

Fund Democracy

October 20, 2013

Via Electronic Filing

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: **File No. 265-28: Recommendations of the Investor as Purchaser
Subcommittee on Broker-Dealer Fiduciary Duty,
SEC Investor Advisory Committee**

Dear Ms. Murphy,

Fund Democracy greatly appreciates the opportunity to express support for the SEC Investor Advisory Committee's recommendation that broker-dealers be subject to a fiduciary duty when providing personalized investment advice to investors. As noted by the Committee, the existing regulatory regime "does not offer adequate investor protection when broker-dealers offer advisory services." Investors reasonably expect that broker-dealers' recommendations will be based on investors' best interests. They may rely on that expectation to their detriment, however, because broker-dealers are subject only to a suitability obligation, which permits them to sell products that, while technically suitable, may be intended to serve the best interests of the broker-dealer rather than their client.¹

Fund Democracy strongly endorses the Committee's recommendation to regulate broker-dealers as investment advisers under the Investment Advisers Act when they provide personalized investment advice or hold themselves out as advisers. Neither practice is consistent with broker-dealers' claim that their investment advice is "solely incidental" to their brokerage services and that on that basis they may rely on the broker-dealer exclusion from regulation under the Advisers Act.² The Committee's approach would mitigate the risk that different

¹ See, e.g., Report on Conflicts of Interest, FINRA at 4 (Oct. 2013) (even when broker-dealers' compensation grids pay a flat percentage of revenues, regardless of product recommended, "registered representatives still have an incentive to favor products with higher

² See Investment Advisers Act Section 202(a)(11)(C). The SEC staff's interpretation of "solely incidental" in the definitional exclusion for broker-dealers in the Advisers Act is overbroad, including scenarios in which it is the brokerage that is truly incidental to the investment advice.

fiduciary standards would apply to broker-dealers and investment advisers by applying the existing standard under the Advisers Act to both. This would be the most efficient way to ensure that investors receive an appropriate, uniform level of protection.

Fund Democracy also endorses the Committee's recommendation regarding rulemaking under Section 913 of the Dodd-Frank Act. As noted by the Committee, the fiduciary standard applicable to broker-dealers must be principles-based to ensure that it is not weaker than the standard under the Advisers Act. The alternative of applying an exclusively rules-based standard would result in an inflexible standard that facilitated evasion. The essence of the fiduciary duty arises from the relationship of trust and confidence between the financial professional and the client, not from a precisely definable, finite set of interactions reflected in a limited set of conduct-specific rules.³ A fiduciary standard that arises solely from a set of discrete, fact-based rules would provide inferior protection to investors and undermine the goal of uniform regulation of personalized investment advice.

While rulemaking should preserve broker-dealers' flexibility to receive different forms of transaction-specific advice, the Committee correctly observes that the Dodd-Frank Act mandates that the Commission consider rulemaking that specifically addresses forms of compensation that create conflicts of interest for financial professionals. As stated in a recent FINRA report:

Conflicts of interest can arise in any relationship where a duty of care or trust exists between two or more parties, and, as a result, are widespread across the financial services industry. While the existence of a conflict does not, per se, imply that harm to one party's interests will occur, the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly.⁴

The FINRA report catalogues the diverse and pervasive conflicts of interest in the broker-dealer industry that demonstrate the need for a fiduciary standard to protect investors. While broker-dealers contend that "there is no evidence that investors

³ See Michael Koffler, *Six Degrees of Separation: Principles to Guide the Regulation of Broker-Dealers and Investment Advisers*, 41 Sec. Reg. & Law Rep. 776 (Apr. 27, 2009) ("Given the equitable nature of fiduciary law, it is not tenable to set forth a fiduciary's responsibilities in a detailed manner or to specify a convention to govern their activity. Nor would it be in the public interest to do so. And it certainly would not be consistent with the way fiduciary law has evolved and been interpreted for hundreds of years.").

⁴ Report on Conflicts of Interest, *supra* note 1 at 1.

are being harmed by the current suitability standard,”⁵ FINRA correctly reports that “the history of finance is replete with examples of situations” in which broker-dealers’ conflicts of interest harm investors – yet these conflicts are not required to be disclosed, much less prohibited, under the suitability standard.

Another key to effective fiduciary rulemaking, also noted by the Committee, is the prevention of hat-switching by broker-dealers. Broker-dealers must not be permitted to provide their clients with a tailored financial plan that triggers a fiduciary duty only to shed that duty when the client implements the plan through the same broker-dealer. The relationship of trust and confidence created at the outset of the relationship leads investors to expect that the execution of the advice will also be required to reflect their best interests. Investors will reasonably expect that a continuing relationship will be subject to a continuing fiduciary duty.

Finally, Fund Democracy strongly supports the Committee’s recommendation that broker-dealers provide a document that discloses the most important information about its relationship with clients. The document should highlight the broker-dealer’s compensation arrangements and conflicts of interest in order to ensure that investors are equipped to make an informed decision *before* retaining an adviser. The document should be provided prior to the initial retention of the broker-dealer, just as an adviser’s brochure must be provided to clients prior to entering into an engagement.

As a member of the inaugural Investor Advisory Committee, I am especially pleased to see the Committee move forward on this issue. The Committee should be commended for its forceful stand and prudent recommendations. On behalf of Fund Democracy, I strongly encourage the Commission to follow the well-considered recommendations of the Committee’s business and investor representatives in

⁵ Letter from Kevin Carroll, Managing Director and Associate General Counsel, SIFMA to Elizabeth Murphy, Secretary, SEC (Oct. 11, 2013) *available at* <http://www.sec.gov/comments/265-28/26528-39.pdf>.

taking action to ensure that personalized investment advice is subject to a fiduciary standard regardless of the type of financial professional providing it.

Sincerely,



Mercer Bullard
President and Founder

cc: The Honorable Mary Jo White, Chair, SEC
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
Joseph Dear, Chair, SEC Investor Advisory Committee
Barbara Roper, Chair, Investor as Purchaser Subcommittee