The Derivative Project

Via Electronic Filing

December 30, 2010

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. 4-606: Study Regarding Obligations of Brokers, Dealers, and Investment Advisers

Re: Study on Enhancing Investment Adviser Examinations under Section 914 of the Dodd Frank Wall Street Reform and Consumer Protection Act, File No. DF Title IX—Enhancing IA Examinations

Dear Ms. Murphy:

The Derivative Project appreciates the opportunity to submit comments concerning the Study on the Obligation of Brokers and Investment Advisors, in addition to submitting comments on Enhancing Investment Advisor Examinations.

The Derivative Project began as an advocacy group concerning regulation of over the counter derivatives and has expanded its focus today, post Dodd Frank, as an educational and advocacy organization focused on fostering sustainable economic growth of the U.S. Economy, through prudent investment of American's retirement dollars. The Derivative Project supports:

1. Incorporating investment curriculum in primary and secondary schools to better prepare individuals for their future retirement investment responsibility
2. Use of the existing SEC Investor Education and Advocacy Budget to institute needed investor protection, immediately, to reduce taxpayer dollars for SEC fraud investigations:

    - Highlight the difference between a stockbroker and a SEC registered investment advisor on the SEC website and incorporate basics of cost-effective retirement investing today
    - The SEC should ban all confusing "designations" and outline the acceptance of a single examination and title for a SEC Registered Investment Advisor Fiduciary, that affirms the intention of the Investment Advisors Act of 1940 of an Investment Advisor Profession
    - Develop new standards for the Chartered Financial Analyst (CFA) Exam that includes financial statement analysis on derivatives.

3. Utilize the existing SEC Enforcement Budget to target violations of the Investment Advisors Act of 1940, resulting from material conflicts of interest, to protect individual investors

4. Re-institute Glass Steagall, to eliminate the need for use of taxpayer dollars to monitor financial institutions' speculative investments.

5. Ban credit default swaps (naked) that do not hedge an underlying bond position.

The Derivative Project bases these recommendations to the SEC on over 25 years direct experience in risk management of foreign currencies in over the counter derivatives for a major U.S, commercial bank, commercial and international banking and direct experience as a dually registered NASD representative and SEC registered investment advisor and Series 4 Options Principal.

The Derivative Project has concerns with conflict of interest when the SEC and the Department of Justice rely exclusively on "academic" expertise to chart a new course. Academicians can offer a valuable perspective; however when the income they or their institutions receive is significant, they cannot be considered "impartial". The SEC can receive the most impartial advice on the proper steps the agency should take to meet its goal of investor protection from individuals that have been in the trenches, both advising clients and as an individual investor.

Summary Concerning the Obligation of Brokers and Investment Advisors

- **Effectiveness of Examination and Enforcement Programs**

Section 914 of Dodd-Frank directs the SEC to study the need for enhanced examination and enforcement resources for investment advisors. The financial crisis of 2008 has revealed the most shocking lack of enforcement by the SEC of the Investment Advisors Act of 1940, legal concepts that have been well-established with SEC v. Capital Gains Research Bureau, Inc.

SEC Registered Investment Advisors are not fiduciaries under the Investment Advisors Act of 1940 because the SEC has allowed an inherent conflict of interest, whereby the SEC registered investment advisor would receive more income if the client were in equities rather than bonds or cash.

Here is the Securities and Exchange Commissions own definition of fiduciary under the Investment Advisors Act of 1940:

- Lori A. Richards, Director, Office of Compliance Inspections, SEC spoke February 27, 2006 to an Advisor Compliance Summit and stated "A fiduciary must act for the benefit of the person to whom he owes a fiduciary duty, to the exclusion of any contrary interest. She stated the Advisers Act: "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."[2] And, the Court said that: investment advisers are fiduciaries with "an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' … clients."[3]
- 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.

- Ms. Richard states the question is not whether the adviser acts appropriately in the conflicted situation, but merely whether the conflict itself exists.

- **SEC Registered Investment Advisors and Their Role as Fiduciaries: The Basics That the SEC Must Address in Their Study to Congress and A Principal Cause of the Loss of $2 Trillion of American's Retirement Assets in the 2008 Financial Crisis: Material Conflict of Interest by SEC Registered Investment Advisors and Their Firms**

Here are two glaring examples where material conflict exists and this conflict has been brought to the attention of SEC Chairwoman Shapiro and the SEC Office of Investor Education and Advocacy.

Example I of Fiduciary Breach of Investment Advisors Act of 1940
Charles Schwab Private Client Service –

The SEC states its definition of fiduciary duty highlighted above. In Charles Schwab Private Client Service, a client pays Charles Schwab a monthly fee for investment advice that is calculated on the assets under management. The Charles Schwab SEC registered investment advisor then proposes the asset allocation and the investments to carry out the allocation to the client. However, the Charles Schwab SEC registered investment advisor does not get paid if his Charles Schwab Private Client Advisor moves assets to cash. Thus, in situations, like the collapse of Bear Stearns, when there is tremendous uncertainty in financial markets, it may be prudent to take some profits, move clients to cash and wait out the financial uncertainty that will most certainly impact the equity and or bond markets.

Unfortunately, in this instance, Charles Schwab Private Client was advised in November 2007 to do exactly that, to protect the principal of its investors close to retirement or in retirement. Why didn't Charles Schwab Private Client do so? As a firm, Charles Schwab would have lost income and the individual SEC registered investment advisors would have received a smaller paycheck. This was a clear breach of fiduciary duty. A material conflict exists in the design of this product and as SEC Ms. Richard stated above, " The question is not whether the advisor acts appropriately in the conflicted situation, but merely whether the conflict itself exists."

What Should Happen Now? Why Isn't the SEC Taking Action to Eliminate the Conflict and Protect the Retirement Investor?

The SEC should fine Charles Schwab, take some proceeds from the fine to reimburse the retirement investors (over 59 ½) of Schwab Private Client and require Schwab to redesign their "Private Client Service" to immediately eliminate the material conflicts of interest under the Investment Advisors Act of 1940.

Another Example of lack of Current Enforcement of the Investment Advisors Act of 1940, When there is a documented breach of Rule 206(4)-4 -- Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients

The SEC has been alerted to the fact that Charles Schwab Private Client employs SEC registered investment advisors that have past regulatory fines for breach of fiduciary duty in excess of

$110,000, that are not being disclosed in an ADV to the client and an ADV is not being given to the client, as required by law. Why doesn't the SEC fine Charles Schwab in this instance and offer help for the harmed retirement investor?

Example II of Fiduciary Breach of Investment Advisors Act of 1940
Asset Management Firms Increase Their Income if they are in Equities Over Bonds –

Here is a quote from a Bloomberg News article from August 29, 2010:

By Bloomberg News

August 29, 2010 6:01 am ET

Retail investors, burned by two market crashes in a decade, have shunned stocks for the longest stretch in more than 23 years, upsetting the balance of power in the $10.5 trillion mutual fund industry.

Bond funds attracted more money than their equity counterparts for 30 straight months through June, according to the Investment Company Institute. Preliminary data show the trend continued in July, matching the streak posted by bonds from 1984-87.

The shift is pressuring asset managers, especially equity-focused firms such as Janus Capital Group Inc. and The Capital Group Cos., because bond funds charge about 20% less in fees.

"Investors are using bond funds as a haven from the turmoil in equity markets, squeezing firms previously accustomed to the fatter fees charged by stock funds. On a dollar-weighted basis, the average stock fund collects 76 cents in fees for every $100 invested, compared with 61 cents for bond funds, according to Lipper Inc.

The impact can be seen in return on equity; a measure of profitability reported by publicly traded asset managers.

- At T. Rowe Price Group Inc., ROE fell to 22% in the second quarter of this year from 26% in the fourth quarter of 2007, the last full quarter before the bond-dominance streak began. Stock and blended portfolios accounted for 72%of the company's $391 billion in assets, down from 80%.

In this instance, during the 2008 financial crisis, many asset managers had warning signs, but stubbornly advised their 403B and 401k holders to stay in equities over bonds or cash. Was it because it was more profitable?

Investment News, the securities industry's paper for Advisors, published an article this afternoon, "DOW to hit all-time record next year? Odds look good." Speculative bets on stock market directions need to be explained by fiduciaries and advice by fiduciaries must be based on sound economic fundamentals. The difference between speculation and fundamental analysis is an education needed at this point by both Registered Investment Advisors (RIA)'s and individual investors. It is articles, such as this one in *Investment News* today, that serve to send out false advertising to sway individual retirement investors out of the safety of bonds into equities to increase asset managers' profitability.

Conclusions on Investment Adviser Examinations

The Charles Schwab Private Client Service is clearly in breach of fiduciary duty under the Investment Advisors Act of 1940, asset management firms that make more money if clients' assets are in equities, instead of bonds and cash, have contributed to millions of dollars of needless losses for retirement investors and the U.S. economy overall. It was the short-sightedness of Charles Schwab and asset management firms to increase their bottom line and that of its Advisors, over the good of protecting millions of retirement investors and the U.S. economy overall, during the 2008 financial crisis.

Finally, when a complaint has been made, the SEC must investigate and enforce it under Investment Advisors Act of 1940, Enforcement Section 209:

- ✓ *d. Action for injunction. Whenever it shall appear to the Commission that any person has engaged, is engaged, or is about to engage in any act or practice constituting a violation of any provision of this title, or of any rule, regulation, or order hereunder, or that any person has aided, abetted, counseled, commanded, induced, or procured, is aiding, abetting, counseling, commanding, inducing, or procuring, or is about to aid, abet, counsel, command, induce, or procure such a violation, it may in its discretion bring an action in the proper district court of the United States, or the proper United States court of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices and to enforce compliance with this title or any rule, regulation, or order hereunder. Upon a showing that such person has engaged, is engaged, or is about to engage in any such act or practice, or in aiding, abetting, counseling, commanding, inducing, or procuring any such act or practice, a permanent or temporary injunction or decree or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning any violation of the provisions of this title, or of any rule, regulation, or order there under, to the Attorney General, who, in his discretion, may institute the appropriate criminal proceedings under this title.*

Therefore, The Derivative Project recommends that the SEC clearly report to Congress on what is preventing them from enforcing clear violations of the Investment Advisors Act of 1940 and responding to retirement investors who seek to understand why.

It is imperative that the SEC comment on these questions and provide detail answers to Congress to determine what level of funding is needed to enforce breaches of the Investment Advisors Act of 1940:

- Why has the SEC not responded to these complaints about material conflict of interest in the Charles Schwab Private Client Service? Is the SEC too close to Charles Schwab and is it the revolving door between Wall Street and its regulators that prevents enforcement rather than "lack of personnel"? Charles Schwab's Executive Vice President was on the Board of FINRA recently and oversaw this complaint on material conflict of interest, as a Board Member, concerning a Charles Schwab's dually registered broker and SEC registered investment advisor. FINRA took no action against Charles Schwab despite knowledge of these regulatory breaches.

- In sum, before Congress awards additional taxpayer dollars for regulation and enforcement, it appears the conflicts of interest between the SEC and the firms it regulates must be resolved.

- If the SEC clearly defines the role of the investor with their retirement funds, the individual retirement investor can be educated to take on the responsibilities to protect them self. But if you have Wall Street saying we are your "trusted advisor" and we will take care of you, but then refuse to do so in a down market, through legalese in deceptive contracts, through no enforcement because regulatory firms are indebted to the securities firms, you are building an environment that requires more regulators and less growth for the individual investor and the U. S. economy overall.

Should Stockbrokers be subject to The Investment Advisors Act of 1940 and be held to a Fiduciary Standard?

No, stockbrokers should **not** be subject to the Investment Advisors Act of 1940 fiduciary standard. It is going to create too much in regulatory costs and will present too many ways for securities firms to continue to deceive clients. Keep it simple.

The role of a fiduciary implies that one is dealing with a professional, such as a doctor or a lawyer. The role of a fiduciary implies a level of education and training. The role of a fiduciary implies a level of experience.

The history of the Investment Advisors Act of 1940 reveals the intent of this law by Congress was to establish a profession for investment professionals that give advice.

Therefore, an investment professional that gives advice requires:

- Experience – The SEC must define the number of years that one must train and have on the job experience, such as a doctor, to become a SEC registered investment advisor. This would include on the job training in derivatives and financial statement analysis, beyond textbook knowledge.

- Training – The SEC must define the acceptable certification to become a SEC registered investment advisor. The Derivative Project recommends that the CFA become the only permissible certification for a SEC registered investment advisor, because that organization is the furthest along in developing an appropriate fiduciary curriculum.

- Education – What is the curriculum required to adequately prepare a fiduciary investment advisor? If one-steps back and looks at the financial crisis of 2008, investment advisors' education was as to blame as recent new reports of conflicted academics at Colombia and Harvard. Where was Martin Feldstein, Professor Emeritus of the National Bureau of Economic Research, serving on the Board of AIG, protecting investors? Did he not understand counterparty credit risk and systemic risk? It is critical that the SEC demand that those on Boards, that those that are fiduciary advisors be trained to ask the basic questions. The collapse of AIG was not as a result of hard to understand derivatives mathematics as Treasury Secretary Paulson and Mr. Geithner testified to Congress. The collapse of AIG was due to the simple over-extension of credit (selling/contracting in far too many credit default swaps than one had the capacity to fund, given a 20% change in the value of the underlying asset.) The U.S. Department of Justice has deemed this as a "stupid" error and not fraud. Therefore, all the regulation in the world cannot deal with the "stupidity defense". It is time the SEC mandates critical training, experience and educational standards to serve on corporate boards and to be a SEC registered investment advisor.

  As we now all know from the most recent financial crisis, the individual investor cannot count on a Harvard Professor Emeritus of Economics and the National Bureau of Economics or the Dean of Columbia's business school to identify future systemic risk.

  It will be the experience and training of the hands-on fiduciary advisors that are incentivized and driven to protect and grow their client's assets, because they are not conflicted and know it benefits society overall, not just the greed of a few, such as Professor Feldstein and AIG's financial products unit. Through our capitalist system, it will be the most trusted, most effective SEC registered fiduciary advisors that will rise to the top, based on their integrity and capabilities in their investment advice and the understanding of the financial markets.

Dodd Frank Urges More Training for the Individual Investor, but the Real Training and Curriculum is Required for the SEC Registered Investment Advisor

Was lack of any CFA training on how to analyze a balance sheet for derivative dealers, such as AIG, a contributing factor to the use of taxpayer dollars to bailout AIG? Or was it simply greed, because no one wanted the "financial gravy train" to end?

- The CFA Curriculum on Derivatives is devoid of any training on financial statement analysis of firms that trade derivatives, or how to "analyze counterparty credit risk, a term that was not used in the text book. For example, the CFA's 2003 Textbook " ***Analysis of Derivatives for the CFA Program"*** states (in discussion on picking a counterparty for derivatives) that "banks, in particular, are involved in consumer and commercial lending, which can be quite risky. In the United States, for example, we have seen banking crises involving bad loans to the real estate industry and underdeveloped countries." This is a very elementary statement and The Derivative Project questions that a part of the financial crisis was a result of CFA's not trained on how to analyze counterparty credit risk, financial institutions' financial statements and what to look for with accounting standard SFAS 133.

For example, in the Fall of 2007, Charles Schwab 's research analyst, a CFA, put a strong buy on AIG, despite ***billions*** of dollars of losses disclosed under SFAS 133 from their derivative positions, clearly disclosed in AIG's 2007 Annual Report.

Conclusion

Simplify. It is the confusion that the Securities Industry has created about roles of stockbroker and investment advisor that has caused the need for heightened regulation and unnecessary losses for individual investors, particularly in the most recent financial crisis.

Simplify. Eliminate the conflicts of interest between the firms the SEC regulates and SEC regulatory costs will be cut in half.

Stockbrokers Should Not Be Subject to A Fiduciary Standard

- Stockbrokers should continue to sell product and are in sales. They are not subject to the fiduciary standard of the Investment Advisors Act of 1940.
- Dual registration as a broker and as a SEC registered investment advisor is no longer allowed.
- It is clearly posted on the SEC website the role of a stockbroker and it is "buyer beware", just as it is when one is buying a car or a home. If you don't understand something, don't buy it.
- All certifications for a stockbroker are eliminated, banned by the SEC, other than the Series 7 and State Series 63 registration exam, which the investor understands is comparable to a real estate license, no education is necessary to become a "registered stockbroker."
- A stockbroker will not be allowed to sell product to a retirement account, unless it is a self-directed purchase or sale by the individual investor.
- FINRA will no longer oversee arbitration for customer complaints. Mandatory arbitration will be eliminated. Customer complaints about stockbrokers will be handled in a court of law or by an independent arbitration association, not by a Self Regulated Organization, such as FINRA.

SEC Registered Investment Advisor

Dodd Frank regulatory interpretation can create a new profession of a SEC Registered Investment Advisor that is always held to the fiduciary standard as espoused by the U.S. Courts system in SEC v. Capital Gains. It is the recognition that the current regulatory system failed us, "investment advisors" failed the individual investor and Wall Street securitization income greed, coupled with unchecked counterparty credit risk of credit default swaps exacerbated a "housing bubble".

It is incumbent on Congress and the SEC to eliminate the conflicts that have caused so much pain to so many. The new SEC Fiduciary will have new requirements for:

- Training – On the job training in financial statement analysis and derivatives and over three years experience under a SEC registered investment advisor, prior to certification as a SEC registered investment advisor.

- Education – Approved curriculum in conjunction with the SEC Advocate, who is not an employee of the securities industry or employee of the SEC.

- Certification – Only One Certification, the Chartered Financial Analyst (CFA), that will have a new, enhanced curriculum to prepare the fiduciary advisors for future crisis and how to protect retirement assets in the event of a crisis

- Ethics – Revised in light of the 2008 Financial Crisis

The SEC will have sole authority to regulate all SEC regulated investment advisors (RIA), outside of the State's enforcement authority. A self -regulatory organization (SRO) will not have authority to regulate RIA's.

Should Congress Allocate Additional Money to Enhanced Advisor Examinations?

Dodd Frank States:

"The Commission shall seek to prosecute and sanction violators of the standard of conduct applicable to a broker or dealer providing personalized investment advice about securities to a retail customer under this Act to the same extent as the Commission prosecutes and sanctions of the standard of conduct applicable to an investment advisor under the Investment Advisers Act of 1940."

What does this mean? Is the SEC Commission currently prosecuting a SEC registered investment advisor for material conflict of interest and breach of fiduciary duty under the Investment Advisors Act of 1940? No. As the example above with Charles Schwab Private Client's breach of fiduciary duty, it is cleat that the SEC is not enforcing breaches of fiduciary duty. The SEC is investigating fraud and Ponzi schemes, not straightforward breaches of fiduciary duty.

Dodd Frank requested a study on fiduciary duty and regulatory gaps. This is the biggest regulatory gap. The Investment Advisors Act is not being enforced, yet Dodd Frank states the "Commission shall seek to prosecute…. to the same extent as the Commission prosecutes and sanctions of the standard of conduct applicable …"

The SEC must inform Congress in their study how they are currently enforcing breaches of the Investment Advisors Act of 1940, because as The Derivative Project can attest to, with supporting documentation, the SEC is not currently enforcing breaches of IAA of 1940 when they are brought to their attention.

One can only presume the reason for this is that the SEC is conflicted due to the revolving door between Wall Street and SEC employment.

Therefore, A Private Right of Action Under the Investment Advisors Act of 1940 is the only Way to Change this Regulatory Failure, Not Increased Enforcement Personnel for the SEC

The only way that Congress can truly allow for enforcement of the Investment Advisors Act of 1940 is to give the individual a private right of action to pursue damages in the U.S. Court system when they have suffered losses due to breach of fiduciary duty by a SEC registered investment advisor.

Allocation of Funds to Enhance Investor Protection

- Clear and concise explanations of the role of a stockbroker and the role of a SEC registered investment advisor, front and center on the SEC website:

✓ The "SEC FY 2010 Congressional Justification " allocated millions of dollars to the SEC Office of Education and Advocacy and other departments to improve investor understanding of the markets and investment basics. For $10,000 of the 2011 allocation of the $10 million personnel budget of the Office of Investor Education and Advocacy, an investor advocacy group, such as The Derivative Project, could work with the SEC website to end the current confusion over stock broker and investment advisor.

- As Dodd Frank specifies, allocate funds to develop curriculum in primary and secondary schools to empower individuals to make their own investment choices. Eliminate the shroud of confusion and secrecy created by the securities industry over the role of the individual investor, stockbrokers and investment advisors. It is not necessary to make stockbrokers fiduciaries to eliminate this confusion. Making stockbrokers fiduciaries will increase confusion, increase regulatory costs and result in a watered-down standard of a fiduciary for all retail investors.

- Insist that all 403B and 401k employers hire only SEC registered investment advisors, CFAs, to provide advice.

- Allocate funds to design new education, experience and certification curriculum for a new SEC registered investment advisor and de rigueur training on how to spot bubbles and threats of major moves in stock and bond markets to the downside, with mandatory curriculum on how to use covered call options and equity hedges to protect retiree's portfolios during potential "crisis" periods.

In sum, the SEC has no choice but to take its mission, "Investor Protection" a priority. Congress must take the lead and mandate these simple, cost-effective changes. The SEC has delayed implementing the Office of the SEC Advocate until 2012, as posted on its website today. Ironically, most of the most critical investor protection actions can be done within the existing SEC budget.

Individual investors, "baby boomers", who can fuel the U.S. economy with retirement dollars are in need of some simple protections immediately. This cannot wait until 2012. Double dips in housing, a stalled economy and high unemployment are all very real in the decade going forward. A two-year delay for a SEC investor advocate is not acceptable and changes can be made very easily within the existing SEC Investor Education and Advocacy Budget which has over "68 FTE's " at an approximate personnel cost of $10 million, if one is understanding correctly the SEC FY 2010 Congressional Justification.

The Investment Advisors Act of 1940 was implemented over 70 years ago and is still not being enforced by the SEC today. It is time for Congress to revise this Act and allow for a private right of action in 2011. Individual investors have suffered enough due to the material conflicts of interest by certain Investment Advisors and their firms.

It is time for the individual investor to have legal rights to protect their hard-earned retirement dollars, when SEC investment advisors have broken the law. The United States was founded on a balance of power. It is apparent after the 2008 financial crisis, the Judiciary needs to weigh in to correct the imbalance that has caused losses and despair to so many, despite their hard work and playing by the rules. Those that don't play by the "rules", such as the Investment Advisors Act of 1940 need to be held accountable, today, not in 2012 or beyond.

Thank you for the opportunity to submit these comments.

Sincerely,

Susan Seltzer
President
The Derivative Project