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November 21, 2013

Elizabeth Murphy, Secretary
M. Owen Donley III, Chief Counsel, Office of Investor Education
United States Securities and Exchange Commission
100 F Street
Washington, D.C.20549

Re: Strengthening Investor Protection and the Fiduciary Duty Standard, File No. 265-28

Dear Secretary Murphy and Counsel Donley:

I submit my comments in anticipation of the open meeting of the Securities and Exchange Commission's Investment Advisory Committee on November 22, 2013, as it relates to strengthening investor protection and the fiduciary duty standard for broker dealers no less stringent than investment advisers.

I have over the last several months reviewed Title IX, Investor Protection, of Dodd-Frank, the relevant studies, a number of SEC Rules promulgated post Dodd-Frank and various addresses by the Chair, members of the Commission and the Staff with a view to identify what the Commission and its Staff now deem to be the key issues to investor protection and the direction to be taken to revitalize the effectiveness and spirit of the agency.

The Chair's remarks on May 16, July 30, October 3 and October 9, 2013; those of Commissioner Stein, among other remarks,, September 18, 2013, and Andrew Ceresney, Co-Director of Enforcement September 19, 2013 present a comprehensive view of what is perceived to be the Commission's role and direction. Three (3) of the critical topics, among others; for further discussion are accounting fraud; the fiduciary duty standard for broker-dealers no less stringent than for investment advisers; and an arbitration and claims process perceived to be and in fact fair to the individual and non-institutional investor. I write this letter to share my thoughts on these subjects that I hope will make a significant contribution to the informed dialogue now ongoing.

I. Accounting Fraud:

Andrew Ceresney in an address September 19, 2013 stated "[t]he importance of pursuing financial fraud cannot be overstated "and "comprehensive, accurate and reliable financial reporting is the bedrock upon which our markets are based because false financial information saps investor confidence and erodes integrity of the markets." I wholeheartedly support the heightened focus upon accounting fraud but must add the following qualification. Inaccurate and materially incomplete financial reporting is not always a product of fraud. Problems originate many times in a systemic flaw that if it had been discerned at or near the outset it might not have occurred.

In my practice and scholarship I have found an area worthy for attention in respect to risk avoidance in connection with financial reporting. Intertwined legal and accounting issues such as contingent liabilities, going concern qualifications, and materiality present problems that are worthy of our study, clarification, and the taking of remedial measures.

When lawyers and accountants overlap with the same clients and on the same or correlating issues; they often work at cross purposes which produces flawed financial reporting. It is critical to analyze the issues arising from this context as it shows that more informed communications and further clarification between the professions can avert problems. Critical thinking and informed dialogue will be essential to identify systemic risk, so we can then take appropriate remedial measures. The treatment of interdisciplinary issues fall squarely within the SEC's role in working with the Financial Accounting Standards Board ("FASB") in setting accounting standards for public companies and are also within the oversight responsibilities of the Public Accounting Oversight Board ("PCAOB") on significant issues including financial responsibility of broker-dealers.[1]

II. The Fiduciary Duty Standard And Audited Professionalism

The Study On Investment Advisors and Broker-Dealers (January 2011) with a prime purpose to lead to rule making to establish a fiduciary duty standard for brokers and broker-dealers "no less stringent than for investment advisers" should trigger a reexamination of not only the operative standards of professionalism for brokers but for all categories of positions in the financial services industry and capital markets.

Where there is an expectation that a position brings with it professional responsibilities, it is my view that to accord professional status to categories of key participants in the capital markets that not only includes brokers and investment advisors, but credit and investment analysts, firm supervisory personnel, and compliance professionals is sound policy and will have most beneficial effects.

On the other hand, there needs to be clarity in setting the standards of competency and ethics. Rigidity or mere use of terms of aspiration without filling in the content will not produce the objectives intended and over look what has already been established in the industry in the

[1] Testimony on oversight of the SEC May 16, 2013 of Hon. Mary Jo White.

applicable rules, customs, and practices. There has been for brokers a clear distinction that when they have formal and defacto discretion and have care, custody, and control of a customer's funds and securities they do in fact have fiduciary responsibilities. However, the standards applicable to the broker do not always equate with those applicable to the investment advisor representative. This is the case, where the customer is fully capable of and makes his or her own investment decisions; the trades are unsolicited; and the customer has responsibilities to read and protest confirmations and account statements that are not accurate and that reflect trades the customer never authorized or approved. Moreover the current standards are not either/or, but adapted to the specific context. The brokers has fiduciary obligations in making suitable recommendations and getting best execution but they do not equate to the investment adviser representative's duties. The investment adviser representative has management responsibilities for the client's account and the client is completely dependent on the adviser.

By way of example the suitability concept and the broker's role in the context of a non-discretionary account requires the broker to have a written information base before making a recommendation consistent with the investment objectives of a non-vulnerable customer but does not abrogate the customer's responsibility to check his or her confirmations and account statements and make a timely and documented objection to unauthorized transactions or charges deemed excessive. In that context where the customer has the choice, the full fiduciary obligation is only triggered again when the broker has the duty of best execution, and when the broker has custody of the customer's funds and securities in specific relation to custody.

The better approach in my opinion will be to allow each professional group to set their own standards of competency and ethics with the SEC's oversight to assure whatever the context, the public customer is accorded appropriate protection. Changing labels will not give meaningful content to the rules, customs, and practices that should give informed and beneficial guidance on an ongoing basis to those assuming responsibility for other people's money and securities.

Key to the articulation and lasting internalization of professional standards by the broker, investment advisor, or investment and credit analyst will be textual clarity in the rules that give educative notice as well as rules that make sense in a practical context. Continuous and pragmatic review to reasonably assure the rules will work for the protection of investors will be essential.

While the SEC and other regulators now strive to be everywhere they cannot be everywhere.[2] In part the gaps will be covered by cultures of compliance created and sustained by sound financial service organizations and the professionals they engage or employ and especially with respect to rules that assign supervisory responsibility within the organization. No doubt the SEC seeks to give OCIE's examination process greater breadth and depth but that

[2] Financial statement audits do audit "internal controls" but this is not sufficient to give reasonable assurance of a more comprehensive coverage that even with the maxim um number of inspections and investigations of regulators, can only be achieved if there are independent private sector compliance audits.

too will extend coverage but not reasonably assure its presence in all contexts. To assure even greater investor protection it is my recommendation that the SEC, the industry, and the professions that serve in and for the industry and the investors expand our notions for more comprehensive compliance audits to audit the professionalism of both the individuals serving in professional roles as well as the organizations. These audits should be performed by independent and private sector auditors and will add a new dimension of self-regulation to supplement OCIE and SRO examinations.

These audits should have auditor opinions and/or certifications and representations by the organization and the professionals within them that after the application of reasonable audit procedures the organization and its professionals have complied with applicable law and professional standards of competency and ethics. The existing gaps resulting from the reality of an absence of regulatory omnipresence will have a greater assurance of being filled. These private sector investor protection audits should now be mandatory for investor protection including in areas beyond the scope of the traditional financial statement audit and encompass<u>inter alia</u>, an organization's claims handling procedures and practices.

By way of example to the above in Securities Act of 1933 Release 33-9415 the Commission promulgated a rule "Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A" that on its face eliminates the restriction of the private offering exemption to a limited group and allow such an offering in essence to become mass marketed.

In a talk on September 12, 2013 at the PLI Hedge Fund Management Conference Norm Champ, Director of the Division of Investor Management, stated in respect to the Rule 506 amendment eliminating the prohibition on general solicitation and general advertising for certain offerings, the following:

> "The final rule permits issuers to use general solicitation and general advertising to offer their securities if, among other things, issuers take reasonable steps to verify 'accredited investor' status and all purchasers of the securities are accredited investors. <u>Determination of the reasonableness of the steps taken to verify that an investor is accredited is by an objective assessment by an issuer</u>, and in response to comments the final rule provides a non-exclusive list of methods that issues may use to satisfy the verification requirement for individual investors." (Emphasis added).
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> [A]dvisers should carefully review their policies and procedures to determine whether they are reasonably designed to prevent the use of fraudulent or misleading advertisements and update those policies, where necessary, particularly if the hedge funds intend to engage in general solicitation activity. <u>Hedge fund sponsors</u>

intending to rely on the new rule should also consider whether their current practices for verifying accredited investor status meet the requirements of the new rule." (Emphasis added).

Private sector and independent auditing of the verification of accredited investor status will be essential and prevent to the greatest extent possible participation by non-accredited and unsuitable investors. There must be a heightened consciousness of the risks of general solicitation and auditing to avert those risks. The accounting profession has developed what is termed as a "special procedures engagement" that can serve as a model in this context. Another area that should be subject to an independent private sector audit of compliance procedures and practices on an ongoing basis is investment adviser performance compensation. See 17 CFR Part 275, Release No. 1A 3372, File no 57-17-11.

The above contexts are precisely where an independent compliance auditor applying review and verification procedures would greatly enhance investor protection and supplement the SEC's and the SROs' inspection and investigation processes.

I also believe that professional responsibility in the financial services industry and capital markets can be enhanced by establishing for those groups with recognized professional status, self-regulatory organizations that will set professional standards of competency and ethics under SEC oversight. It would be my recommendation to establish an SRO for investment advisers comparable to FINRA and the PCAOB that would also in addition to regulatory oversight provide a dispute resolution forum. Where industry expertise combine with the participation of public arbitrators it is likely such a forum will maintain the highest level of fairness in perception and reality.

III. Mediation, Arbitration, and Pre-Dispute Claims Resolution

In an address to the North American Securities Administrators Association, Annual/SEC/9(d) Conference April 16, 2013 Commissioner Luis A. Aguilar addressed among other subjects "Efforts to Weaken Investor Protection" and expressed his "main concern ... [that] pre-dispute mandatory arbitration is the denial of investor choice; ... and investors should not have their option of choosing between arbitration and the traditional judicial process taken away from them at the very beginning of their relationship with their brokers and advisers."

Experienced securities lawyers have seen cases where arbitration has been fair to both the public customer and the industry; situations where arbitration has been grossly unfair and almost as costly as litigation in court; and cases in court where customers with smaller claims were overwhelmed by prohibitive costs. If the customers are put in a position to make an informed choice confirmed in writing *separate* from their selection of an adviser, or the type of account they are opening i.e., cash, margin, or option account; and the mediation-arbitration processes is reformed; mediation-arbitration will be the better alternative for most individual and non-institutional customers.

Two critical reforms should be put in place. In a securities arbitration any one of the parties should have the option of having the arbitrators issue a *reasoned award*. This will not only enhance the customer's perception of fair process but also allow the arbitration forum to contribute to and maintain the principled development of the Federal and State Securities Laws. To re-enforce the foregoing, I would also recommend that SROs with arbitration forums have an *internal appeals process* that will also enhance the perceptions of fairness. In today's securities arbitration process non-reasoned awards and judicial deference to arbitrators, unless there is a manifest disregard of law or corruption; does in fact on occasion prevent the truth from coming to light with respect to serious wrongdoing and achieving a fair and equitable result for the public customer.

With reasoned awards and an internal appellate process matters having disciplinary implications will be more readily referred to the SEC and other appropriate regulators and the SRO arbitration forum will be more informative and effective in facilitating regulatory oversight. Regulatory enforcement and rule-making processes will also be greatly enhanced. The complaint and disciplinary history of individual brokers and their firms will also be more information to prospective customers.

Further a more comprehensive claims process that will also be subject to independent and private sector auditing along with professional liability insurance for investment professionals will also confer significant benefits in a number of ways. Professional liability insurance will provide greater investor protection for legitimate investor loss and supplement and possibly prevent SIPIC liquidations. Further the underwriting process will provide additional self-regulation and compliance in order to satisfy the requirements for insurability. Recently FINRA announced that it was considering mandatory professional liability insurance. See Wall Street Journal, October 5, 2013.

I also believe more pervasive professional liability insurance along with the other recommendations I have made, will add to the greater development of professionalism in the financial service industry and shift the prime focus of broker-customer disputes to professional malpractice instead of fraud. Not complying with objective professional standards of financial service competency and ethics developed initially by the industry is more susceptible to reliable and easier proof than fraud or constructive fraud with its scienter and/or reckless disregard standard. In fact under Dodd-Frank there is already a diminishment of the standard of reckless disregard to recklessly failing to comply or in essence, professional malpractice.

I hope the foregoing will be helpful and strengthen the law and the SEC's ability to enhance investor protection. I thank the Commission and the Committee for the opportunity to participate in the informed dialogue of the open meeting and the Commission's other processes.

Respectfully,

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