Speech

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Introduction

Good morning. Thank you, Barry [Barbash] and Paul [Roye], for that kind introduction.[1] Thank you also for inviting me to join you today.

Barry, Paul and I are going to mix up the format a little this morning. I have some prepared remarks, but afterward, we are going to sit down for a chat. In my remarks this morning, I am going to touch on two areas of work that reflect our efforts to be a responsive regulator that seeks engagement from all as we develop regulatory policies: the standards of conduct for investment professionals and liquidity risk management.

Before I dive in, let me pause for the disclaimer. I am speaking today only for myself and not for the Commission, the Commissioners or the staff.[2]

Standards of Conduct for Investment Professionals

The Commission recently proposed for public comment a significant rulemaking package on the standards of conduct for investment professionals.[3] The proposals are intended to serve Main Street investors by bringing the legal requirements and mandated disclosures of investment professionals in line with investor expectations. They reflect over two decades of thought on questions of law and policy that are not easy.

Naturally, as folks have begun to dive into the proposals, various questions are beginning to percolate. I would like to share some thoughts on a few questions that may arise as you review the three parts of the proposed rulemaking – (1) providing clarity to retail investors about investment professionals, (2) enhancing the standard of conduct for broker-dealers, and (3) clarifying the standards of conduct for investment advisers.

Providing clarity to retail investors. We want investors to be able to understand what type of investment professional they are dealing with, how they differ, and why it matters. To that end, under the proposed rules, each firm would need to be direct and clear about whether it is a registered investment adviser, a registered broker-dealer, or both in its communications with investors and prospective investors. In addition, the proposed rules would restrict standalone broker-dealers and their financial professionals from using the terms “adviser” and “advisor.” These terms are so similar to the statutory term “investment adviser” that their use in these situations may mislead the broker-dealer’s prospective customers.

To help educate investors about whether they are talking to a broker-dealer, an investment adviser, or both and why that matters, firms would also be required to provide investors with a new, succinct disclosure that we call a "Relationship Summary." I think it is a good sign that substantive debate around this proposal has already started. Some have asked, would the Relationship Summary really be that helpful to investors? Could the design of the Relationship Summary be improved?

On the first question, I do believe a Relationship Summary would serve as a valuable tool for investors. It would highlight key differences between broker-dealers and investment advisers, including (1) the principal types of services offered, (2) the legal standards of conduct that apply to each, (3) the fees the customer would pay, and (4) certain conflicts of interest that may exist. Advisers and broker-dealers would also need to include relevant questions for investors to ask.

Is there room for improvement? That is exactly what we want the public to help answer. As I said before, these proposals are designed to serve Main Street investors. We want investors, together with consumer groups and the financial professionals who serve them, to help us get it right. We also want to hear from experts in financial literacy, information design, and marketing.

For investors in particular, there are two great ways to provide feedback. First, you can go to the SEC website and use the fillable form to provide your views on a few key questions. Second, we are planning to hold several roundtables around the country where Main Street investors can give us their feedback directly.[4] These will help us shape this important disclosure.

Raising the standard of conduct for broker-dealers. The proposals would not rely on disclosure alone to achieve their purpose – they would also raise the bar for how broker-dealers must treat their customers. Specifically, Regulation Best Interest (or "Reg. BI") would create a duty under the Exchange Act for a broker-dealer to act in the best interest of its retail customer, without putting the broker-dealer's interest ahead of those of the customer.

At the same time, the proposal would seek to preserve the pay-as-you-go broker-dealer model by recognizing how it differs from the investment adviser model. This is important because – despite what some clothing labels may tell you – one size does not fit all. Likewise, I would never tell someone that an adviser is always the perfect fit – just as I would never say that about a broker-dealer. The right investment professional depends on the investor's preferences.

So, given that this is Regulation Best Interest, why is the term "best interest" not defined in the proposal? Although we have not defined the term in the proposed rule text, we have defined the contours of the obligation: a broker-dealer cannot put its interests ahead of the retail customer's and must comply with specific disclosure, care and conflict of interest obligations. As advisers know, a principles-based standard can serve Main Street investors well. Again, one size does not fit all – this approach would provide valuable flexibility to recognize how customers vary from each other and how the industry may change over time.

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.

How does Reg. BI compare to existing advice standards? Reg. BI draws from principles that apply to investment advice under other regulatory regimes, yet it reflects the structure and characteristics of a broker-dealer's relationship with retail customers. For example, both Reg. BI and the fiduciary duty of investment advisers require that the firm act in the best interest of the retail customer or investor. The main difference is when each of the obligations will apply. The duties required under Reg. BI are tied to each recommendation a broker-dealer makes, whereas an adviser's fiduciary duty applies to the ongoing relationship with a client. In addition, neither Reg. BI nor an adviser's fiduciary duty explicitly prohibits particular conflicts of interest.

Clarifying the standards of conduct for investment advisers. The Commission also proposed an interpretation to reaffirm and, in some cases, clarify the Commission's views on the investment adviser fiduciary duty standards. The interpretation would reaffirm that an investment adviser must act in the best interest of its client and owes its client a duty of care and a duty of loyalty. This means, for example, that an investment adviser may not favor its own interests over those of a client or unfairly favor one client over another. It also must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship. The interpretation would also clarify that disclosure about a conflict of interest should be sufficiently specific so that a client is able to decide whether to provide informed consent. The staff recommended proposing this interpretation in order to draw together a range of sources and provide advisers with a reference point for understanding their obligations to clients.

The proposal also includes requests for comment on several areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context.

As you can imagine, each of these proposals was a collaborative effort across many offices and divisions within the Commission, informed by years of public input, including recent comments received following Chairman Clayton's request for information last May. And the collaboration should not end now. Our doors are always open – we want to hear from you.

Liquidity Risk Management

Another area in which we have recently completed some important work is liquidity risk management. Investors in mutual funds and exchange-traded funds expect to be able to exit these funds promptly, and the 1940 Act requires redemption requests to be fulfilled within seven days. As a result, managing the liquidity of the fund's portfolio is a fundamental aspect of the adviser's responsibilities.

In 2016, the Commission adopted an important rule designed to promote effective liquidity risk management practices among open-end funds.[5] It was the end result of significant staff study of liquidity risks post-financial crisis and responsive to repeated and vocal concerns about the market effect of liquidity risks from both domestic and international regulators.

So what did the rule do? The rule established a new framework for understanding and managing liquidity risk by requiring all funds to adopt liquidity risk management programs. It also updated and enhanced outdated guidance regarding the 15% limitation on illiquid investments. And it introduced a new requirement for each fund to classify the liquidity of each investment into one of four "liquidity buckets."

In addition, the rule strengthened liquidity risk reporting to the Commission. For example, funds will be required to report the "liquidity buckets" confidentially to the Commission. This reporting will provide the Commission with visibility into liquidity assessments so that the Commission is better informed as it exercises its role as the primary regulator of funds.

As with any new rule, the staff's work did not end with adoption. The staff actively engaged in outreach with fund groups of various sizes and strategies. The staff also engaged with industry associations and fund service providers who expect to assist funds in implementing the rule. In the weeks and months that followed adoption, as funds and advisers began planning for implementation, good questions were raised about both how to implement certain aspects of the rule and whether the Commission and the staff could address certain unintended consequences.

In response to this feedback, the Division worked on three related projects. First, working with funds and others, the staff responded to a significant number of frequently asked questions.[6] The staff's responses were intended to address important implementation questions raised by funds and others as they sought to establish programs responsive to the rule's requirements. The FAQs include questions related to classification, sub-advisory relationships, ETFs and reporting.

Second, the Division recommended, and the Commission unanimously adopted, a rule to extend by six months the compliance date for the classification and related elements of the rule.[7] The extension is designed to give funds and service providers sufficient time to develop and test classification systems and also seek board approval of their programs. Other provisions of the rule that provide critical investor protection benefits – including the requirements to adopt a liquidity risk management program and to limit illiquid investments to 15 percent of the fund's portfolio – will go into effect as originally scheduled.

Finally, the Division recommended, and the Commission proposed, targeted changes to the rule's related public reporting requirement.[8] In addition to the confidential reporting I mentioned earlier, funds currently would be required to publicly disclose an aggregate fund "liquidity profile" on Form N-PORT. In other words, funds would disclose the total percentage of their portfolio investments that falls into each of the four buckets every quarter. The Commission adopted this aggregated reporting with a view to providing investors with insights on the liquidity risks of the funds in which they invest. In the course of our engagement, however, we heard repeatedly about the challenges related to this reporting. In particular, funds raised concerns that the inherently subjective nature of liquidity assessment could be misconstrued when presented in the manner required. Liquidity classification is a process that will rely on a wide variety of data, assumptions, algorithms and methodologies. Because of this, the information aggregated at this level may not be what it appears, particularly when placed alongside the information from another fund.

In light of this, the Commission issued in March a proposal that would address these challenges by modifying the public reporting.[9] The proposed changes would create a new requirement for funds to discuss their liquidity risk management programs in their annual shareholder reports. The idea is to arm investors with important information, along with appropriate context, to inform their investment decisions. This new reporting would replace the requirement for funds to disclose publicly aggregated liquidity buckets. To further inform investors and the markets of fund liquidity risk profiles, Commission staff also plan to publish anonymized, aggregated data in a report similar to the staff's reports on Form PF. In light of the extensive portfolio level liquidity data to be collected by the Commission, the proposal also tasks the staff with analyzing and presenting to the Commission recommendations on whether any further fund liquidity information may be publicly disseminated without risking the potential for predatory trading or raising concerns with respect to market and investor confusion. The comment period on the proposal ends May 18, and I encourage you to provide input.

Closing

As I hope you gleaned from my remarks today, we are hard at work. Quality engagement was extremely valuable to our efforts on investment professional relationships and liquidity. That kind of engagement is all the more valuable in the final rule recommendations we will need to make. And our work does not stop there. We are also working on a variety of other recommendations for the Commission's consideration including, for example, in the ETF space and the design, delivery and content of disclosure to fund shareholders.

Before I sit down to chat with Barry and Paul, I want to acknowledge the staff of the Division. Behind every disclosure review, every exemptive order, every report and every rulemaking, there is a staff member. And because we have a lot going on and there are just 180 of us, the staff is putting in some long hours these days. They are a tremendous and diverse group, and they are my favorite part about being back at the Commission.

With that, I am going to wrap up my prepared remarks and take some questions from Barry and Paul.

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[1] I would like to thank Naseem Nixon, Sarah ten Siethoff, and Zeena Abdul-Rahman for their assistance in preparing these remarks.

[2] The Securities and Exchange Commission (the "Commission") disclaims responsibility for any private publication or statement of any Commission employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

[3] See *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles,* Exchange Act Release No. 83063 (April 18, 2018); see also *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, Investment Adviser Act Release No. 4889 (April 18, 2018); see also *Regulation Best Interest*, Exchange Act Release No. 83062 (April 18, 2018).

[4] See *Statement on Public Engagement Regarding Standards of Conduct for Investment Professionals Rulemaking*, *available at* https://www.sec.gov/news/public-statement/public-engagement-standards-conduct-investment-professionals-rulemaking

[5] See rule 22e-4 under the 1940 Act [17 CFR 270.22e-4]; see also *Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No IC-32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)].

[6] See *Investment Company Liquidity Risk Management Programs Frequently Asked Questions*, *available at* https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq.

[7] See *Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs*, Investment Company Act Release No. 33010 (Feb. 22, 2018) [83 FR 8342 (Feb. 27, 2018)].

[8] See *Investment Company Liquidity Disclosure*, Investment Company Act Release No. 33046 (March 14, 2018) [83 FR 11905 (March 19, 2018)].

[9] See *Id*.

Related Materials

- Feedback on the Relationship Summary