Evensky & Katz
WEALTH MANAGEMENT

Harold R. Evensky, CFP®
President

August 17th, 2010
U.S. Securities and Exchange Commission
100 F Street, NE Washington, DC 20549
To Whom It May Concern:

This letter is in response to the notice published on the SEC's Web site requesting public comments on regulatory initiatives under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") (PL 111-203).

Reviewing the public commentary preceding the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the subsequent comment letters submitted to date to the SEC regarding the proposed imposition of a fiduciary duty for anyone providing personalized investment advice, the concerns seem to focus on a few primary issues; namely those highlighted in the letters described as Type B.

Type B respondents argue against the broad imposition of fiduciary duty for the following reasons:

I. Suitability standards currently governing broker-dealers and registered representatives are already stringent and heavily enforced. Current regulations already provide strong and appropriate consumer safeguards.
II. Requiring compliance with 'fiduciary standards' will drive many advisers out of the market and eliminate a valuable advisory resource to consumers, especially in middle- and lower-income markets.
III. Additional risk of lawsuits involving registered representatives will increase costs to consumers.
IV. Driving every registered representative to fee-only compensation will not necessarily result in better, unbiased advice for the consumer.

Although those objecting to the imposition of a real fiduciary standard are unquestionably passionate in their beliefs, their concerns and objections are based on a lack of understanding of the fundamental differences between a suitability and fiduciary standard and misinterpretation of the actual impact of fiduciary standards on current business practices. Although it is important to note that the current suitability standard versus the proposed fiduciary standard is not an issue of good versus evil, they are substantively very different standards. I obviously have strong personal opinions on these issues; however, I do not believe I am alone and the following commentary, largely reflects the thoughts and opinions of current and former regulators and jurist.

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I. Suitability standards currently governing broker-dealers and registered representatives are already stringent and heavily enforced. Current regulations already provide strong and appropriate consumer safeguards.

This objection is based on a lack of understanding regarding the fundamental difference in the responsibility of a professional in sales (i.e., suitability) versus a fiduciary relationship. Although the difference is fundamental, the confusion is not new. As an example of one significant difference, namely "disclosure," in a 1948 speech to the Stockbrokers' Associates of Chicago, Louis Loss, Chief Counsel, Trading and Exchange Division, SEC, said,

> "… ***in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation*** than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to make a scrupulously full disclosure of every element of its adverse interest in, the transaction. In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses. ***This requirement has nothing to do with good or bad motive***. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. "[1]. [the emphasis is mine].

The point is that although under a commercial suitability standard there may be strong consumer safeguards, no matter how "high" the standard, the relationship is "arms length (i.e., caveat emptor)," and the fundamental requirements of a fiduciary relationship (e.g., elimination of conflicts of interest and full disclosure of those that cannot be eliminated) do not apply. The importance of these differences and the lack of the public's understanding have been highlighted by many studies including the Rand Report

[1] And, even earlier, Judge Cardoza noted· "…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." *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928)

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In 2005, commissioner Glassman emphasized the fundamental differences[2]

> Although fee-based accounts further blur the line between brokers and investment advisers, their respective regulatory regimes remain distinct. Broker-dealers are subject to a comprehensive regulatory scheme that protects investors in many ways. ***Generally speaking, when a broker makes a recommendation, the recommendation must be a suitable, although not necessarily the best, recommendation for the client. However, broker-dealers ordinarily do not owe their clients duties of loyalty that would require them to make up-front disclosure of each and every conflict…***.
>
> ***So, absent a fiduciary duty arising from a relationship of trust and confidence, a broker does not have a duty to disclose all conflicts***…
>
> ***By contrast, investment advisers are always full-fledged fiduciaries. As a consequence, they owe their clients a variety of fiduciary duties, which includes a duty to disclose conflicts, financial and otherwise - at the beginning of the relationship -- and overall, a duty to put the investor's interests first.*** [my emphasis]

Commissioner Aguilar in his speech to the Investment Adviser Best Practices Summit, March 26, 2010 observed:

> For the last several years, I've been listening to the ongoing debate about what standard should be applied. While many of the standards I have heard proposed are referred to as "fiduciary" standards, these standards do not offer the same robust protection as the fiduciary standard that currently applies to investment advisers. ***In truth, there is only one fiduciary standard, and it means an affirmative obligation to act in the best interests of the client and to put a client's interests above one's own***. [my emphasis]

Also acknowledging this fundamental difference in standards, Richard Ketchum, FINRA Chairman and CEO, remarked at the SIFMA Compliance & Legal Division's Annual Seminar, March 23, 2009 that

> "Generally then, ***the regulatory principals governing the relationship between a B-D and client can be thought of as a balancing of conflicting interests. In contrast, RIAs are subject to a fiduciary standard***." [my emphasis]

[2] Commissioner Cynthia Glassman, Speech Investment Advisors/Broker Dealers, April 6, 2005

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A related objection to a fiduciary standard is that traditional suitability regulation provides better guidance and fiduciary standards are difficult to enforce and follow. For example, one commentator argues[3];

> "In comparing the investment adviser and broker-dealer regulatory regimes, the broker-dealer regulatory regime provides better guidance to registered representatives and their supervisors, and therefore better protection to their customers, because the rules are clear and specific, and the conduct of registered representatives is capable of being monitored and audited. By contrast, the principles-based nature of the investment adviser regulatory regime is more difficult to follow and enforce."

In fact, there is some truth to this concern. For example, Lori Richards, then Director, Office of Compliance Inspections and Examinations at the SEC told attendees at an Investment Adviser Compliance Summit[4]

I would suggest that an adviser, as that trustworthy fiduciary, has five major responsibilities when it comes to clients. They are:

1. to put clients' interests first;
2. to act with utmost good faith;
3. to provide full and fair disclosure of all material facts;
4. not to mislead clients; and
5. to expose all conflicts of interest to clients.

These responsibilities overlap in many ways. If an adviser is putting clients' interests first, then the adviser will not mislead clients. And, if the adviser is not misleading clients, then it is providing full and fair disclosure, including disclosure of any conflicts of interest.

How do the responsibilities of a fiduciary translate into an adviser's obligations to clients each and every day? This is a key question. Probably no statute or set of rules could contemplate the variety of factual situations and decisions that an advisory firm faces. Can you imagine the number of rules and releases and regulations that this would require? ***Instead, the Advisers Act incorporates an adviser's fiduciary duty under Section 206, and envisions that, in whatever factual scenario, the adviser will act in the best interests of his clients***.

3 SEC Letter Type A Example; http://www.sec.gov/comments/4-606/4606-1059.htm
4 Lori A. Richards, Eighth Annual Investment Adviser Compliance Summit, February 27, 2006

And, as Mr. Ketchum has remarked: [5]

> The answer to this crisis is not regulation for regulation's sake but, rather, more thoughtful regulation that is better targeted and enlightened by the lessons of recent events. And that is a tough mission to accomplish in this environment. Recently, Hector Sants, Chief Executive Officer of the FSA, a regulator heralded by financial services firms because of its commitment to less obtrusive principles-based regulation, said, "There is a view that people are not frightened of the FSA. I can assure you that this is a view I am determined to correct. People should be very frightened of the FSA….A principles-based approach does not work with individuals who have no principles. We will seek to make judgments on the judgments of senior management and take actions if in our view those actions will lead to risks to our statutory objectives. This is a fundamental change."

Mr. Ketchum concluded, the ultimate point, and one all too often ignored is that

> "… above all, investors are waiting to see if we deserve to earn their trust again."

II. <u>Requiring compliance with 'fiduciary standards' will drive many advisers out of the market and eliminate a valuable advisory resource to consumers, especially in middle- and lower-income markets.</u>

It is difficult to understand why compliance with fiduciary standards "will drive many advisers out of the market." Financial advisors subject to the fiduciary standards of the '40 act have been successfully operating under a fiduciary standard for over 70 years and Investment Advisors subject to ERISA have successfully and profitably operated as fiduciaries for almost 40 years. The question is not will some practitioners be driven out of the market but is the public well served by practitioners who cannot or will not adhere to fiduciary standards.

Further more, the objection misses the point that the purpose of the law is to protect the consumer. Kathryn McGrath, then Director, Division of Investment Management, SEC, made that very point in 1987 in a speech to the Mutual Funds and Investment Management conference:

5 Richard Ketchum, Remarks from the SIFMA compliance & Legal Division's Annual Seminar, March 23, 2009

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> "… to the second point I'd like to make. It's related to the first, and it's something that I think people in the investment company and advisory industry must keep first and foremost in their minds at all times. ***The management of other people's money, through investment companies or by giving advice about investing in other securities, is a business, to be sure it's a very profitable business, and there's nothing wrong with making profits, that's the American way. But it is not just a business, certainly not an ordinary business. It is a fiduciary activity, a trust***. The people in this business, most particularly investment advisers and investment company officers, directors and staff, are from the outset and in the end, much more than business people. ***They are fiduciaries, entrusted with the savings of millions of people, to whom they owe a fiduciary duty in the handling of those savings. And so fiduciary principles, the highest standards of care, loyalty and judgment about what is in the best-interests of your clients and shareholders, not merely what makes good business sense from your own point of view, must guide your actions***. [my emphasis]

Obviously the issue is not new. Andrew Donohue, Director, Division of Investment Management, in discussing the fiduciary responsibilities of fund managers, told members of the Investment Company Institute in 2006:[6]

> ***If fund managers are not striving to further their investors' interests, then they should no longer have the privilege of serving investors. If someone cannot abide by a fiduciary's code of conduct, then there should be no place for that person in an industry that is dedicated to fiduciary values.*** [my emphasis]

It seems obvious that this should apply to anyone providing personalized investment advice.

III. <u>Additional risk of lawsuits involving registered representatives will increase costs to consumers.</u>

As with the prior objection, this is a difficult one to respond to as it is made without substantive support. Although the effort of meeting the higher fiduciary standard may result in additional compliance and supervision cost, as fiduciaries only the cost justified by the benefit may be passed onto the consumer. Furthermore, in evaluating the impact of additional cost (if any) a reasonable analysis must take into account the potential savings resulting from investment pricing based on fiduciary versus suitability standards.

[6] Speech to the Investment Company Institute Security Law Development Conference 2006,

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Commissioner Walter captured the essence of the issue in her comments to Mutual Fund Directors Forum Ninth Annual Policy conference,[7] namely, it is not a question of employment or compensation structure but rather whose interest should be protected.

> ***I believe that regulation of a financial professional should depend on what she does, not what she calls herself or how she is paid.*** As a corollary, I also believe ***strongly that retail investors should not bear the burden of understanding distinctions between financial professionals that have become increasingly less relevant over the years.*** [my emphasis]

IV. Driving every registered representative to fee-only compensation will not necessarily result in better, unbiased advice for the consumer.

Although it is indeed true that a fee-only compensation structure will not necessarily result in better, unbiased advice for the consumer, this is a classic straw man argument, i.e., a fallacy based on misrepresentation of the consequences of requiring a fiduciary standard. As proposed in the Dodd-Frank bill, there is simply no basis for suggesting a direct relationship between the requirement of a fiduciary standard when personal financial advice is provided and the requirement to provide fee-only advice. In fact, traditional brokerage services may still be provided both on a commission and suitability basis and advice driven transactions may be provided under a commission compensation structure and fiduciary standard.

A recent and related objection is to the proposed change for 12b(1) fees. Echoing the arguments against the fiduciary standard, it has been suggested that without 12b(1) fees, many registered representatives will be driven from the profession and small clients will be underserved. In fact, should 12b(1) fees be completely eliminated, brokers would be able to charge exactly the same percentage fee as the current12b(1), except the charge would be direct to the client. Of course, independent of the SEC's potential implementation of a fiduciary standard for all advice, regardless of compensation structure, direct billing would, under current law, make the relationship one of a fiduciary[8]. Given that the argument for maintaining the 12b(1) fee is that the broker deserves to be compensated for his advice, the shift from a suitability to a fiduciary standard should not be objectionable. It certainly cannot be credibly argued that it will be the cause of brokerage disintermediation. As Mr. Donohue said, "If someone [providing investment advice] cannot abide by a fiduciary's code of conduct, then there should be no place for that person in an industry that is dedicated to fiduciary values."

[7] Commissioner Elisse Walter, Mutual Fund Directors forum Ninth annual Policy conference, May 5, 2009

[8] Of course this would not only require that the advisor be held to a fiduciary standard, it would also mean that if the client no longer received or perceived value from the advisor's advice, he could fire the advisor and still maintain his investment position. This differs from the current 12b(1) compensation structure were an advisor is paid the 12b(1) whether advice is desired and/or provided or not. And, should an investor elect to fire the advisor, in order to eliminate the ongoing 12b(1) fee, he would have to liquidate the investment position (possibly facing a liquidation penalty).

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Déjà vu all over Again

Even though, as Ms. Richards has said, "Some people think 'fiduciary' is a vague word that's hard to define, but it's really not difficult to define or to understand. … A fiduciary must act for the benefit of the person to whom he owes fiduciary duties, to the exclusion of any contrary interest," it would be ludicrous to suggest that the implementation of a fiduciary standard is a simple matter. However, the fact that implementation may be difficult is not a valid reason for avoiding the appropriate standard. As noted earlier, difficult though it may be, it has been a successful standard in the investment profession for almost 70 years.

Again returning all the way back to 1948, I will conclude with the thoughts of Mr. Loss[9]:

> This brings me to an important chapter so far missing in the story. To say this much without more is a little like the law school professor who was asked by a first-yea~ student what the difference was between a question of law and a question of fact, and replied that questions of law are decided by the judge and questions of fact by the jury. That is all very true, but it did not inform the student how to tell which category a particular question fell under. Similarly here, before one can tell which of the two Hughes doctrines to apply, it is necessary to decide whether a firm is acting in a particular transaction as a dealer pure and simple or as a fiduciary. In some cases, as in the Arleen Hughes case itself, the answer is easy: A firm which is registered as an investment adviser, and which admittedly renders investment advice with respect to the same transactions in which it purports to act as principal, can hardly deny its fiduciary status. But suppose the firm is not registered as an adviser and has no fancy contracts with customers; it simply buys and sells securities as principal, rendering the incidental investment advice which we all know is universal in the industry and without which it could hardly operate. When does such a firm cross the line from the first Hughes doctrine to the second? … Obviously, where a firm confirms as broker for the customer there is no problem. The firm has assumed all the obligations which the law imposes upon an agent. But the sending of a principal confirmation is not always conclusive that the firm is really dealing at arms length and hence subject only to the first Hughes doctrine. All you have to do is see one or two cases where a salesman gets a lonely widow 80 years old to think he is the most wonderful fellow in the world because he sends her flowers on her birthday or maybe rubber tips for her crutches (this actually happened in one case). When you see a few characters of that sort purporting to act as principal in arm's-length transactions, it becomes obvious that a principal confirmation cannot be conclusive. How then do you decide? I am afraid the answer cannot be given with anything approaching mathematical certainty. The only answer I know depends not so much on any magic words but upon all of the surrounding circumstances, including the degree of sophistication of the parties and the course of conduct between them. And this is one time you can't blame the lawyers. The law must operate on the habits of people and the way most of us do business. A customer does not typically walk into a firm's office with a lawyer at his elbow

[9] 1948 speech to the Stockbrokers' Associates of Chicago, Louis Loss, Chief Counsel, Trading and Exchange division, SEC

> and say "Will you buy m, 100 shares of X stock at 50 or better on a one-percent commission?" This would be a clear agency transaction. Or, if a customer were to come in off the street the way a housewife walks into a grocery store and say "Do you have any X stock" and upon receiving an affirmative 'answer were to ask how much will you charge me for 100 shares of the X stock you have?1f and the firm were to say $48 and the customer were to say "Let me have it," it would be clear that the parties had entered into a principal transaction. But what usually happens? If a customer does come in without solicitation, he is apt to say, "Buy me 100 shares of X stock"-which is in effect an invitation for an agency transaction. But the salesman happens to be interested in principal transactions. So some vague talk ensues which leaves the question of capacity quite muddled and the firm then sends a "principal" confirmation. Very likely a court of law would hold that this amounted to an agency transaction unless the firm could show very clearly that it had made and the customer had accepted an express counter-offer to enter into a principal transaction. Even more typically, of course, the customer does not come in off the street but is actively solicited by a salesman, who will almost inevitably render some advice as an incident to his selling activities, and who may go further to the point where he instills in the customer such a degree of confidence in himself and reliance upon his advice that the customer clearly feels -- and the salesman knows the customer feels -- that the salesman is acting in the customer's interest. ***When you have gotten to that point, you have nothing resembling an arm's-length principal transaction regardless of the form of the confirmation. You have what is in effect and in law a fiduciary relationship.*** [my emphasis]

The "You" Standard

I believe that for practitioners there is a simple test to determine when they will be subject to a fiduciary standard; I refer to this as the "YOU" standard. If an investor calls and says, "I'd like to buy 100 shares of XYZ" – suitability standard. If an investor calls and says, "What does your firm think of XYZ stock?' and the advisor says "we believe ……" – suitability standard. If the investor says "Do you think I should buy XYZ stock?' and the advisor says "Yes, I think YOU …" – Fiduciary!

Consumer Call to Action

As Chairman Schapiro has said[10]:

> The fiduciary duty means that the financial service provider must at all times act in the best interest of customers or clients. In addition, a fiduciary must avoid conflicts of interest that impair its capacity to act for the benefit of its customers or clients. And if such conflicts cannot be avoided, a fiduciary must provide full and fair disclosure of the conflicts and obtain informed consent to the conflict.

[10] Chairman Mary Schapiro, New York Financial Writer's Association Annual Awards Dinner, June 18, 2009

> A fiduciary owes its customers and clients more than mere honesty and good faith alone. A fiduciary must put its clients' and customers' interests before its own, absent disclosure of, and consent to, conflicts of interest.

For the consumer the solution is easy, why wait six months or a year to get the protection they deserve when they can have it now – for free! They simply have to ask their advisor to agree to in writing the Five Fiduciary Principles[11]:

- Put the client's best interest first;
- Act with prudence; that is, with the skill, care, diligence and good judgment of a professional;
- Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts;
- Avoid conflicts of interest;
- Fully disclose[12] and fairly manage, in the client's favor, any unavoidable conflicts.

These five simple declarations could well serve as the core of an SEC mandated fiduciary standard.

It's like mom and apple pie; who could object?

Cordially yours,

Harold Evensky, CFP

[11] The Committee for the Fiduciary Standard: Five Fundamental Fiduciary Principals
[12] It is important to note that as critical and important as is adequate disclosure is, it is but one of the elements of a fiduciary duty. For example, the Rocky Mountain Financial Planning, SEC No-Action Letter noted "We do not agree that an investment adviser may have interests in a transaction and that his fiduciary obligation toward his client is discharged so long as the adviser makes complete disclosure of the nature and extent of his interest. While section 206(3) of the [Advisers Act] requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent.