

# JOSEPH CAPITAL MANAGEMENT, LLC

A FEE ONLY INVESTMENT ADVISORY FIRM

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March 8, 2005

Chairman and the Commissioners, S.E.C.  
c/o Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

Re: File No. S7-25-99; Proposed Rule: "Certain Broker-Dealers Deemed Not To Be Investment Advisers"

Dear Mr. Chairman and the Commissioners:

In the ongoing debate over the wisdom of the Proposed and Reproposed Rule I have sensed a lack of understanding, both within the Proposed Rule itself and in some of the comments submitted, of the all-important concept of a "fiduciary." In this correspondence, which supplements my several prior comments,<sup>1</sup> I address the all-important issue of the fiduciary duties imposed upon those who provide investment advisory services, and why the SEC's proposal to permit investors to "waive" fiduciary duties is inappropriate. Sections of this correspondence include:

- A. What Is The Nature of Fiduciary Status?
- B. Should Investors Be Able To Choose Fiduciary or Non-Fiduciary Status For Functionally Equivalent Professional Services?
- C. What Standards of Conduct Should Apply To Investment Fiduciaries?
- D. A Proposal for Restructuring the SEC's "Division of Investment Management" As The SEC's "Division of Investment Fiduciaries."
- E. The Fiduciary Duty Of Those Who Provide Investment Advisory Services Is The Critical Issue In Any Examination of The Proposed Rule.

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<sup>1</sup> See comments of Ron A. Rhoades dated February 17, 2004, April 5, 2004, August 30, 2004, November 7, 2004, and November 30, 2004, and comments of Joseph (sic) Capital Management, LLC dated January 24, 2005, to the January 7, 2005 (Re-)Proposed Rule, "Certain Broker-Dealers Deemed Not To Be Investment Advisers," available at <http://www.sec.gov/rules/proposed/s72599.shtml>. See also Rhoades, "The SEC's New Failure to Protect Investors: The Defeat of the Proper Application of Fiduciary Duties to Investment Advisory Activities," available at [www.srconsultant.com](http://www.srconsultant.com).

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“As the size and complexity of the investment management industry continues to grow, competitive and market pressures may work to compromise the fiduciary and ethical principles that form the bedrock of the advisory business.”

- Remarks before the ALI-ABA Course of Study,  
Investment Adviser Regulation  
by Paul F. Roye, Director, Division of Investment Management  
U.S. Securities and Exchange Commission  
Washington, DC  
January 28, 2005

A. What Is The Nature of Fiduciary Status?

The term "fiduciary" comes to us from Roman law, and means "a person holding the character of a trustee, or a character analogous of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires."<sup>2</sup> Fiduciaries have a duty, created by undertaking certain types of acts, to act primarily for the benefit of another in matters connected with such undertaking.<sup>3</sup> We utilize the term "fiduciary" to mark certain relationships where a party with superior knowledge and information acts on behalf of one who usually does not possess such knowledge and information. In these relationships the person with the dominant position (hereafter the "fiduciary") acts

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<sup>2</sup> Black's Law Dictionary, 5<sup>th</sup> Edition (1979).

<sup>3</sup> Id.

as if the interests of the other party (hereinafter the “client”)<sup>4</sup> were the fiduciary’s own. The greater the knowledge, experience and required degree of expertise of the fiduciary, relative to the knowledge and experience of the client, the more significant the fiduciary association becomes as a protector of the client’s interest. Interestingly enough, the Tully Report noted this important disparity between the provider of investment advice and the consumers of investment advice when it noted:

As a general rule, [brokers] and their clients are separated by a wide gap of knowledge–knowledge of the technical and financial management aspects of investing. The pace of product innovation in the securities industry has only widened this gap. It is a rare client who truly understands the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many. This knowledge gap represents a potential source of client abuse, since uninformed investors have no basis for evaluating the merits of the advice they are given.<sup>5</sup>

In other words, individual investors often start off, in their discussions with financial consultants, from a position of contractual weakness and, as to the complex operations of the securities markets and the vast array of products and techniques, from the position of relative ignorance. Fiduciary status is imposed by the law upon the party with the greater knowledge and expertise, in this instance the person seeking to provide investment advisory services, in recognition by the law that the client is in need of protection and care.

Each party to a fiduciary relationship possesses the opportunity to consent to the relationship or to terminate the relationship. Fiduciary rules therefore reflect a consensual arrangement covering special situations in which fiduciaries promise to perform services for clients and receive substantial power to effectuate the performance of the services in circumstances in which the clients cannot efficiently monitor the fiduciaries’ performance.

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<sup>4</sup> A generic word to designate the party to whom a fiduciary obligation is owed might be “entrustor.” Terms applied in specific contexts include client, patient, beneficiary, shareholder, partner, and ward. I choose to utilize the word “client” as the best fit for an “entrustor” in the context of the investment consulting relationship.

<sup>5</sup> Report of the Committee on Compensation Practices (April 10, 1995) (the “Tully Report”), at p. 15.

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Fiduciary relationships are relationships in which the fiduciary provides to the client a service that public policy encourages. When such services are provided, the law recognizes that the client does not possess the ability, except at great cost, to monitor the exercise of the fiduciary's powers. In this regard, the client may be incapable of understanding the (often multiple) conflicts of interest which the person with greater knowledge and expertise will possess, and may not understand the potential ramifications of such conflicts of interest. Moreover, usually the client cannot afford the expense of engaging separate counsel or experts to monitor the conflicts of interest the person in the superior position possesses, as such costs might outweigh the benefits the client receives from the relationship with the fiduciary.

Fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment management or law, in recognition of the value such services provide to our society. For example, the provision of investment consulting services under fiduciary duties of loyalty and due care encourages participation by investors in our capital markets system. Hence, in order to promote public policy goals, the law requires the imposition of fiduciary status upon the party in the dominant position. Through the imposition of such fiduciary status the client is thereby afforded various protections. These protections serve to reduce the risks to the client which relate to the service, and encourage the client to utilize the service. Fiduciary status thereby furthers the public interest.

Enforcement of the protections thereby afforded to the client by the presence of fiduciary duties is shifted to the courts and/or to regulatory bodies. Especially through the latter, the costs of enforcement of fiduciary duties is shifted from the individual clients to the taxpayers.

Why would a person take on the role of a fiduciary, and be subject to fiduciary duties? Why would a person desire to become an investment adviser, knowing that the fiduciary's conduct will be subject to a high degree of scrutiny? The law imposes on a fiduciary duties of loyalty and due care which limit the freedom of the fiduciary and/or require certain additional actions to be undertaken by the fiduciary for the client. However, the benefit of the assumption of fiduciary status is the increased marketability of the fiduciary. By endowing fiduciaries, such as investment advisers, with a reputation for honesty backed by strict adherence to fiduciary standards of conduct and rigid enforcement by regulatory bodies, the fiduciary is the recipient of a greater ability to promote and market his or her services. However, should the regulatory body permit the fiduciary duties to be eroded, or should the regulatory body permit others to undertake substantially the same services as those provided by the fiduciary without imposition of fiduciary

status, the increased marketability of the fiduciary is thwarted. This in turn leads to a degenerative cycle in which:

(1) The expert does not desire to enter into the profession of the fiduciary, as the same services can be performed under lesser standards (i.e., with greater freedom of action, and with less risk exposure to the fiduciary) under a functionally similar occupation. There is no clear benefit to the expert in terms of increased marketability of services, which might otherwise arise from the assumption of the fiduciary mantra.

(2) The client, who does not possess the knowledge and skill to discern the functional distinctions between the expert fiduciary and the expert non-fiduciary, and confronted with two occupations which functionally provide the same services (and, as is the case now with “financial consultants,” often utilize the same titles), is unable to distinguish any increased benefit from those who possess fiduciary status. Even written disclosures, however detailed and prominent, cannot overcome the client’s lack of knowledge, given the wide gap of knowledge which exists between the experts and the client. Often the client perceives that the expert non-fiduciary is supposed to act objectively and in the client’s best interest (i.e., under fiduciary standards of loyalty and due care), when in fact this does not occur. Instead, the expert non-fiduciary possesses conflicts of interest, the nature and effect of which are seldom understood by the client until after harm results.

(3) The foregoing interplay leads to a downward spiral which results in the erosion of the reputation enjoyed by the fiduciary’s profession. Functionally similar non-fiduciaries engage in conduct which results in harm, and such conduct is then attributed to the profession by consumers who fail to understand the distinctions between the fiduciary and non-fiduciary who perform the same services. Concurrently, clients become less trusting of their advisors and less likely to utilize the services which public policy sought to promote. In the case of the investment advisory profession, this results (over time) in clients fleeing the capital markets system altogether (since they do not perceive that there is any trusted guide to help them navigate through the complex world of investing in securities), and the clients retreat to the “safe” worlds of cash accounts and certificates of deposit. The result - loss of individual investor

confidence in our capital markets system, and its eventual demise.<sup>6</sup> This result is not just theoretical. It is happening - to a degree - today. I have personally seen this result. I have observed investors so upset with the poor advice received from stockbrokers and the conflicts of interest which the stockbrokers possessed that the investor refuses to even consider investing in stocks or bonds again. This is a real phenomenon, made worse by ongoing news of scandal after scandal in the securities industry. Not a week goes by when I don't add at least one, and usually several, articles to my collection of "Wall Street abuses" - gleaned from the pages of the Wall Street Journal, the New York Times, and the SEC's and NASD's pronouncements. All is not well in our capital markets, and we risk further erosion of the confidence in our capital markets should high standards of conduct for its participants not be preserved.

Fiduciary status does not result from the negotiations of parties to a proposed contract. While entry into a relationship by the parties is voluntary, the law and public policy play a crucial role in the imposition of fiduciary status and the relationships which follow from it. The law vests power and authority in the fiduciary, but requires the fiduciary to exercise that power and authority under strict standards of conduct for the client's benefit. The fiduciary's desire to assume the burdens of such strict standards of conduct results from the monopoly afforded to the fiduciary profession by the law.<sup>7</sup> The client is encouraged to enter into the advisory relationship under the law's assurance that the fiduciary, who possesses superior knowledge as to the subject matter on which advice will be given, will not exploit the client. The law thereby promotes security for each party to the fiduciary relationship - security to the client in terms of the increased duties and protections afforded, and security to the fiduciary in terms of marketing power.

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<sup>6</sup> The SEC acknowledged the importance of investor confidence in fiduciary investment advisers when it adopted the Code of Ethics requirement, stating: "We expect that the proposed rule may indirectly foster capital formation by bolstering investor confidence." (Jan. 20, 2004 Proposed Rule).

<sup>7</sup> The fiduciary is not afforded a monopoly himself or herself. Rather, the profession of the fiduciary is afforded the monopoly. Within the profession the client, or consumer, will often possess a wide range of service choices. Despite the range of services which may be offered within the profession, each choice within that profession requires common fiduciary duties which are owed to the client.

B. Should Investors Be Able To Choose Fiduciary or Non-Fiduciary Status  
For Functionally Equivalent Professional Services?

Also of importance to the debate over the Proposed Rule is the ability of the investor (client) to choose whether or not to have the fiduciary duty applied to the investment advisory relationship. The Proposed Rule sets forth certain disclosures to be provided to clients under which clients are encouraged to ask about the distinctions between investment advisory accounts (which would not ordinarily be subject to fiduciary duties imposed by the Advisers Act) and fee-based brokerage accounts (which are not subject to the fiduciary duties imposed by the Advisers Act) and, presumably, make a choice. Is presenting such a choice a good option?

It is important to contrast the broker-client relationship, which is driven by contract and under which broad fiduciary duties are usually not imposed, with the investment advisor-client relationship under which broad fiduciary duties are imposed by law. Fiduciary law does not regulate the parties' behavior as to whether a relationship should be established. However, once the fiduciary and client enter into a relationship, the bargain concerning the duties owed by the fiduciary is governed not by contract but by law. This is because fiduciary status is imposed by law upon relationships in situations where the contracting parties possess vastly different knowledge and expertise. Fiduciary status is imposed, in part, because the client is not capable of negotiating, contractually, the protections which the client should be afforded.

For registered investment advisers, the intent of Congress in the enactment of the Advisers Act and its imposition of fiduciary duties are well-summarized by the U.S. Supreme Court's landmark decision in *SEC vs. Capital Gains Research Bureau*:<sup>8</sup>

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<sup>8</sup> 375 U.S. 180 (1963). See also, *SEC v. Wall Street Publishing Institute, Inc.*, 591 F. Supp. 1070, 1082 (D.D.C. 1984), stating: "[S]ection 206 established federal fiduciary standards to govern the conduct of investment advisers." See also, *In the Matter of F.W. Thompson Company, Ltd. and Frederick W. Thompson, Respondent*, Administrative Proceeding File No. 3-10280, available at <http://www.sec.gov/litigation/admin/ia-1895.htm>, stating in part, "Congress enacted the Advisers Act to prevent conflicts of interest from affecting the judgment of investment advisers ... Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers to exercise the utmost good faith in dealings with clients. Thus, an investment adviser has an affirmative duty to act in good faith for the benefit of its clients and to

The Public Utility Holding Company Act of 1935 'authorized and directed' the [SEC] 'to make a study of the functions and activities of investment trusts and investment companies ... The report reflects the attitude - shared by investment advisers and the Commission - that investment advisers could not 'completely perform their basic function - furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments - unless all conflicts of interest between the investment counsel and the client were removed.' The report stressed that affiliations by investment advisers with investment bankers, or corporations might be 'an impediment to a disinterested, objective, or critical attitude toward an investment by clients. . . .'

This concern was not limited to deliberate or conscious impediments to objectivity. Both the advisers and the Commission were well aware that whenever advice to a client might result in financial benefit to the adviser - other than the fee for his advice - 'that advice to a client might in some way be tinged with that pecuniary interest [whether consciously or] subconsciously motivated' ... The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations, which contained the following canon: '[An investment adviser] should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect.'

Other canons appended to the report announced the following guiding principles: that compensation for investment advice 'should consist exclusively of direct charges to clients for services rendered'; that the adviser should devote his time 'exclusively to the performance' of his advisory function; that he should not 'share in profits' of his clients; and that he should not 'directly or indirectly engage in any activity which may jeopardize [his] ability to render unbiased investment advice.' These canons were adopted 'to the end that the quality of services to be rendered by investment counselors may measure up to the high standards which the public has a right to expect and to demand' ....

This study and report ... culminated in the preparation and introduction ... of the bill which, with some changes, became the Investment Advisers Act of 1940. In its 'declaration of policy' the original bill stated that: 'Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission . . . it is hereby declared that the national public interest and the interest of investors are adversely affected ... when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients ... It is hereby declared that the policy and purposes of

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disclose fully and fairly all material facts ... A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision."

this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section ...

The Investment Advisers Act of 1940 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 incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested ...<sup>9</sup>

As stated in the U.S. Supreme Court decisions, those providing investment advisory services should not be able to relieve themselves of the fiduciary obligations which are imposed by law. In other words, when imposed by law (such as through the Advisers Act), the supposed fiduciary should not be able, by contract, to negate the application of fiduciary duties.

In essence, the Proposed Rule would ask clients to choose to not be afforded the fiduciary protections of the Advisers Act if they choose a fee-based brokerage account. The Proposed Rule would permit clients to waive<sup>10</sup> fiduciary duties. While bargaining with the potential fiduciary on the issue of waiver, the clients must fend for themselves as independent parties. Their right to rely on the potential fiduciary for objective, unbiased advice must be eliminated. In fact, during the bargaining process, if a fiduciary relationship already exists, the entire relationship must be terminated for the bargaining to occur.

This begs the question, raised in the latest version of the Proposed Rule, as to whether circumstances exist under which the fiduciary protections afforded to individual investors by the Advisers Act may be waivable. Should the individual investor, prior to receipt of investment advisory services, be permitted to choose to enter into either a fiduciary relationship (governed by the Advisers Act) or a non-fiduciary fee-based brokerage account relationship under which investment advisory services are given (not governed by the Advisers Act)?

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<sup>9</sup> Id., at 187-201. (Emphasis added).

<sup>10</sup> Waive (vb.): [T]o abandon, renounce, or surrender (a claim, privilege, right, etc.); to give up (a right or claim) voluntarily. Black's Law Dictionary (7<sup>th</sup> Ed. 1999).

I submit that there are three requirements, all of which must be met, in order for a waiver of fiduciary protections to be permitted:

First, clients must be put on clear notice that, with respect to the particular duties that they waive, they can no longer rely on their fiduciaries.

Second, the firm or organization presenting the client with the choice must be able provide the client with sufficient information so as to enable the client to make an informed, independent and intelligent decision regarding the waiver, and the waiver must be fair and reasonable.

Third, the waiver must not effect a denigration of the fiduciary profession, as a result of the actions of the non-fiduciaries.

As to the first requirement, it may be possible to draft a notice that fiduciary duties do not apply to fee-based brokerage accounts (at least a written and detailed one accompanying a contract for fee-based brokerage services), and the first of the three requirements might be met. However, the second and third requirements for waiver of fiduciary duties are highly unlikely to be met, for reasons summarized as follows.

As to the second requirement set forth above, the client must fully and completely understand the protections they are waiving and that they must fend for themselves. In essence, the client must be able to undertake, autonomously, an informed waiver. Given the complexity of the securities industry and the complexity of the fiduciary concept in general,<sup>11</sup> it is highly unlikely that the typical investor/client will

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<sup>11</sup> "PIABA believes that mandatory disclosures, warnings, and explanations are of little practical value in establishing investor protection in this area. This is particularly true in view of the complexity of the concepts at issue. It is unrealistic to expect that the average investor will be able to understand and evaluate a meaningful analysis of a brokerage firm's duties under the federal securities laws in contrast to an investment adviser's duties under the Advisers Act. Further, suggesting that investor confusion can be addressed by designating a person at the brokerage firm to explain the terminology ignores the implications of the obvious conflict of interest. Boilerplate disclosures for advisory accounts cannot be deemed a substitute for imposing the statutory duties otherwise applicable under the Advisers Act." Comments of Laurence S. Schultz, Federal Legislation Committee Chairman, Public Investors Arbitration Bar Association, February 4, 2005.

possess the knowledge to make such an informed, intelligent decision.<sup>12</sup> As a result, the quality of the client's consent is very doubtful. Moreover, given the many standard "forms" and "account disclosures" which are signed upon the commencement of most brokerage firm account relationships, this all-important disclosure is unlikely to receive the scrutiny and contemplation it deserves by the investor.<sup>13</sup> Hence, the second requirement is very unlikely to be satisfied (and certainly would not be met for the investors in the lower quartile of pertinent knowledge, who are called upon to make the decision which the SEC's Proposed Rule would have them make). Does this sound paternalistic? Perhaps, but in many situations paternalism - the need to protect the client (entrustor) to advance the public good - is the reason behind imposition of fiduciary duties. As stated by Professor Frankel:

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<sup>12</sup> It should be asked whether any intelligent individual investor seeking continuous and/or comprehensive investment advice would, if fully armed with an understanding of the protections afforded to the investor by virtue of having an investment fiduciary (versus not having an investment fiduciary), desire to waive such protections. In other words, a fully informed and rational investor who seeks out objective, trusted investment advice would nearly always choose to possess an account subject to the Advisers Act, and would not choose a fee-based brokerage account not subject to the Advisers Act.

<sup>13</sup> Most individual investors are not lawyers, are unsophisticated as to Wall Street's terminology, and are highly unlikely to read and understand a highly important disclosure when confronted by a multitude of other forms and disclosures. For an example of the length and complexity of such disclosures, see Comments of John H. Schaefer, President and Chief Operating Officer, Morgan Stanley, February 7, 2005, in which he notes: "In that regard, we have a 'plain English' description of the role of the broker in fee-based brokerage accounts, which we include in materials in a welcome package upon account opening and sent annually. For the reference of the SEC, we have attached these as Annexes I and II." Can you imagine an individual investor actually reading all of this information, much less understanding it? In Annex I, immediately following the descriptions of types of brokerage accounts and investment advisory accounts, is another section which states: "How We Compensate Your Financial Advisor. Your Morgan Stanley Financial Advisor is a trained and licensed securities professional who can help you define your financial goals and develop an investment strategy and action plan to achieve them. He or she provides investor education and personalized financial information to help you implement that plan with financial products and services suitable for your individual needs. He or she provides ongoing guidance in response to your changing needs and a changing financial marketplace." (Emphasis added.) As demonstrated by the foregoing mixing of terminology, this "plain English" brochure is anything but, as it blurs the distinctions between brokerage services and investment advisory services, rather than educate the individual investor on the distinctions. Note also that the word "fiduciary" is not used in these documents.

Paternalistic protections, that is, protections of members of a class regardless of their own express and clear intent, are not limited to fiduciary law. Such protections are grounded in many and diverse principles, and exist in the law of contracts as well. Paternalistic attitudes can derive from the observation that most members of a particular class lack competence or sufficient bargaining power and are therefore incapable of independent consent to waive their legal protections or bargain around them. Further, members of a protected class may be "rationally apathetic" and fail to protect themselves. If the disappointment of members of a class, such as investors, can affect the system, for example, by a "run" on the financial markets, the investors' waivers may be ignored ... Another reason for mandatory fiduciary duties is the policy to provide fiduciaries with a level playing field, and to deter them from competing by dishonest treatment of entrustors or by providing less-than-acceptable quality of services. For example, the Securities Acts put market fiduciaries and contract actors on such a level playing field by prohibiting waivers of rights under the Acts.<sup>14</sup>

The Proposed Rule improperly seeks to solve some of the problems associated with a waiver of the fiduciary relationship by referring the client to a member of the brokerage firm who possesses sufficient knowledge of the distinctions between fiduciary and non-fiduciary accounts. In essence, in such situations the client, lacking substantial knowledge of the securities laws and regulations governing investment advisers and broker-dealer firms, would be looking to the brokerage firm's representative for advice. In essence, the brokerage firm's representative would be cast into a role as a "surrogate decision-maker." However, unless the surrogate decision-maker is himself or herself an independent fiduciary, without conflicts of interest, and governed by standards of conduct (which need to be defined), this does not solve the problems associated with the Proposed Rule's idea of an ability by a client to "waive" the application of the Advisers Act.<sup>15</sup>

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<sup>14</sup> Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209 (1995)

<sup>15</sup> Again, it must be asked whether any fiduciary, acting as a surrogate decision-maker or advisor to a client as to whether to waive fiduciary duties of one who desired to provide investment advice, could ever advise a client to forego the fiduciary duty. There is no advantage in the waiver of the legal requirement to act in the client's best interests, as a fiduciary, since the same services could be obtained, for the same fees (or less, in some instances) from another advisor who chooses to be bound by the fiduciary duty. If a choice were to exist, there simply is no situation in which a fiduciary would advise a client to forego the fiduciary protections afforded to the client by the Advisers Act.

The third requirement stated above - that the fiduciary's profession not be denigrated as a result of functionally equivalent services being provided by non-fiduciaries - is also not met. Having two professions which possess differing standards of conduct for the same functional services will inevitably lead to investor confusion and, as a result, a loss of reputation for the profession subjected to the higher fiduciary standards (investment advisers). (For further discussion of this point, please refer to Section A of this comment letter.) This is especially true when the members of the different professions - one subject to fiduciary standards, the other not - can refer to themselves by similar terms ("investment adviser" or "investment consultant" vs. "financial adviser" or "financial consultant"). Moreover, given the tremendous amount of advertising by broker-dealer firms in recent years touting their advisory functions under fee-based accounts,<sup>16</sup> it would take a great deal of re-education of the investment public, over an extended period of time, to enable investors to be able to make the distinctions between the investment advisory profession and the broker-dealer profession. It is in the public interest for the SEC to preserve and promote the investment advisory profession. The public good requires that certain institutions based upon trust be preserved. The SEC should not erode the investment advisory profession by permitting others, not bound by the high standards of conduct imposed upon investment advisers, to undertake the same functions.

It should be noted that, to the extent that fiduciary obligations are imposed to ensure entry into relationships based upon trust and confidence - where fiduciary duties arise as a result of the superior knowledge which the fiduciary holds - conflicts of interest should not be waivable. In essence, the greater the inequality in bargaining power, the greater the difficulty of waiver under the law. The client should not, in circumstances such as those that exist between investment advisers and clients, in which (as acknowledged by the Tulley Report) a great deal of distinction exists in the relative knowledge and skill of the parties, be capable of waiving the fiduciary's duty to act in the best interests of the client.

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<sup>16</sup> "In its original proposal, the Commission conceded that 'that some broker-dealers offering these new accounts have heavily marketed them based on the advisory services provided rather than the execution services, which raises troubling questions as to whether the advisory services are not (or will be perceived by investors not to be) incidental to the brokerage services.' Advertisements and sales materials for fee-based and other brokerage accounts routinely emphasize terms and use descriptive phrases that create a strong impression that advisory services are an important, even central element of the services provided. These communications often refer to brokers as 'financial consultants' or similar titles that imply their primary role is advisory. No amount of disclosure can correct the misleading impression created these communications." Comments of Fund Democracy, Consumer Federation of America, Consumers Union, and Consumer Action, to the Proposed Rule, Feb. 7, 2005.

The Proposed Rule in essence seeks to provide a broad exception to the fiduciary duty requirements imposed upon those who provide comprehensive and/or ongoing investment advice to clients. This exception will erode the fiduciary aspects of the entire investment advisory profession. As stated by Chief Judge Cardozo of the Court of Appeals of the State of New York:

Many forms of conduct permissible in a workaday world for those acting at arm's-length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.<sup>17</sup>

I submit that the effectiveness of the “waiver” which is suggested by the Proposed Rule is highly doubtful. It is further doubtful that the Proposed Rule can be “fixed,” as the concept of “choice of fiduciary or non-fiduciary investment advisory services” advanced by the SEC is contrary to established legal principles governing the nature of fiduciary relationships. Other commentators to the Proposed Rule have also expressed grave doubt over the meaningfulness of disclosures for similar and other reasons.

It is important to note a significant distinction between (non-fiduciary) fee-based brokerage accounts and (fiduciary) investment advisory accounts. Under the former the account agreements frequently contain the statement that no tax advice is given during the course of the brokerage relationship.<sup>18</sup> Registered investment advisers, by contrast, should not be able to waive the necessity to give tax advice, given its central importance to the net returns an investor receives.<sup>19</sup> As stated by Professor Macey, the “fiduciary

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<sup>17</sup> *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928).

<sup>18</sup> “Morgan Stanley does not provide tax or legal advice. Always consult with your own accountant or attorney concerning the tax or legal implications of your investment decisions.” From Morgan Stanley brokerage account documentation, found in Annex II of comments of John H. Schaefer, President and Chief Operating Officer, Morgan Stanley, February 7, 2005.

<sup>19</sup> An example of the impact of poorly planned investment decisions can be seen from this excerpt from the SEC’s Final Rule, Disclosure of Mutual Fund After-Tax Returns, 17 CFR Parts 230, 239, 270, and 274

duty of care requires that decisions on behalf of an entrustor be made after gathering relevant information, deliberating, and acting with ‘wisdom and caution.’<sup>20</sup> If the registered investment adviser lacks tax expertise necessary to integrate tax advice within the investment advisory process, the registered investment adviser should either acquire such expertise by education, provide such expertise through employment of agents, or require (in the terms of the advisory agreement with the client) that tax counsel be engaged by the client as a condition of entering into the fiduciary relationship. The duty of due care, in the context of providing investment advisory services to individual investors, necessarily involves the application of tax minimization strategies. The investment adviser’s duty to incorporate tax planning into the investment decision-making process is part of the fiduciary duty of due care, and likewise should not be capable of waiver.<sup>21</sup>

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[Release Nos. 33-7941; 34-43857; IC-24832; File No. S7-09-00]: “[T]axes are one of the most significant costs of investing in mutual funds through taxable accounts. In 1999, mutual funds distributed approximately \$238 billion in capital gains and \$159 billion in taxable dividends. Shareholders investing in stock and bond funds paid an estimated \$39 billion in taxes in 1998 on distributions by their funds. Recent estimates suggest that more than two and one-half percentage points of the average stock fund's total return is lost each year to taxes. Moreover, it is estimated that, between 1994 and 1999, investors in diversified U.S. stock funds surrendered an average of 15 percent of their annual gains to taxes. Despite the tax dollars at stake, many investors lack a clear understanding of the impact of taxes on their mutual fund investments.”

<sup>20</sup> Regulation of Financial Planners, White Paper Prepared for the Financial Planning Association (April 2002), at page 28.

<sup>21</sup> In the opinion of the author, registered investment advisers who engage in the sale of most variable annuity products in nonqualified accounts undertake substantial professional risk, especially when selling such products to retirees. The fiduciary duty of due care requires a consideration of taxes and costs, and alternative (and lower-cost) means of achieving risk reduction (afforded, to a very limited degree, by a variable annuity product’s “death benefit” or “guarantee”). By contrast, insurance agents and stockbrokers do not appear to possess such stringent duties, and only possess a duty to consider the client’s tax status under the lesser standard of “suitability.” For more discussion on the inappropriateness of variable annuities, see the appendix to the author’s August 30, 2004 comments to the SEC on this Proposed Rule, or obtain the report, *Why You Should Avoid Variable Annuities* (an excerpt from 2003 book, *The Science of Investing*, distributed as a public service by the Joseph Financial Group), available at [www.josephpartners.com](http://www.josephpartners.com), under “Publications” / “Articles”. Interestingly, neither the SEC nor the NASD requires a review of the tax implications of variable annuities as part of the suitability analysis. The following was summarized as the “suitability obligation” in a recent report: “In recommending the purchase of a deferred variable annuity, a registered representative would be required to determine that:

Moreover, the concept of waiving fiduciary duties is very similar (if not essentially identical to) the concept of a “hedge clause” in investment advisory contracts. The basic test for determining the legality of a particular hedge clause is contained in an early release of the SEC. It is interesting to note that this release was written not only in the context of investment advisory agreements, but was also intended to address the use of hedge clauses by brokers and dealers. The release simply states that “the anti-fraud provisions of the Securities and Exchange Commission statutes are violated by the employment of any legend, hedge clause, or other provision which is likely to lead an investor to believe that he has in any way waived any right of action he may have....”<sup>22</sup> This test is consistent with Section 215(a) of the 1940 Act which states that “[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation or order thereunder shall be void.”

In determining whether a particular hedge clause does, in fact, mislead the client into believing that he has waived any state or federal right of action, it should be remembered that any breach of an adviser's fiduciary duty to his client may, ipso facto, give rise to a fraud action under the securities laws. Along these lines, the SEC has noted that “[a]n investment adviser is a fiduciary. As such he is required by the common law to serve the interest of his client with undivided loyalty ... [A] breach of this duty may constitute a fraud within the meaning of clauses (1) and (2) of Section 206 of the Investment Adviser Act (as well as

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- the customer has been informed of the unique features of the variable annuity;
  - the customer has a long-term investment objective; and
  - the deferred variable annuity as a whole, and its underlying sub accounts, are suitable for the customer, particularly with regard to risk and liquidity.

The registered representative would be required to document these determinations.”

Joint SEC/NASD Report on Examination Findings Regarding Broker-dealer Sales of Variable Insurance Products, June 2004. The critical omission of the determination of suitability from a tax perspective is apparently missing from the duties imposed upon brokerage firms and insurance agents which engage in the selling of these products. In addition, the concept of suitability fails to require the product salesperson to look at the overall costs of the product relative to its benefits. An investment advisor, held to the higher fiduciary standard, must consider the tax impact of the product upon the investor, as well as costs of the product relative to its benefits. A fiduciary is simply held to a higher standard of care, and such requires the acquisition and application of a higher degree of expertise.

<sup>22</sup> Release No. 40-58, (April 18, 1951), Fed. Sec. L. Rep. (CCH) para. 56,383-6.

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the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934)."<sup>23</sup> Thus, an adviser's hedging of liability may also contravene common law standards of fiduciary responsibility. In other words, the mere attempt to have a client sign a form, in which the client would negate the application of fiduciary duties, is in and of itself a violation of the fiduciary duty imposed by the Advisers Act. In other words, using contracts which seek to limit or avoid an adviser's liability under the law (hedge clauses), and using contracts or forms which seek to limit a client's options with regard to the pursuit of a civil case or arbitration, are per se unlawful under the Advisers Act.

The last of a series of major federal securities statutes passed after the stock market crash of 1929, the Advisers Act intended to eliminate perceived abuses in the securities industry. Despite its enactment some 65 years ago, the SEC has failed to wield this tremendous consumer protection tool with vigor. It's time for the SEC to more fully seek an understanding of the importance of fiduciary status as a means of maintaining investor confidence in our capital markets system and protecting the interests of the individual investors. Many commentators have already refuted, by both factual and legal argument, the SEC's assertions that a broker-dealer firm's suitability and other obligations somehow equate to a registered investment adviser's fiduciary duty and that individual investors would not be harmed by the Proposed Rule. I hope the SEC can more fully explore the important concept of fiduciary status to gain a deeper understanding of the distinctions on the duties imposed upon investment adviser representatives and registered representatives. Additionally, I hope the SEC will understand why statutory imposition of fiduciary status should not be capable of waiver by the potential client of a fee-based advisor.

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<sup>23</sup> Release No. 40-40 (Jan. 5, 1945), Fed. Sec. L. Rep. (CCH) para. 56,374.

C. What Standards of Conduct Should Apply To Investment Fiduciaries?

Under English law, from which our system of jurisprudence was initially derived, it is reasonably well established that fiduciary status gives rise to five principal duties: (1) the no conflict rule preventing a fiduciary placing himself in a position where his own interests conflict or may conflict with those of his client or beneficiary; (2) the no profit rule which requires a fiduciary not to profit from his position at the expense of his client or beneficiary; (3) the undivided loyalty rule which requires undivided loyalty from a fiduciary to his client or beneficiary; (4) the duty of confidentiality which prohibits the fiduciary from using information obtained in confidence from his client or beneficiary other than for the benefit of that client or beneficiary; and (5) the duty of due care, to act with reasonable diligence and with requisite knowledge, experience and attention. From these five broad duties, and other sources, can be derived various standards of conduct.

The SEC's recent initiatives, including the code of ethics rule and the rule requiring investment advisers to institute compliance policies and procedures, are attempts to reinforce the fiduciary status of investment advisers and to have investment fiduciaries define certain standards of conduct to which they must adhere. However, these recent rules are quite general in their requirements. The SEC's recent pronouncements have not promulgated a long list of actual standards of conduct for investment fiduciaries.

"Standards of conduct" ("SOCs") as used in this comment letter refer collectively to the rules the laws, government regulations, professional association ethical rules and internal principles<sup>24</sup> that guide the structure, systems, procedures, and day-to-day decisions of the registered investment adviser firm. They also include the rights and entitlements of individuals established by contract or the assumption of a certain status under the law.

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<sup>24</sup> Internal principles include a firm's own mission statement, values statement, or adopted code of ethics, as well as the personal standards of the firm's members.

Standards of conduct which are properly developed, implemented, and monitored contribute to the welfare of the firm's key stakeholders and respect the rights of all constituencies affected by its operations.<sup>25</sup> The constituencies, or stakeholders,<sup>26</sup> of the RIA firm include its shareholders and employees, business partners, those who refer clients to the RIA firm and those to whom the RIA firm refers clients, clients of the firm, and the local communities in which the RIA firm does business. Stakeholders may also include the RIA profession itself.

The RIA firm must adhere to certain legal and regulatory constraints. In addition, if the RIA firm desires to remain a “trusted advisor” to the client, the RIA firm should go further and adopt certain additional practice philosophies. Following are twelve standards of conduct for RIA firms providing personal financial planning and/or personal investment advisory services:

SOC 1-3: Adherence To the RIA Firm’s Duty of Loyalty To The Client

1. The RIA firm should choose a business model and adopt a practice philosophy which seeks to eliminate material conflicts of interest in order to maintain integrity and objectivity.

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<sup>25</sup> Free and capitalistic societies, such as the United States, depend upon voluntary as well as legally coerced action to maintain a stable, productive society and accomplish community objectives. Employees in general, and perhaps top executives in particular, want to work for an organization respected for its integrity and for its contributions to society.

<sup>26</sup> While stakeholder theory has achieved a degree of acceptance in the strategic management literature, there is substantial resistance to stakeholder reasoning in the financial-economics literature, as there is a counter-movement favoring stronger stockholders' rights. I do not suggest that business entities must set aside profit motives, nor do I suggest that all standards of conduct for firms be codified into law or governmental regulations. Rather, as a management strategy, stakeholder theory reasons that effective corporate managers pay attention to those constituencies which are vital to the survival and success of the firm. Stakeholder theory therefore describes an approach for improving corporate profits. Therefore, I suggest that the implementation of standards of conduct should be linked to business goals, such as the firm's need to attract loyal clients, generate referrals from clients and sources of influence, and promote the retention of productive employees. For example, an RIA firm's support of community projects and charitable endeavors could be promoted through press releases, newsletters, and advertising.

2. The RIA firm should affirmatively and prominently disclose all material conflicts of interest which cannot be eliminated.
3. The RIA firm should adopt internal standards for managing conflicts of interest which are not eliminated. This includes, but is not limited to, the adoption and periodic revision of a Code of Ethics, and appropriate firm systems, compliance policies and procedures, and engagement practices.

SOC 4-7: Defining The RIA Firm's Relationship With the Client

4. The RIA firm should assume fiduciary status with respect to the client.
5. The RIA firm should document the scope of the engagement in writing.
6. The RIA firm should undertake measures to ensure confidentiality of client information.
7. The RIA firm should seek to educate the client, including the develop of reasonable expectations as to the results which can be accomplished.

SOC 8-12: Adherence To The RIA Firm's Duty of Due Care In the Provision of Services

8. The RIA firm should achieve and maintain the level of competence required to render the financial and/or investment advice being sought, either through the RIA firm's own efforts or through the adoption of a team approach with other professionals or firms.
9. The RIA firm should gather necessary factual information regarding the client which is necessary and appropriate to provide the recommendations.
10. The RIA firm should undertake due diligence as to investment products recommended to the client, seeking to select those investments which best meet the client's needs.<sup>27</sup>

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<sup>27</sup> "A fiduciary must always act in the client's best interest (even when it is not in his or her own best interests). Therefore, it may be a breach of fiduciary duty to recommend a S&P 500 mutual fund with a 5% load when you know of a fund with an equivalent track record that is no-load and has low annual expenses."

11. The RIA firm should adequately document both the recommendations given and the material facts underlying the documentation in a written financial plan or investment policy statement.
12. The RIA firm should ascertain if the client desires plan implementation, monitoring, and/or revision assistance and either provide such services or refer the client, through a due diligence process, to other appropriate service providers.

This is just one listing of the fiduciary standards of conduct for RIA firms. Other lists of standards of conduct exist, embodied in statutes, regulations, and the codes of various organizations composed of fiduciaries. A more thorough listing of standards of conduct, a detailed presentation of the sources of these standards, their applicability to real life situations, and the presentment to investment fiduciaries, is warranted. The SEC should seek to encourage, if not lead, an effort to define such standards of conduct for investment fiduciaries. Once developed, the SEC should seek to aggressively promote standards of conduct through educational endeavors and other means, and encourage the ongoing development of the standards of conduct as the securities markets, technologies applied by RIA firms, services employed by RIA firms, and investment theories evolve.

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Donald Moine, Are You A Fiduciary?, From the August 13, 2000 MorningstarAdvisor.com, available at <http://www.prudentinvestoract.com/Are%20You%20a%20Fiduciary.pdf>. The fiduciary duty is not one which is subject to compromise. This specific duty - to undertake due diligence to select the best investment products to meet the client's needs - is the duty which broker-dealers are afraid of assuming when acting as fee-based advisors to their clients. Large wirehouses, if saddled with the much higher fiduciary duty (compared to the lower standard of product suitability), would see their profit margins dwindle if they were forced to act in the best interests of the client under a fiduciary standard. Very seldom would they be able to extract additional fees through the sale of proprietary, high-expense and/or high-turnover funds. Make no doubt about it - the entire debate regarding the Proposed Rule comes down to the desire of large broker-dealer firms to preserve a business model which many clients no longer desire. Clients desire truly objective advice. Many large broker-dealer firms tout the objectivity of their advice and that they act "in the client's best interest," but they are unwilling to accept the legal duty to do so by assuming the fiduciary mantra. The impetus behind the Proposed Rule is, at least in part, by the desire to preserve the high-profit business of its proponents. "The (broker-dealer) industry is simply trying to minimize fiduciary liability and maximize its profit margins ... The need for innovation is clear, but our dominant institutions cannot and will not work against their immediate self-interests to initiate innovation. This is why they will not acknowledge our fiduciary status ...." Stephen C. Winks, A New Year, A New Profession - Fiduciary Advisors for 2005: How We Get There From Here (Jan. 2005), available at [www.srconsultant.com](http://www.srconsultant.com).

D. A Proposal for Renaming the SEC's "Division of Investment Management"  
As The SEC's "Division of Investment Fiduciaries."

What's in a name? A lot. The SEC's Division of Investment Management is a misnomer, given its broad scope. Given the key fiduciary duty imposed upon investment advisers, whether they be to mutual funds / hedge funds or to individual investors, the SEC should rename this division as the "Division of Investment Fiduciaries" and establish within it two separate and distinct departments (or separate into two separate divisions): "Fiduciary Investment Managers" for the regulation of mutual funds and investment advisers to mutual funds; and "Fiduciary Investment Consultants" for all other federally-registered investment advisers.<sup>28</sup> Greater attention should then be paid to the Fiduciary Investment Consultant area and their unique supervisory needs and advancement of the investment counsel profession. (A third department may be required to accommodate the oversight of companies under the Public Utility Holding Company Act of 1935.)

The requirement of compliance policies and procedures, a chief compliance officer, and a code of ethics are welcome enhancements to the regulatory scheme for investment fiduciaries. A number of additional actions can be taken by the SEC to emphasize the importance of fiduciary duties, including:

- Revising the SEC's own consumer literature to more fully explain the duties owed to investors by various market participants;
- Increasing the educational standards required of investment adviser representatives;
- Advocating before the U.S. Congress the equalization of tax treatment for clients of investment advisers in comparisons to clients of broker-dealers;

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<sup>28</sup> "It's tough enough to define the demarcation between brokers and investment advisers. The additional challenge is to define the demarcation between advisers; specifically between money managers and investment consultants, both of which are being regulated by the Investment Management Division with the same rules and regulations. The lack of specific regulatory controls for investment consultants is creating additional problems." Comments of Donald B. Trone, AIFA, President, Foundation for Fiduciary Studies, February 4, 2005.

- Forming a working committee to more fully explore the concept of fiduciary duties of investment advisers, seeking to define and expand upon standards of conduct, and incorporating current efforts already underway through such organizations as the Foundation for Fiduciary Studies, the Society of Fiduciary Advisors, etc., with the goals of establishing “best practices” for investment fiduciaries to pursue, providing education concerning fiduciary concepts to the investment advisory community, and enhancing the reputation and prestige of the investment advisory community.

E. The Fiduciary Duty Of Those Who Provide Investment Advisory Services Is  
The Critical Issue In Any Examination of The Proposed Rule.

As I stated in my initial comment letter on this Proposed Rule, submitted over one year ago, “It is critical to the reestablishment of trust and confidence by investors in Wall Street that registered representatives who also seek to provide investment advisory services adhere to the Investment Advisers Act of 1940. Rather than lessen the fiduciary role of those who seek to provide investment advisory services to clients, the Commission should act to clarify the fiduciary duty of broker-dealer firms who also seek to act under the Investment Advisers Act of 1940. Those who seek to provide investment advisory services should embrace the necessity to act in the best interests of the client, not seek to lessen their fiduciary role.”<sup>29</sup>

The fiduciary duties applicable to investment advisers, and the importance of fiduciary status as a protection for individual investors and our capital markets system, is worthy of an entire book, if not a lengthy treatise. It is clear that the fiduciary duty afforded those who receive investment advisory services is a very important protection. Furthermore, it is clear that the primary impetus behind the Proposed Rule is the desire by brokerage firms to provide ongoing and/or comprehensive investment advisory services through fee-based brokerage accounts without being subject to the all-important standards of conduct required of a fiduciary. Other commentators have reached similar conclusions regarding the many flaws in the Proposed Rule, particularly as it relates to fiduciary duties, and the negative impact of the Proposed Rule upon individual investors:

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<sup>29</sup> Comment of Ron A. Rhoades, B.S., J.D., Chief Compliance Officer and Director of Research, Joseph Capital Management, LLC, February 17, 2004.

- ❑ “It is the Commission's job to ensure that investors are adequately protected. By that standard, the Commission's past policy has failed abysmally. It does not provide investors with any ability to distinguish between financial professionals subject to two very different standards of conduct. It does not provide adequate disclosure of conflicts of interest by brokers offering advice. And it does not make clear that every broker offering investment advice should be considered a fiduciary with an obligation to place the customer's interests ahead of the broker's own.” Comments of Barbara Roper, Director of Investor Protection, Consumer Federation of America, February 7, 2005.
- ❑ “The difference between an investment advisor’s fiduciary duty and a broker’s duty of suitability standard is substantial ... We strongly believe that once a fiduciary relationship with a client has been established by the broker-dealer or a related entity, all accounts with that client should be managed as advisory accounts.” Comments of Joel H. Framson, CPA/PFS, CFP, Chair, Personal Financial Planning Executive Committee, American Institute of Certified Public Accountants, February 7, 2005.
- ❑ “We concur with the Commission’s concern that ‘customers and potential customers [may not] understand the differences between advisory and brokerage accounts, including the differences in fiduciary duties owed to investors by advisers and brokers’ ... (per TD Waterhouse survey) 58% of investors incorrectly believe that both stockbrokers and investment advisers have a fiduciary responsibility to act in an investor’s best interests in all aspects of the financial relationship ... these fee-based advice brokerages should accept that they owe fiduciary duties to the investors to whom they offer investment advice, just as do investment advisers ... investors deserve assurance that these financial planning services are performed subject to strict and clear fiduciary duties.” Comments of Timothy P. Pinnington, President and Chief Executive Officer, TD Waterhouse USA, February 7, 2005.
- ❑ “This letter is one of the few sent on behalf of the investing public ... The [Advisers] Act holds service providers to a stricter standard than the standard generally applied to brokers under the Securities Exchange Act of 1934 ... notwithstanding the various safeguards cited in the Commission’s release. The critical and fundamental difference between the broker-dealer and investment-adviser regulatory schemes is the per-se fiduciary status of the registered investment adviser. A registered broker dealer ordinarily is not deemed a fiduciary—however heavily it otherwise might be regulated

by the Commission, the NASD and the states. A broker's suitability obligations simply do not equate to the statutorily imposed fiduciary obligations that run between a registered investment adviser and his or her clients. Put another way, it is the burden of the injured investor to persuade a fact-finder that, under a particular set of facts and circumstances, an individual broker-dealer might be deemed to have owed that investor a fiduciary duty. An advisory client, in contrast, need only allege a breach of the registered adviser's statutory fiduciary duty and force that adviser to demonstrate that the relationship of trust and confidence was not, in fact, breached." Comments of Glenn M. Pape, CFP, Board Chair and Sarah Ball Teslik, Chief Executive Officer, Certified Financial Planner Board of Standards, Inc., February 6, 2005.

□ "[T]he legislative history demonstrates that a significant concern was to ensure that the provision of advisory services would be subject to the higher fiduciary standard to which professionals were held ... The CFA/ZAG and TD Waterhouse survey demonstrate that investors' expectations are defined by the functional services they receive, and they expect that advisory services will be accompanied by the higher standard to which a fiduciary is held." Comments of Mercer Bullard, Founder and President, Fund Democracy, Assistant Professor of Law University of Mississippi, Barbara Roper, Director of Investor Protection, Consumer Federation of America, Sally Greenberg, Senior Counsel, Consumers Union, and Ken McEldowney, Executive Director, Consumer Action, February 7, 2005.

□ "The congressional intent in establishing the Act was to hold Registered Investment Advisers to a higher duty, that of a fiduciary, to their clients; to require full disclosure by the Registered Investment Adviser of any conflicts of interest in appearance or in fact; and to regulate their market conduct carefully so that the quality of the advice and services rendered to the investing public would be maintained at a high level. We need only look at the pronouncements of the SEC itself to see that this is so. In a public speech delivered on May 1, 2000, Ms. Lori Richards Director, Office of Compliance Inspections and Examinations noted:

So many investors need assistance wading through the overwhelming myriad and varied information out there to separate the wheat from the chafe -that they need investment advice from a fiduciary they can trust. While many people have predicted that the growth of the do-it-yourself investor will ebb, I think that your challenge as investment advisers is to present investors with an alternative that they can have

confidence in, and can continue to have confidence in. In a very large part, I believe that investors' confidence in investment advisers is founded on good compliance. Your clients' faith in you is based on the fact that you act in their best interests, and in compliance with the law. This trust is critical, and it must be well-founded ...

Until 1996, our program underwrote both Broker Dealers and Registered Investment Advisers. Beginning in 1993 we began to examine the differences in claims arising from Broker Dealers and those from Registered Investment Advisers. Our predisposition was, because of their heightened legal duty, that Registered Investment Advisers would present claims with both greater frequency and severity than Broker Dealers. To our surprise, just the opposite was the case -claims against Broker Dealers dominated and were, on average, twice as frequent and twice as severe as those made against Registered Investment Advisers. Upon further examination, the differences became even more apparent -while Registered Investment Advisers had the heightened duty of a fiduciary, the evidence unequivocally suggested that they also, at the risk of regulatory censure or sanctions, did a demonstrably more effective job in meeting the needs of the investing public.” Comments of Bayard Bigelow, III, MBA, CPA, President and CEO, The Cambridge Alliance, January 4, 2005.

- ❑ “[If] supporters [of the Proposed Rule] are so concerned about, and dedicated to, serving the interests of the consumer, why are they so opposed to an actual requirement to put the clients interests first and to being held accountable for such representations? This is the essence of the problem with this rule. The best way to make sure that the clients interest comes first is to require advisors to actually put the clients interest first and enforce that requirement.” Comments of Dan Moisand, President-Elect, Financial Planning Association, Feb.7, 2005.
  
- ❑ “The clear legislative intent of Congress was to protect investors and to safeguard the honest investment adviser. The creation of a lower standard for advisory services diminishes the public perception of the integrity of registered investment advisers, who are subject to a higher fiduciary standard ... The brokerage execution services offered in the fee-based programs are clearly subordinate to the investment advice, and the advice is not subject to a fiduciary standard (citing letter of Securities Industry Association to the SEC, Sept. 22, 2004, at 4: ‘While broker-dealers are not fiduciaries, they are nonetheless required to deal fairly with customers....’) ... Brokers may be held to be fiduciaries in certain fact-specific situations, but they have no overriding duty of loyalty to the customer. For the most part, brokers’ counsel vigorously object to a fiduciary duty in

arbitration proceedings [citing comment letter of NASD arbitrator Mitchell B. Goldberg, Esq., to the SEC, Aug. 25, 2004] ... While a brokerage firm's advertising will portray its registered representatives as trusted advisers, the true relationship is revealed in their lawyers' strenuous objections to any faint whiff of fiduciary status in a customer dispute [citing When a Broker's Advice Isn't, Exactly, Wall Street Journal, page B14, Jan. 12, 2005]. Comments of Duane R. Thompson, Group Director, Advocacy, Financial Planning Association, February 7, 2005.

- ❑ “[C]onsumers today believe that when they pay a fee for service they have entered into a special relationship in which their adviser is bound to act in their best interests. Consumers have indicated by their preference for this service model that this fiduciary duty is their expectation. Consumers’ reasonable expectation of this level of personalization and care should afford them the protections offered under the Investment Advisers Act of 1940 ....” Comments of Ellen Turf, CEO, The National Association of Personal Financial Advisors, February 7, 2005.
  
- ❑ “[P]ortfolio management, selection of portfolio managers, and asset allocation services, even where performed on a non-discretionary basis, should not be considered to be solely incidental to brokerage transactions. Such services are core investment advisory services that should be subject to the fiduciary protections of the Advisers Act. These services have a ‘quintessentially supervisory or managerial character’ that the Commission recognizes ‘as a critical indicator of services that warrant the protection of the Advisers Act because of the ‘special trust and confidence inherent’ in such relationships’ ... the opportunity for investor confusion persists where a broker is permitted to use terms that imply a relationship of trust and confidence but, in effect, disclaims fiduciary responsibility for such relationships.” Comments of David G. Tittsworth, Executive Director, Investment Counsel Association of America, February 7, 2005.
  
- ❑ “The SEC fails to acknowledge that the suitability rule and the liability provisions of the federal securities laws apply only to purchases and sales of securities. The application of these principles to brokerage firms for advisory or other nonbrokerage services is questionable. It is important for investor protection that the fiduciary duty obligations contained in the Advisers Act apply to these firms. It is also important to investors that they receive the additional disclosures mandated by the Advisers Act, which are not required under the federal securities laws. PIABA believes the loss of these protections is investor harm. In short, broker-dealers providing investment advice and

financial planning must be subject to the same legal standards as are applicable to other investment advisers.” Comments of Laurence S. Schultz, Federal Legislation Committee Chairman, Public Investors Arbitration Bar Association, February 4, 2005.

Interestingly enough, the broker-dealer firms who are proponents of the Proposed Rule fail to understand the nature of fiduciary status and the very high standard of conduct required by investment advisors under the Advisers Act. This is clear in such silly and altogether misleading comments such as:

- “[The SEC’s proposed] disclosure implies that customer’s rights, the firm’s duties and obligations, and the applicable fiduciary obligations are greater with respect to an investment adviser account than they are with respect to a brokerage account. As we have previously discussed, this is simply not the case.” Comments of Elisse B. Walter, Executive Vice President, NASD, February 11, 2005.
  
- “Implicit in these assertions would appear to be the view that being subject to fiduciary standards is somehow better than being subject to broker-dealer rules.” Comments of Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, February 7, 2005.

Such statements are inconsistent with prior statements from broker-dealer firms.<sup>30</sup> Moreover, I find such lack of understanding of the fiduciary duties of investment advisers and the necessity of protecting

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<sup>30</sup> The large broker-dealer firms switch their arguments to suit their purposes. In the Final Extension of Temporary Extension from the Investment Advisers Act for Certain Brokers and Dealers, Investment Advisers Act of 1940 Rel. No. 626; Securities and Exchange of 1934 Rel. No. 14714 (April. 27, 1978), the release noted that “[a]nother reason some broker-dealers have given for desiring an exemption from the Advisers Act is their belief that an investment adviser, as such, may be held to have higher duties to his clients than does a broker or dealer to his customers.”

Indications of the inconsistency of the broker-dealer industry’s position is also revealed in comments relative to the Proposed Rule submitted by Harold Evensky, CFP, a well-regarded registered investment adviser and frequent speaker at investment adviser industry events. “Based on my experience as a practicing financial planner for over 25 years, a NASD arbitrator and an occasional expert witness in securities cases, it is inconceivable to me that any rational observer, at least one concerned with the interest of public investors, can support a Broker-Dealer Exemption ... I can assure you that the prudent broker-dealer counsel often makes a significant distinction in the responsibilities of BDs vs. RIAs.”

individual investors through the application of such fiduciary duties, from both the self-regulatory organization which supervises broker-dealer firms and from the trade organization which represents broker-dealer firms, to be highly disturbing.

Some of the suggestions proposed by broker-dealer firms in various comments submitted to the SEC indicate the great abuse to which individual investors are, and may be subjected, under the Proposed Rule. For example, one recent letter suggests that a fee-based brokerage account would not be subject to the Advisers Act when a “a client after receiving and considering a financial plan concerning at least in part the advisability of investing in securities, decides to implement certain transactions in a brokerage account.” At which point, if any, was the client clearly informed that the client was no longer an investment advisory client, that the protections afforded to the client by the fiduciary status of the “financial advisor” no longer were applicable, and that the “financial advisor” before the investor had just transformed into a product salesperson without the legal duty to put the client’s best interests first? Even if the client had been informed (even in writing, in one of the many documents put in front of the client), would the client have really known the distinctions between the first relationship governed by fiduciary duties and the second, transformed and changed relationship not governed by fiduciary duties? Additionally, once a financial plan is given, are not further explanations of that financial plan going to be provided during its implementation and thereafter, and are not modifications to that plan likely? Should the broker-dealer be able to turn “fiduciary status” on and off, like a dimly lit bulb hidden in a corner of the office, with the unknowing investor/consumer barely perceiving (if at all) the difference in the room’s lighting?

The nature of fiduciary status is the essence of the issue at hand. Fiduciary status, and its high standards of conduct, are imposed because consumers, occupying a position of greatly inferior knowledge and skill given the complicated subject matter before them, must be afforded the protections which result from the adviser shouldering fiduciary responsibility. Fiduciary status should not be capable of waiver. Fiduciary status should not be capable of being “turned on and off” by any person. Once fiduciary relationship is established, it should thereafter be continuously applied to all activities - since the individual consumer will not be able to discern between those activities which are “clearly advisory” in nature and those which are only “incidentally advisory” in nature.

Want to find a discussion of fiduciary duties or its application (or nonapplication) to fee-based accounts in the comment letters recently submitted by the CEOs and General Counsels of the major broker-dealer firms? Such discussions are altogether missing - despite the fact that the failure of the Proposed Rule to apply fiduciary duties of investment advisors to fee-based brokerage accounts under which investment advisory services are provided is the key issue in the debate over the Proposed Rule and its adverse impact upon millions of individual investors. Ignoring the Proposed Rule's fatal flaw will not make it go away. By their silence on this important issue and their inability to counter the compelling arguments which favor investor protection through the application of the Advisers Act and its broad fiduciary duties, the CEOs and General Counsels of large broker-dealer firms thereby implicitly acknowledge that no good reason exists under either law or public policy which would warrant the failure to apply the all-important fiduciary duty upon all those who seek to provide ongoing and continuous investment advisory services.

It is apparent that leaders of the broker-dealer industry (with the notable exception of T.D. Waterhouse, whose courage in opposing the Proposed Rule is laudatory) fail miserably in understanding the much higher degree of care required of investment advisers, as opposed to brokers who are only subject only to the lesser suitability standard. Either that or they seek to mislead the SEC and the public into permitting broker-dealer firms to perform functionally equivalent investment advisory services<sup>31</sup> but subject to a much

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<sup>31</sup> Evidence of the real intent of the broker-dealer industry, to avoid the higher standards required of fiduciaries, is revealed in past activities: “[T]o participants who were involved in the original drafting of the duties of a financial planner, brokerage interests strongly objected to [the imposition of a fiduciary duty] requirement. And given the fact that many suitability claims and other litigation are filed against financial planners acting in the capacity of registered representatives or insurance agents, and much of this is arbitrated outside of easily researched court records, the clarity of this duty must remain, for the moment, elusive—except in the minds of those who promote a higher duty.” Duane Thompson, *Tasking the Task Force: When is a CFP® Certificant a Fiduciary?*, *Journal of Financial Planning*, March 2004.

lesser standard of care.<sup>32</sup> No wonder broker-dealer firms have paid billions in fines over the past several years for their misconduct.

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<sup>32</sup> The NASAA's online "Investment Advisers Guide" (available at [http://www.nasaa.org/industry\\_regulatory\\_resources/investment\\_advisers/456.cfm](http://www.nasaa.org/industry_regulatory_resources/investment_advisers/456.cfm)) highlights the many rules which the broker-dealer firms seek to avoid in seeking the exception from the broker-dealer act, stating: "The anti-fraud provisions of the Investment Advisers Act of 1940 and most state laws impose a duty on investment advisers to act as fiduciaries in dealings with their clients. This means the adviser must hold the client's interest above its own in all matters. Conflicts of interest should be avoided at all costs. However, there are some conflicts that will inevitably occur, such as a person being licensed as a securities agent as well as an adviser. In these instances, the adviser must take great pains to clearly and accurately describe those conflicts and how the adviser will maintain impartiality in its recommendations to clients. The SEC has said that an adviser has a duty to:

- Make reasonable investment recommendations independent of outside influences
- Select broker-dealers based on their ability to provide the best execution of trades for accounts where the adviser has authority to select the broker-dealer.
- Make recommendations based on a reasonable inquiry into a client's investment objectives, financial situation and other factors
- Always place client interests ahead of its own.

When examiners review advisory books and records, they will be on the lookout for undisclosed or misrepresented conflicts of interest and prohibited practices. Some are obvious and some not so obvious. Some examples of practices that advisers should avoid are:

- Acting as an issuer or affiliate of an issuer of securities
- Recommending unregistered, non-exempt securities or the use of unlicensed broker-dealers
- Any activity that acts as a fraud or deceit on clients
- Charging unreasonable fees
- Failing to disclose to all customers the availability of fee discounts
- Using contracts which seek to limit or avoid an adviser's liability under the law (hedge clauses)
- Limiting a client's options with regard to the pursuit of a civil case or arbitration
- Borrowing money from or lending money to clients

Other situations which require disclosure of the conflict include, but are not limited to:

- The adviser or its employees are also acting as a broker-dealer and/or securities agent
- The adviser is receiving transaction-based compensation, including 12b-1 or other marketing fees, related to securities recommended to its clients
- The adviser receives any type of compensation from any source for soliciting or referring clients to another adviser or a broker-dealer.
- Hidden fees in the form of undisclosed service charges, wrap fees or expenses reimbursed by other parties.

The examiner will view perceived conflicts from the point of view of the customer; was the disclosure or lack of disclosure a factor in the client's decision to use an adviser's services or ratify an adviser's recommendations? Was the customer misled? Was the customer placed at a disadvantage or taken unfair advantage of as a result of the conflict and the adviser's compliance with disclosure requirements? The burden of proof lies with the adviser."

The fact that so little attention is paid to fiduciary duties by large firms has not gone unnoticed. John Bogle, Founder of the Vanguard Group and President of the Bogle Financial Markets Research Center, notes:

The problem with corporate America, it seems increasingly clear, lies in the fact that far too many corporate executives and directors have been placed in positions of great power and authority without an adequate understanding of their fiduciary duties, and that too many institutional intermediaries have failed to take them to task and demand that the interests of shareowners be served.<sup>33</sup>

Broker-dealer firms apparently want the freedom to ignore the best interests of individual investors by escaping the application of the Advisers Act to activities which clearly fall within its purview. The world has changed, but broker-dealer firms don't want to. Investors have changed their desires in what they want. More and more, individual investors recognize the need for objective investment counsel. Broker-dealer firms want to provide advice, and tout their "objectivity," but without the requirement to be fiduciaries and without the higher duties fiduciary status would bring.

The SEC's own prior comments regarding the necessity for imposition of fiduciary duties on those who provide fee-based advice should not go unnoticed:

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 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 fiduciary; she has asked for

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<sup>33</sup> John C. Bogle, Corporate Governance and Mutual Fund Governance - Reflections at a Time of Crisis, remarks before the Corporate Governance Conference, the New York Society of Securities Analysts, New York, NY, November 21, 2003, available at [http://www.vanguard.com/bogle\\_site/sp20031121.html](http://www.vanguard.com/bogle_site/sp20031121.html).

and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients. [Emphasis added.]<sup>34</sup>

It seems unconscionable that the SEC would change course so dramatically with this Proposed Rule and not impose fiduciary duties upon those who provide investment counsel on a fee basis, to the detriment of millions of individual investors. There simply is no good legal or public policy reason which supports the Proposed Rule. No large regulatory burden would be imposed upon broker-dealer firms by letting the Proposed Rule lapse. As stated in comments by the Consumer Federation of America, “There is no reason to think that brokerage firms that can live comfortably with advisory regulation of fee-based discretionary accounts or wrap accounts couldn't similarly accommodate advisory regulation of non-discretionary fee-based accounts. Thus, there is every reason to believe that brokers would continue to offer such accounts, even if the accounts were regulated as advisory accounts.”<sup>35</sup>

In contrast to the SEC, the North American Securities Administrators Association (NASAA)<sup>36</sup> and its many members - state regulators of investment advisory activities - certainly understand the necessity of the

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<sup>34</sup> In re: Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948). The fact that this decision was rendered only eight years after the enactment of the Advisers Act provides further weight to the intent of Congress to regulate all fee-based advisory relationships under the Advisers Act. Ms. Hughes was dually registered as both a broker and an investment adviser.

<sup>35</sup> Comments of Barbara Roper, Director of Investor Protection, Consumer Federation of America, October 5, 2004.

<sup>36</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. was founded in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation. As stated in recent testimony before Congress, “We continue to remain vigilant and prepared to face attempts by special interests to neutralize state regulators who are aggressively protecting investors. These interests will continue to complain about the ‘patchwork quilt’ they think they see whenever they look out across the country. What they are seeing is 50 state agencies working collaboratively to keep the industry free of wrongdoing and instilling consumer confidence in the marketplace. It is not regulation that keeps investors away from the marketplace — it is greed and wrongdoing that goes unchecked that undermines investor confidence.” [The Role of State Securities Regulators in Protecting Investors, Testimony of Ralph A. Lambiase, Director, Division of Securities Connecticut Department of Banking & President, NASAA, before the Committee on Banking, Housing, and Urban Affairs United States Senate, June 2, 2004.]

imposition of fiduciary duties upon those who provide investment advisory services. For example, the NASAA's model rules regarding investment advisers state:

A person who is an investment adviser or a federal covered adviser is a fiduciary and has a duty to act primarily for the benefit of its clients ... While the extent and nature of this duty varies according to the nature of the relationship between an investment adviser and its clients and the circumstances of each case, an investment adviser or a federal covered adviser shall not engage in unethical business practices ....<sup>37</sup>

Furthermore, the NASAA was quite clear in opposing the Proposed Rule, stating in prior comments to the SEC:

A broker-dealer should be prohibited from advertising that an account is anything other than a brokerage account, or that advisory services also are available, unless the broker-dealer is appropriately registered under the Investment Advisers Act of 1940. Numerous states already require persons who "hold themselves out" as providing investment advisory services to be registered as investment adviser. [Citation omitted.] By adopting a similar rule, the Commission will create a level playing field and provide consistent treatment of all broker-dealers and investment advisers. Investors will benefit from the distinction in that only those persons who qualify as investment advisers and are willing to subject themselves to a fiduciary standard of care for client accounts will be able to "hold themselves out" as providing such services.<sup>38</sup>

Hence, it is clear that the SEC's actions have the potential to create a grave difference in the regulatory scheme applicable to investment advisor representatives, as the states retain the authority to investigate actions of fraud and deceit by investment adviser firms and their representatives.<sup>39</sup> The states have

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<sup>37</sup> Rule 102(a)(4)-1. Unethical Business Practices of Investment Advisers; adopted April 27, 1997; amended April 18, 2004.

<sup>38</sup> Comments of Franklin L. Widmann, NASAA President and Chief, New Jersey Bureau of Securities, dated October 6, 2004, regarding the Proposed Rule.

<sup>39</sup> "If an investment adviser is registered with the SEC, the states may not require registration, licensing, or qualification of the investment adviser or its supervised persons, except that states may license, register, or otherwise qualify investment adviser representatives who have a place of business located within

traditionally been a strong protector of the individual investor. A broker-dealer firm which holds itself out as providing financial planning services while not being registered as an investment adviser would likely be undertaking an action involving fraud or deceit which is subject to investigation and action by the states and which is not preempted by federal law.<sup>40</sup> Given the NASAA's position, it is clear that the SEC's Proposed Rule could well spell the end of coordinated enforcement actions between the SEC and the state regulators involving many investment advisory activities. Moreover, since many state investment adviser regulatory schemes often grant to investors a private right of action for breaches of fiduciary duty whereas federal law does not expressly provide for such private remedies,<sup>41</sup> the attempt by large broker-dealer firms to be excluded from the application of the Advisers Act could be seen as an ill-advised (at least for consumers) and poor attempt to substantially limit, in the many states, the potential liability of broker-dealer firms who provide investment advisory services. Additionally, it has become well known that state regulators, such as New York State Attorney General Elliot Spitzer, appear to possess a deep understanding of both the concept of a fiduciary and the necessity to strictly enforce fiduciary duties of loyalty and due care.

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that state. Additionally, the states retain the authority to investigate and bring enforcement actions in the case of fraud or deceit, and as otherwise permitted by the NSMIA, by SEC registered investment advisers and their associated persons." [Emphasis added.] Memorandum of Understanding, April 27, 1997, adopted by NASAA and its members, regarding NSMIA.

<sup>40</sup> See Senate Report [S. REP. NO. 293, 104th Cong., 2d Sess. 3-4 (1996)] to the National Securities Markets Improvement Act of 1996 [Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code), stating, "Both the Commission and the states will be able to continue bringing anti-fraud actions against investment advisers regardless of whether the investment adviser is registered with the state or the SEC."

<sup>41</sup> For example, under the Connecticut Uniform Securities Act (CUSA), the fiduciary nature of the adviser's role carries great implications, since Section 36b-29(b)(1) of the CUSA expressly provides for civil damages against any person who violates Section 36b-5(a) (CUSA), regardless of scienter. This should be contrasted with the federal Investment Advisers Act of 1940 which fails to provide for any express civil liability (with the exception of rescissionary and restitutionary actions under Section 215(b)) or implied right of action under Section 206. *Transamerica Mortgage Advisors v. Lewis*, 44 U.S. 11 (1979); accord, *Neilson v. Professional Financial Management Ltd.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 93,938 (D.Minn. April 15, 1987). Moreover, in addition to providing for civil fraud actions, Section 36b-29(b)(1) of the CUSA holds investment advisers strictly liable for violations of Sections 36b-5(b), 36b-5(c), 36b-6(c) and 36b-24(b) of CUSA.

F. Concluding Thoughts.

The application of fiduciary duties to investment advisory activities requires - and deserves - a great of attention from a multitude of practitioners, academics, and industry leaders, each contributing their own knowledge, expertise, and experience to the development of fiduciary concepts and to the education of participants in the capital markets. This letter is but one attempt to shed further light on the nature of fiduciary duties of investment advisors and the importance of the preservation of high standards of conduct for all those who provide investment advisory services.

While I comment in Section A of this comment letter upon the economic aspects of the fiduciary duty relationship from the standpoint of the fiduciary (i.e., the desire by an expert to enter into fiduciary status as to their clients in order to gain a marketing advantage which results from increased reputation), these economic aspects, while important, are not the primary drivers of opposition to the Proposed Rule. While the debate over the Proposed Rule has profound and lasting concerns for the future continuation of the investment advisory profession, the primary motivation behind the vast majority of comments submitted by financial planners and investment adviser representatives was not out of competitive concerns but out of concern for the effect of the rule on individual investors. While the Securities Industry Association, which represents broker dealer firms, may fail to understand this desire to do good for others, for fiduciaries the placement of other's interests of their own is natural and occurs daily. Many, if not the vast majority, of fiduciaries choose to serve others out of personal desire. For example, why did I desire to become an attorney? Because I saw in the profession the ability to assist others in need, and I wanted to be part of such a noble endeavor. Why did I and my partners form an registered investment adviser (RIA) firm, and why did I desire to also become an investment adviser representative? Because I and my CPA/partners saw within our community a need for objective financial planning and investment advisory services, and we desired to ensure that our clients receive such services from highly qualified advisors. As many of the commentators have pointed out, including both investment adviser representatives and registered representatives, opposition to the Proposed Rule is not primarily driven by economic considerations of the commentators but rather because they believe the Proposed Rule will do far more harm than good to individual investors. I wholeheartedly agree with such an assessment. As I have stated previously in my prior comments, I foresee in the Proposed Rule, in its January 7, 2005 form, an opportunity to distinguish myself from non-fiduciaries and thereby provide a marketing edge for my firm.

Nevertheless, I feel compelled to speak out against the Proposed Rule as I believe it will harm individual investors greatly.

The Proposed Rule has been characterized by the Securities Industry Association and by many brokerage firms, and even to a degree by the SEC itself, as a “financial planner” versus “registered representative” struggle. It is not that at all. The sole issue is what is in the best interests of the individual investor. In this regard, the struggle is between those who are opposed to providing fiduciary protections to individual investors (broker-dealer firms) and those who seek to protect individual investors. I hope the SEC ends up in the latter category.

I have attempted to follow the SEC’s suggestions in the reproposal of the Proposed Rule and define the term “solely incidental” in some fashion that would appropriately draw the line so as to define when and when not investment advisory services are “solely incidental.” After much thought, including a review of the many other comments submitted by other commentators, I am convinced that no rational person can draw such a line - other than the lines which were drawn by the Investment Advisers Act of 1940 itself. It is clear that attempts to extend the lines beyond the accepted (primary) definitions of “solely” and “incidental” and the non-use of the bright line test “for which no special compensation is received” painfully result in a gross distortion of the plain language and clear meaning of the Advisers Act and a failure to enforce the will of the U.S. Congress and its desire to protect individual investors. By the Proposed Rule the SEC seeks to change the law of the land, instead of reasonably interpret the law and sensibly apply the law.

Moreover, the SEC’s Proposed Rule is fundamentally flawed in that it seeks to lower the bar - to substantially lower the standards of conduct of those who provide investment advisory services in a comprehensive, holistic, or ongoing manner.<sup>42</sup> The Proposed Rule was initially designed to foster a fee-

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<sup>42</sup> Other flaws exist in the Proposed Rule as re-proposed January 6, 2005. Perhaps the first major flaw is the SEC’s acceptance of the concept that fee-based brokerage accounts are a mere repricing of services. While there may be instances where this is true, as where trades are undertaken in fee-based accounts as a means of saving upon commissions and the client does not receive ongoing advice from the registered representative of the broker-dealer. However, this is not the primary way such fee-based brokerage accounts have been marketed by the broker-dealer industry. As stated in comments dated Feb. 7, 2005 by Fund Democracy, Consumer Federation of America, Consumers Union, and Consumer Action: “In developing this rule proposal

based compensation structure which is admittedly less subject to conflicts of interest than commission-based compensation. However, as many commentators have pointed out, great harm that would result from the non-application of the fiduciary duties imposed by the Advisers Act to the fee-based accounts of broker-dealer firms. It is altogether clear that the benefits to individual investors of the Proposed Rule are far outweighed by the great and lasting harms the Proposed Rule would inflict upon individual investors and upon our capital markets system.

Moreover, the plain language and clear meaning of the Advisers Act, its legislative history,<sup>43</sup> case law (including *Lowe vs. SEC*), the standards of conduct applicable to fiduciary advisers,<sup>44</sup> and public policy all

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and attendant policy discussion, the Commission appears to have unquestioningly adopted the brokerage industry's sophistry that a mere change in the structure of the compensation they charge should not affect their status under the Advisers Act if the services they provide remain the same. This argument fails for a number of reasons. First and foremost, the industry's argument fails because the services provided under commission-based programs often are not, in fact, solely incidental; the programs should have been subject to adviser regulation for many years. The Commission has implicitly conceded this point by its belated realization that the broker exclusion should not be available to commission-based discretionary accounts or financial planning. Second, the industry's argument fails because the services provided by brokers have changed dramatically over time. Brokers' advertisements for their fee-based accounts often seek to attract business by boasting about the new level of financial planning and advisory services being provided. Unlike the incidental services provided by full-service brokers in the past, the advisory services provided by full-service brokers today are critical and even predominant. Congress anticipated this situation by specifically requiring that brokers providing such advisory services be subject to adviser regulation."

<sup>43</sup> A compelling legislative history of the Advisers Act is presented in the comments of Barbara Roper, Director of Investor Protection, Consumer Federation of America (February 7, 2005). This entire comment is worthy of careful reading. Ms. Roper summarizes: "When read in its entirety, the legislative record clearly shows: that Congress was aware of and concerned about abuses associated with brokers offering investment advice; that its concern about these abuses was one motive behind the legislation; and that Congress consciously rejected the approach of providing brokers with a blanket exception and instead chose to provide only a narrow exception for brokers engaged exclusively in certain typical brokerage activities."

<sup>44</sup> The high standards of conduct which were intended by the Advisers Act are aptly summarized by John H. Walsh (Chief Counsel, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission) in "A Simple Code of Ethics: a History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry," 29 Hofstra L.Rev. 1015 (2001), available at [http://www.hofstra.edu/PDF/law\\_walsh.pdf](http://www.hofstra.edu/PDF/law_walsh.pdf), stating in part: "During the debate in Congress, the special professional relationship between advisers and their clients was recognized. It is, said one representative,

support the application of the Advisers Act to the fee-based accounts offered by broker-dealer firms. Additionally, fee-based services will continue to be provided by broker-dealer firms in response to market demand for such services,<sup>45</sup> even if dual registration of such firms as an RIA is required. In fact, since the introduction of the Advisers Act many investment advisers have also been brokerage firms,<sup>46</sup> many current brokerage firms are already dually registered, and the compliance burden in having to comply with the Advisers Act would be minimal.

Important contributions have been made to this debate by those interested parties who submitted nearly 2,000 comments to the Proposed Rule. Many astute observations have detailed the real-world distinctions between those who sell products and those who seek to provide objective advisory services. These comments have led to a greater understanding of the key distinctions between fiduciary investment counselors and non-fiduciaries. These comments have also highlighted the critical role of the Investment Advisers Act of 1940 as one of the most important consumer protection statutes of the 20<sup>th</sup> Century. The

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‘somewhat [like that] of a physician to his patient.’ The same Congressman continued that members of the (investment advisers) profession were ‘to be complimented for their desire to improve the status of their profession and to improve its quality.’ The method chosen for achieving these goals was of a piece with most of the prior legislation—fraudulent practices inconsistent with these ideals were made unlawful. Specifically, section 206(1) made it unlawful “to employ any device, scheme, or artifice to defraud any client or prospective client.” Section 206(2) made it unlawful “to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” All of the themes of this history are reflected in the legislative history of the Advisers Act. First, the Act was explicitly motivated by the desire to protect and enhance advisers’ professional ethics. Second, this objective was to be reached by prohibiting conduct inconsistent with the ideal. Third, even associational self-regulation made an appearance in the idea that all advisers suffered from the stigma placed on the unethical fringe elements, and in the idea that federal regulation was needed to support the industry’s voluntary effort to establish a code of ethics.” *Id.* at 1067-8 (citations omitted).

<sup>45</sup> The mission of the SEC to protect individual investors should not be cast aside. “It is not the Commission’s job to preserve the broker’s regulatory status when the broker’s business model has changed so dramatically. It is the Commission’s job to ensure that investors are adequately protected.” Comments of Barbara Roper, Director of Investor Protection, Consumer Federation of America (Feb. 7, 2005).

<sup>46</sup> In the 1941 Annual Report of the Securities and Exchange Commission, it was noted that “approximately 25 percent of the effectively registered investment advisers are also registered with the Commission as brokers and dealers.”

SEC's Proposed Rule would limit the application of the Advisers Act by having an exception swallow the rule and, in the process, set back perhaps the greatest accomplishment in securities regulation in the past 100 years.<sup>47</sup>

The many comments submitted in response to the Proposed Rule have additionally made clear that the ultimate resolution of the issues presented by the Proposed Rule (whether it occur through SEC rule-making action or subsequent judicial review) will likely determine, for years or decades to come, the definitions of "financial planners," "wealth managers," "financial consultants," and similar terms. This is because the resolution of the Proposed Rule will determine whether or not broad fiduciary duties are always to be imposed upon the persons performing comprehensive and/or ongoing investment advisory activities. As a result, the resolution of this Proposed Rule has the potential to define, at least broadly, the standards of conduct under which such professionals who seek to utilize such titles must operate. I applaud my colleagues and the many others who have contributed toward a greater understanding of the many critical issues involved in this Proposed Rule.

It should be noted that the Proposed Rule is an outgrowth of an important choice made by thousands, if not millions, of individual investors - to no longer be a customer who is sold products, but rather to be served in an objective fashion by those who seek to avoid the inherent conflicts of interest present in commission-based, transaction-based compensation. As I noted in my original comments to the Proposed Rule, dated February 17, 2004, there is a "growing need and demand for unbiased investment information and guidance" by individual investors. While the intent of the original 1999 Proposed Rule was laudable in that it sought to encourage this paradigm shift toward objective advice, the Proposed Rule unfortunately

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<sup>47</sup> "[President Franklin D. Roosevelt (FDR)] told the press in March 1933 that his principal objective was to restore the idea that dealers in securities, both new and old, and people who worked on exchanges, are fiduciaries. Did he succeed? ... Investment advisers are fiduciaries. In 1963, the Supreme Court read the legislative history for the Advisers Act, and decisively concluded that investment advisers are fiduciaries for their clients. FDR did not specifically mention advisers in 1933, which is understandable because it was only during the 1930s that investment counsel began to publicly identify themselves as a separate component of the securities industry. Nonetheless, their professional status represents the fullest accomplishment of the Brandeisian strand in FDR's policy vision. Advisers are professional fiduciaries who must exercise disinterested judgment on their clients' behalf." John H. Walsh, A Simple Code of Ethics: a History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry, 29 Hofstra L.Rev. 1015, 1079 (2001), available at [http://www.hofstra.edu/PDF/law\\_walsh.pdf](http://www.hofstra.edu/PDF/law_walsh.pdf).

was, and continues to be, fatally flawed as to its lack of intellectual justification and its long-term adverse effects on individual investors. Rather than benefit the public, the adverse effects of the Proposed Rule undermine the all-important fiduciary protections deserved by investors who seek out investment advisory services. Indeed, the Proposed Rule has led the SEC to commence down a “slippery slope” - at the bottom of which is a complete erosion of the important protections afforded to individual investors who seek out objective and unbiased investment advice.

As revealed in the bulk of the comments submitted to the SEC, the important consumer protections afforded to investors by the Advisers Act should not be cast aside by the Proposed Rule. Rather, by carefully reviewing and analyzing all of the comments submitted, especially those which cast important light on the legislative history of the Advisers Act and the important public policy implications of the Proposed Rule, the SEC now possesses the opportunity to modify its course. The SEC now possesses the opportunity to apply the important protections afforded to individual investors by the Advisers Act. The SEC possesses the opportunity to confirm the Adviser Act’s imposition of fiduciary status on all those who provide ongoing and/or comprehensive investment advisory services. The SEC possesses the opportunity to succeed in its primary mission - the proactive protection of the individual investor and, in so doing, the preservation of our capital markets system.

It is disturbing that the SEC staff has apparently not looked at the issues involved in an objective fashion, as indicated by the no-action position taken in the original Proposed Rule (without the benefit of prior public comment), in the language and tone of the January 6, 2005 Reproposed Rule, and in comments made by SEC staff in a letter dated January 6, 2005 to the New York Times, SEC Staff would be served to remember the words of the SEC’s first General Counsel, Judge John Burns, who stated that: “[p]ublic confidence [would] return ... with the enforcement of high standards, and [that] the maintenance of high standards [would be] assured when it [became] unnecessary to depart from them in order to meet the competition of lower standards.”<sup>48</sup>

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<sup>48</sup> John J. Burns, Address at the Bondmens Club of Chicago 2, 5-6 (May 23, 1935)  
(transcript available in the SEC Library at 2 SEC Speeches, 1934-61).

The Proposed Rule is the single most important issue facing the Commission in recent years. Careful study and analysis of the many issues presented, and implications for individual investors, is warranted. I hope that the Commissioners will reach out to the many consumer organizations which have submitted comments in opposition to the Proposed Rule, ask the necessary tough questions of SEC staff, and read the many comments submitted. I hope that the Commissioners will change course to a new direction - one in which the Advisers Act is applied as Congress intended. I further hope that the Commission will respect the interests of individual investors and the necessity to preserve confidence in our capital markets system.

I encourage the SEC to withdraw the Proposed Rule and to permit broker-dealer firms a reasonable time to transition their customers who are in fee-based brokerage accounts to investment advisory accounts.

I encourage the SEC to advance the all-important fiduciary principles applicable to investment advisory activities, and to encourage all investment advisory firms and their representatives to seek out, and adopt, best practices. The recent requirements for appointment of a Chief Compliance Officer, the adoption of compliance policies and procedures, and the requirement for adoption of a Code of Ethics, are a welcome start to this goal. More can be done by the SEC, including the education of industry participants regarding the concepts underlying the fiduciary status of investment advisers and an illumination of the specific duties which follow from fiduciary status. SEC support of research into fiduciary duties, and education of investment advisers and individual investors on the benefits which flow from fiduciary status, would be welcome.

I encourage the SEC to not permit, by means of some form containing an illegal hedge clause, an individual investor to “opt out of” or “waive” the protections afforded by fiduciary status and the application of the Advisers Act.

I cannot wonder if Director Paul Roye’s recent comments, set forth at the beginning of this comment letter, that “competitive and market pressures may work to compromise the fiduciary and ethical principles that form the bedrock of the advisory business,” may well forecast the demise of the investment management profession, should the Proposed Rule be adopted.

I encourage the SEC, through the proper application of fiduciary status upon all those who provide ongoing and/or comprehensive investment advisory services, to protect individual investors, preserve the integrity and reputation of the investment advisory profession, and thereby enhance and maintain our capital markets system.

Should the Commissioners or SEC staff desire any additional commentary, or if I can be of any assistance in any other manner, please do not hesitate to contact me. Thank you.

Very truly yours,

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