to influence financial intermediaries' recommendations to their clients, such as by creating incentives to inappropriately favor some products over others. To enable investors to assess these incentives and make better informed investment decisions, we believe financial intermediaries should be required to provide relevant disclosure for all retail investment products they sell, including variable annuity contracts and separate accounts. From an investor perspective, the need for this type of disclosure is neither intermediary-specific nor product-specific. It is equally important for both broker-dealers and investment advisers, and equally important for all retail investment products—not just registered funds.[21]

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[17] The Section 913 Study recommended that the SEC "facilitate the provision of uniform, simple and clear disclosures to retail customers about the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest" and "consider the utility and feasibility of a summary disclosure document containing key information on a firm's services, fees, and conflicts and the scope of its services." In addition, Section 917 of the Dodd-Frank Act requires the SEC to conduct a study regarding financial literacy among investors. The Section specifically requires the SEC to identify, among other things: (1) "methods to improve the timing, content, and format of disclosure to investors with respect to financial intermediaries"; (2) "the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service that is typically sold to retail investors"; and (3) "methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products." A report is due to Congress by July 2012.

[18] *See* FINRA Notice of Filing of Proposed Rule Change and Amendment No. 1 to Adopt NASD Rule 2830 as FINRA 2341 (Investment Company Securities) in the Consolidated FINRA Rulebook, 76 Fed. Reg. 26779 (May 9, 2011). Although this particular proposal has since been withdrawn, we believe it nevertheless evidences FINRA's continued interest in pursuing this rulemaking.

[19] *See* Disclosure of Services, Conflicts and Duties, FINRA Regulatory Notice No. 10-54 (October 2010).

[20] *See, e.g.,* Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the U.S. House of Representatives Subcommittee on Capital Markets and Government Sponsored Enterprises on "Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence" (June 24, 2011), available at http://www.ici.org/pdf/11_house_mf_oversight_tmny.pdf; and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated May 31, 2011, available at http://www.ici.org/pdf/25232.pdf.

[21] *See, e.g.,* Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the U.S. House of Representatives Committee on Financial Services on "Industry Perspectives on the Obama Administration's Financial

We recognize that developing such disclosure is a substantial undertaking, and requires careful consideration of a number of issues. For example, regulators must understand how disclosures could be made most efficiently and with minimal disruptions to the sales process. To the extent that disclosures may be made orally to investors transacting over the telephone, mechanisms for tracking compliance must be considered. The appropriate substance of the disclosure, possibly including information about broker compensation and conflicts of interest, must also be determined.

We are pleased that the Dodd-Frank Act directed the SEC to consider these issues through the studies in Sections 913 and 917. We also support the product-neutral approach of Section 919 of the Act, which expressly affirms the SEC's authority to require broker-dealers to provide information to retail investors with respect to *any* product or service the investor may purchase.

We urge Congress to continue to view broker disclosure as a critical need for retail investors across *all* products, and to discourage regulatory initiatives that would single out registered funds. Requiring point-of-sale disclosures only prior to selling registered funds would create incentives for broker-dealers and other intermediaries to sell products not subject to the same requirement, even when those products are potentially less suitable or do not offer the same level of regulatory protection and other benefits for investors. As former NASD Chairman Robert Glauber said, "[a]n investor should be sold a security because it's right for him or her, not because it's easier to sell than something else."[22]

Conclusion

We appreciate the opportunity to share our views with the Subcommittee, and we look forward to working with Congress and regulators as they seek to address these many important issues in the best possible way for the millions of American investors who rely on registered funds to achieve their investing goals.

Regulatory Reform Proposals" (July 17, 2009), available at http://www.ici.org/govaffairs/testimony/09_reg_reform_jul_tmny.

[22] *See* Remarks by Robert Glauber, Chairman, NASD, at the Investment Company Institute's 2006 General Membership Meeting (May 18, 2006), available at http://www.finra.org/PressRoom/SpeechesTestimony/RobertR.Glauber/p016642. Similarly, in the context of Rule 12b-1, Barbara Roper of the Consumer Federation of America stated that by considering fee disclosures as "a mutual fund issue, instead of a broker compensation issue, sort of more holistically, you run the risk that you make mutual funds less attractive to sell. And I think that would be a very bad thing." *See* Remarks by Barbara Roper, Director of Investor Protection, Consumer Federation of America, at the Securities and Exchange Commission's 12b-1 Roundtable, Unofficial Transcript, p. 196, available at http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf.