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Reg BI threatens affiliate fund sales, advisory fees

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The **Securities and Exchange Commission**'s best interest rule could put a serious damper on sales of proprietary mutual fund products and potentially require some fund advisers to give up fund management fees. That is one of the key concerns of the mutual fund industry as it formally weighs in on the SEC's proposal for this first time this month.

The SEC earlier this year proposed a suite of three new rules aimed at changing the standards of conduct and disclosure for broker-dealers and investment advisers. The centerpiece of the proposals is Regulation Best Interest, which would oblige B-Ds to act in the best interest of their customers. The agency also made plans to create the new Form CRS — on which B-Ds and IAs would have to explain to clients the nature of their relationship, the fees they charge, and any potential conflicts — and proposed a clarification of the existing conduct standard for advisers.

As the comment period on the proposals closed Aug. 7, the fund industry was sounding the alarm that the commission's plans could unnecessarily crimp sales of proprietary fund products. The SEC's current plan could both make it more difficult for firms to sell proprietary funds and potentially require affiliated mutual fund advisers to give up their advisory fees. Many of the largest mutual fund shops have affiliated brokerage arms and could be impacted.

The issue stems from the particular way the SEC wants brokers to address conflicts of interest. The proposed best interest requirement would require B-Ds to have compliance policies in place ensuring that they would both disclose any material conflicts of interest, and "mitigate or eliminate those material conflicts of interest arising from financial incentives."

"It's very difficult to try to identify material conflicts of interest that don't have a financial basis to them," said **Dechert** Partner **K. Susan Grafton**, who met with agency staffers in June to discuss the proposal. "It would be helpful for the SEC to give examples of what they had in mind, or

ultimately to combine those two concepts in a way that makes clear when it is appropriate to have disclosure only, and when elimination or mitigation are required."

The proposal would require financial conflicts to be eliminated at the firm level, rather than at the level of the individual representative, a requirement that goes beyond the standard laid out in the **Department of Labor**'s recent fiduciary rule, making it a conflict of interest under the rule for a broker to recommend proprietary funds over third-party products, the **Investment Company Institute** has said.

"A broker-dealer (like an investment adviser) should be permitted to address material conflicts at the *firm level* by disclosing them, and not further mitigating or eliminating such conflicts, as long as they do not otherwise result in a material financial incentive to the broker-dealer representative making the recommendation," wrote the ICI's **Paul Schott Stevens**.

So long as an individual representative doesn't get paid more money for sales of proprietary funds over third-party funds, a B-D shouldn't have to mitigate or eliminate the firm-level conflicts associated with such sales, the ICI argues.

There has definitely been confusion over the disclosure obligations in the rule, which stake out new territory for B-Ds, said **Drinker Biddle & Reath** Partner **James Lundy**, a former branch chief in the SEC's enforcement division. "Depending on materiality you have may have to mitigate – that concept doesn't exist in the disclosure regime that has governed IAs for decades."

As it stands, "Reg. BI can be more strict than the [standard under the Investment Advisers Act] in that it requires removal of conflicts rather than disclosure of conflicts," agreed **Ropes & Gray** Counsel **David Tittsworth**, the former president of the **Investment Advisers Association**.

Losing advisory fees

The fund industry group also expressed concern that the current proposal could force the advisers of mutual funds affiliated with B-Ds to give up their advisory fees. In the proposal the commission explained that a B-D could fulfill its conflict of interest obligation by, "in the case of conflicts related to affiliated mutual funds, crediting fund advisory fees against other broker-dealer charges – thus effectively eliminating the material conflict of interest."

The proposal suggests that a fund adviser would have to relinquish the fees it charges for managing an affiliated mutual fund, said the ICI's Stevens, arguing that such a requirement is inconsistent with the Dodd-Frank Act, which said that "the sale of only proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation" of a potential standard of conduct.

The ICI also noted that the proposed duty of care that would be imposed on B-Ds would prohibit them from recommending a security that is more costly than a reasonably available alternative. The proposal seems to suggest that this could oblige a B-D to consider investment options beyond those

it already offers, the ICI said, asking the SEC to confirm that it would still be permissible for a B-D to offer only a limited range of fund products, including proprietary products.

With the comment period closed, the commission and its staff will now be reviewing the several thousand comments – many of them form letters – that it has received on the proposal, and considering potential revisions.

"There is still a long road to go and getting the comments [are] a significant piece of the puzzle," Tittsworth said. "But you are looking at a long time before a potential commission vote on any of these rules."
