August 30, 2010

U.S. Securities and Exchange Commission
Response to Request for Public Comment on
[Release No. 34-62577; IA-3058; File No. 4-606]
Study Regarding Obligations of Brokers, Dealers and Investment Advisers

On its face, this element of the Dodd/Frank Financial Reform Package seems straight-forward. Is there a need to re-define the fiduciary standard as it applies to investment professionals who work for broker/dealers?

This policy question arose initially in 1999, culminating in a 2005 SEC Rule titled: "Certain Broker-Dealers Deemed Not to Be Investment Advisers." The Rule was challenged by the Financial Planning Association and overturned in the now famous FPA v SEC case; (also called the "Merrill Lynch Rule.")

This landmark litigation led to the current definitive analysis on the topic conducted by the RAND Corporation and released in January, 2008. (available for download here: http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf)

The debate appears to have to main combatants, whose positions are detailed by the roughly 1,000 filed responses.

Briefly summarizing.

One group claims there are sufficient regulations in-place. This segment of investment professionals work for, (or through,) more traditional broker/dealers where the relationship between the individual and the entity is clearly defined. Using the parlance of the industry, these investment professionals are said to be "captive."

The opposing segment, (represented largely by the burgeoning financial planning community,) maintains that investors are owed a common set of disclosures and standards. For the sake of simple comparisons, this group can be characterized as the "independents."

However, the current dialogue misses the point of why the fight is so divisive.

Securities regulations regarding definitions, designations and disclosure burdens with respect to present day investment account relationships are indeed hopelessly outdated. The problem is the proposed "fixes" are equally flawed as they are superficial, seeking to further clarify language artfully crafted by investment attorneys through years of arduously fitting the "square peg" of an investment account contractual relationship, into the "round hole" of securities regulation.

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Put simply, the comprehensive answer to the fiduciary standard carries with it a host of consequences that challenge the most fundamental operating principles of the investment industry. In order to solve the policy question raised, nothing short of a complete overhaul of the landmark securities acts is required. And judging by the tenor of the just concluded financial reform debate, Congress seems unwilling to weigh deeper into complexities of the global investment industry.

This dilemma can best be explained by quoting Russell Ackoff, thought to be one of the founders of management consulting, who once famously said…

"All of our social problems arise out of doing the wrong thing righter."

"The more efficient you are at doing the wrong thing, the wronger you become. It is much better to do the right thing wronger than the wrong thing righter."

Ackoff's quotes were directed to social issues, but his concept is perfect for how many securities regulations have been advanced through time.

Consider the bedrock legislation that defines the investment world.

The Securities Act of 1933. What is a security today? How do investments in derivatives, leveraged ETF's, credit default swaps and other investment vehicles qualify as securities?

The Exchange Act of 1934. On any given day, the bulk of the reported trade volume in listed equity securities occurs "off the floor" through a new network of electronic networks that do not resemble the open outcry markets of just a few years ago.

Investment Advisers Act of 1940. Are hedge funds advisers? Are Financial Planners Advisers? What about CPA's who now hold multiple licenses? Are they CPA's first and investment professionals second?

Just a few years ago, it was not difficult to define what an investment bank was. Then in the blink of an eye the most venerable investment houses morphed into universal banks.

Against this backdrop, are two camps fighting a battle while ignoring the war.

The financial press and academia have detailed the larger issue, defining it as the "blurring" of financial services. However, the real issue comes down to a few salient points, again best understood by savvy investment professionals.

The problem for investors is rooted in the distinction between the "buy-side" and the "sell-side."

For years, the major investment houses were able to skillfully benefit from both sides of a securities transaction or relationship.

In one moment, Merrill Lynch could offer securities for sale; then purchase these same securities for its investment clients through a captive sales force. These investment professionals carried the designation defined by a “series 7 license.” However, as fees began to replace commissions in the early 1990’s, investment professionals working for investment houses began to seek compensation based both on commissions and fees.

To make the blurring even more profound, “hybrid” account relationships further muddied the definitions of “assets under management,” who was fiduciary of record.

As the definition of a fiduciary was broken into component pieces, including fees for custody, clearing, trading, valuing securities and conducting due diligence, the quagmire became even more vexing.

This debate will not be solved by any of the language currently being debated. New designations for investment professionals that go beyond the current licenses will be required before a true solution can be claimed.

Respectfully submitted,

Robert Radano