August 13, 2010

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

Re: File No. 4-606

Dear Commissioners:

Please allow this comment letter to stand in support of the imposition of a fiduciary duty on broker-dealers who provide advice to retail investors.

A large portion of Americans have their wealth working for them in the capital markets. To help lay people navigate the complexity of the capital markets, we often engage the services of a financial professional. Because these financial professionals are responsible for the life savings of tens of millions of Americans, these professionals should be held to the highest standards of care, trust, and professional conduct. This high standard is currently known as the fiduciary standard and this standard should be extended to all those who provide financial advice to the investing public.

The current standard of care for the recommendation of a security by a registered representative is the suitability standard. Suitability refers to the "appropriateness" of a recommended transaction when considering the risks associated with the transaction, the customer's other security holdings, his financial situation (income and net worth), his financial need, and his investment objectives. Suitability is general governed by the following provisions of the federal securities laws:

- Section 10(b) of the securities Act of 1934
- SEC Rule 10b-5
- NASD Conduct Rules 2110; 2120, 2310
- Variable Annuities - FINRA rule 2330
- Options - NASD Conduct Rule 2860, Section 19
- Municipal securities - MSRB Rule G-19(b)
- Penny stocks - SEC Rule 15g-9
- Certain credit transactions - SEC Rule 15c2-5

Although these provisions may seem robust and adequate, the fact of the matter is that, given the important function that investment professionals play in attempting to ensure the financial health of many Americans, these investment professionals need to be held to an even higher standard.

Understanding of regulatory standards

Generally, retail customers do not understand the legal or regulatory standards applicable to investment professionals. The confusion comes from many sources:

First, the duty of care that a retail investor is owed is never adequately explained to them. Ideally, when a registered representative engages a customer, as a matter of course that registered representative should disclose what his obligations are with respect to the customer's investments (*e.g.*, select suitable investments, look out for the customer's best interests, etc.). This however, is not done.

Second, the terms used to describe an investment professional are so varied that it is nearly impossible to determine whether your investment professional is a broker-dealer (subject to a suitability standard) or an investment adviser (subject to a fiduciary standard). The terms used to describe investment professionals can range from insurance agent, [1] representative, registered representative, associate, account manager, client services associate, financial planner, financial adviser, investment consultant, investment counselor, investment adviser, etc.

Third, the nature of the relationship can also lead to ambiguity. The investment professional may make investment recommendations to the customer and the customer has to assent to the recommendation before the trades are made. That said, a customer has no basis to assent, which is precisely the reason he goes to an investment professional in the first place. The investment professional can sleep at night knowing that the customer agreed with him and the customer is then lead to believe that the investment professional's liability for unsuitable recommendations is limited because the customer agreed to pursue the recommendation. This is simply not fair to the investor.

Fourth, the expense of asserting the rights of an aggrieved investor is too high. In order to pursue a claim against a broker-dealer, an investor will likely have to surrender one-third of any proceeds awarded by a court or arbiter to his attorney, meaning the investor will not be made whole. In addition, an investor believes he would have little recourse against an investment professional in a mandatory arbitration forum which is set up and administered by the industry that injured the investor in the first place.

Fifth, for registered professionals who engage in other non-securities business, it is often difficult for an investor to know what standard applies to what situation. For instance, when an investor goes to his State Farm agent, that agent may sell him auto insurance, mutual funds, variable annuities, fixed annuities, life insurance and homeowners insurance. An investor will not know for which products the insurance agent has a heightened duty (suitability or fiduciary) and for which products the agent is a mere sales person.

---

[1] For example, your State Farm agent can sell you a mutual fund, variable annuity or variable life insurance policy.

Finally, the current standards applicable to registered representatives are unclear. In some circumstances, registered representatives do have a fiduciary duty to customers. This fiduciary duty arises from state agency law. When a registered representative makes a trade for a customer, he is acting as the customer's agent and therefore has a duty to execute trades while being held to a fiduciary standard of care in the execution of the trade. That said, no fiduciary duty currently exists with respect to the actual recommendation of a trade. This on-again, off-again fiduciary standard can be a very difficult concept for an investor to wrap his head around.

Regulatory Gaps

There are several regulatory gaps in the retail investment world that should be filled by regulations.

1. The current suitability structure is flawed in that it provides a limited number of enumerated elements a registered representative must consider in making a recommendation. FINRA's general suitability requirements obligate the seller of a security to reasonably believe that his or her recommendations are suitable for the customer in light of the customer's financial status, the customer's tax status; and the customer's investment objectives. Instead, the standards should be a complete facts and circumstances (or totality of the circumstances) examination of the client, including life expectance, locality, estate planning objectives, cost of the investment options, alternate investment options, etc.

2. Generally, when engaging a customer, certain disclosures and agreements must be given to the customer regarding the broker and another set of disclosures must be provided regarding any investments. The amount of paperwork provided to an investor when engaging the services of a financial professional is daunting and ensures that these documents will not be read. Forcing a customer to acknowledge receipt and that they have read and understand the documents is no solution to this problem. Instead, the disclosures need to be boiled down so that only relevant information is provided and is provided in a manner that is consistent throughout the advisor and brokerage industries.

Implications of a fiduciary standard:

If a fiduciary duty is imposed upon broker-dealers, this will fundamentally change how brokerages choose which funds to offer and will promote competition and thereby lower prices for mutual funds and other investment products.

Today, mutual funds compete to retain shelf-space at brokerage firms, as these firms cannot reasonably offer every mutual fund under the sun. In deciding which funds to offer, brokerage shops base the decision on several criteria including customer demand, performance, name recognition, etc. Another major criterion is the amount of revenue the brokerage might receive from the mutual fund. This revenue might come in the form of distribution fees (rule 12b-1 fees), services fees, revenue sharing, the use of funds that are affiliated (under common ownership) with the brokerage, commissions, soft dollars, etc. Under the current suitability standards, the requirement is that a recommendation to purchase these securities be reasonable and not that the recommendation is the best available or the least expensive among several possible suitable choices.

Under a fiduciary standard, brokerage firms will have to choose the product which is the most appropriate for customers and put the customer's interests ahead of his own. This means that brokerages will be forced to look for less expensive mutual funds to offer.

As an example, currently the prices of an S&P 500 index fund vary greatly.[2] Under current suitability standards, if an investment professional determines that an S&P 500 index fund is a suitable investment, he can recommend an investment in an S&P 500 fund. The cost of the fund is not a required element that must be considered. Under a fiduciary duty standard, the investment professional that selects the S&P 500 fund, must then consider the cost of the fund and determine if this S&P 500 fund is the least expensive of those available to the investor and recommend that fund over one which may be more expensive. This will also cause the broker-dealer to ensure that he has a competitively priced offering of mutual funds that he can offer to customers.

A test for the SEC: The SEC should go into brokerage firms and see if any of them offer more than one index fund with the same fee structure that tracks the same index. If any of these funds have sold any interests in the more expensive fund without an adequate explanation, you would have evidence that a brokerage is not meeting the duties it owes to its clients. If the more expensive fund offers a greater financial benefit or is affiliated with the broker, than there is a *per se* breach of fiduciary duty.

Imposing a fiduciary standard of care may also fundamentally change the way the brokerage industry and investment professionals receive compensation. As such, the SEC should expect resistance from the industry and for the industry to attempt to build in certain loopholes.

Other considerations:

A. The fiduciary duty, if imposed, should run from (1) the registered representative, (2) the branch manager (or other principal, OSJ, or supervisor) and (3) the brokerage firm to the customer.

---

2 For instance, the Invesco S&P 500 Index C (SPICX) is 10 times more expensive than the Vanguard 500 Index Fund Investor Shares (VFINX)

B. The standards imposed upon broker-dealers in the recommendation of securities have implications that extend beyond the securities world. For instance, the National Association of Insurance Commissioners ("NAIC") based their Model Suitability Regulation for Annuity Transactions on FINRA's suitability standard, and has actually sought to keep pace with the standards set by the securities industry.[3] In determining a course of action, I ask that the SEC consider the big picture application and the macro-effect any rule making might have both on the securities industry as well as any ancillary effects on other industries.

C. The SEC should pressure Congress and other agencies to go even further with a fiduciary standard. Mortgage brokers, insurance professionals and the like should all be held to a fiduciary syandard of care. The amount of personal wealth tied up in these industries is staggering. These industries are responsible for a large portion of the assets of the American public and therefore all individuals in these industries should be held to the highest standards of care.

D. The SEC, through sales practice protections or qualitative regulation of the investment products should limit the amount of fees payable to a registered representative as the fees are excessive.

- A variable annuity can pay commissions of up to 9% (under the Investment Company Act of 1940) to a registered representative. If an investor has $500,000 for which he seeks investment advice on how to invest, a registered representative can sit down with this investor for an hour or two and recommend the purchase of a variable annuities. That registered representative can get a $45,000 commission for selling this product to the customer. The Investment Company Act of 1940 should be amended to limit these excessive commissions, or the SEC should impose some sale practice protections (including a fiduciary standard) that might limit these commissions.
- A mutual fund can pay commissions of up to 5% (under the Investment Company Act of 1940) to a registered representative. If an investor has $1,000,000 for which he seeks investment advice on how to invest this sum, a registered representative can sit down with this investor for an hour or two and recommend the purchase of several mutual funds. That registered representative can get a $50,000 commission for selling these funds to the customer. In a few years, when the customer returns to reassess his

[3] In 2003, the NAIC adopted the Senior Protection in Annuity Transactions Model Regulation, which was patterned after FINRA's general suitability requirements and extended suitability requirements to annuity transactions with seniors. In 2006, the NAIC extended this regulation to cover transactions with customers of all ages, renaming the model the Suitability in Annuity Transactions Model Regulation. In March 2010, the NAIC adopted revisions to its Model Annuity Suitability Regulation based on the requirements of FINRA's rule 2330 that is specifically tailored to deferred variable annuities.

investments, the registered representative can make additional commissions by recommending the customer change his investments. The Investment Company Act of 1940 should be amended to limit these excessive commissions, or the SEC should impose some sale practice protections (including a fiduciary standard) that might limit these commissions.

- A brokerage can charge markups up to 5% on a securities transaction. That means that an investor would lose 5% off the top on any purchase and the investor would lose 5% on the proceeds on any sale. These markups are excessive and outside the bounds of reason. The SEC and SROs have promulgated regulations regarding best execution, but left open the opportunity for excessive markups. The SEC should impose some sale practice protections (including a fiduciary standard) that might limit these markups.

Sincerely,

John Lincoln

P.S. Attached is a document I drafted a few years back explaining the concept of unsuitability.

UNSUITABILITY

Suitability Definition:

The "appropriateness" of a recommended transaction when considering the risks associated with the transaction, the customer's other security holdings, his financial situation (income and net worth), his financial need and his investment objectives.

Applicable Provisions:

- Section 10(b) of the securities Act of 1934
- SEC Rule 10b-5
- NASD Conduct Rules 2110; 2120, 2310
- Variable Annuities - FINRA rule 2330
- Options - NASD Conduct Rule 2860, Section 19
- Municipals - MSRB Rule G-19(b)
- Penny stocks - SEC Rule 15g-9
- Certain credit transactions - SEC Rule 15c2-5

Elements of Unsuitability:

- The transaction was recommended by the salesperson.
- The recommended transaction involved either speculative, risky securities, and/or 20% or more of the customer's liquid net worth, and/or a transaction not reasonably expected to be beneficial to the customer.
- Facts about the customer were disclosed to the salesperson prior to the recommendation, such as:
    - No sophistication or limited experience in dealing with the risks of the recommended security; and/or
    - Limited net worth and/or annual income; and/or
    - Financial needs indicating that the customer could not afford the loss of the entire investment; and/or
    - Investment objectives of a conservative nature, such as safety of principal and limited risk.
- No reasonable basis for the recommended securities (the nature of the security, and/or the transaction size).

Proof:

- **The transaction was recommended by the salesperson.**

  - Customer’s account statement (or transaction confirmation) reflecting the disputed transaction.
  - Customer’s testimony recalling the circumstances, date and other details of the representative’s recommendation.
  - Firm’s research report, sales literature or other report recommending the transaction.
  - Issuer’s annual report, press release, newspaper clipping or other report used by the Representative and/or the firm.
  - Customer’s account statements showing absence of similar security type and/or size.
- **The recommended transaction involved either speculative, risky securities, and/or 20% or more of the customer’s liquid net worth, and/or a transaction not reasonably expected to be beneficial to the customer.**
  - Prospectus, sales literature, 10-K Report describing speculative nature.
  - Personal financial statement of customer showing net worth and income.
  - Opening account information card showing employment education.
- **Facts about the customer were disclosed to the salesperson prior to the recommendation**
  - Testimony of customer detailing circumstances of pertinent disclosure to his/her salesperson.
  - Opening account information card showing disclosed objectives, financial condition.
  - Prior account statements showing limited investment history.
  - Customer letters or memos to or from salesperson concerning facts disclosed and desires stated.
- **No reasonable basis for the recommended securities (the nature of the security, and/or the transaction size).**
  - **Documents, articles concerning industry practices in limiting recommendations on such securities.**

Important Principles

- Fair-Dealing - The prohibition against unsuitable recommendations of securities by salespersons is based on the obligation of fair dealing with customers.
- Equity Securities Generally - Other than churning, which is unsuitable because of the frequency of trades and is discussed below, unsuitable recommendations occur when, based upon the facts disclosed about the customer's affairs, the salesperson recommends certain transactions without having reasonable grounds for believing that the recommended transactions were suitable for that customer.
- Penny Stocks and Other Low-Priced Stocks - Because of the high risk and speculative nature of such stocks, unsuitable recommendations are a major concern, particularly when the recommendation is made to investors who cannot afford to risk the loss of their entire investment.

- Mutual Fund Switching - A salesperson recommends, without a reasonable basis, the liquidation of a customer's mutual fund to purchase another mutual fund having similar investment objectives, for the purpose of generating additional commissions for the salesperson's own benefit. (i.e. a person owns a Class A Mid-Cap fund with XYZ, broker recommends purchase of a Class A S&P500 Fund with ABC, when there exists an XYS S&P500 Index Fund. Customer subject to a front-end load that would not be applicable if the customer purchased shares within the same fund family. [broker's defense is good cause or reasonable basis])

- Mutual Fund Class Shares – Brokers should recommend mutual fund class shares that meet the customer's investment objectives, namely, the appropriate class share should be chosen based on the customer's time horizon, amount invested, and what class and family the funds are coming from to purchase the new shares. *[Note: not all funds have classes]*

  - See http://www.nasd.com/Investor/Alerts/alert_mfclasses.htm for a description of mutual fund class shares.

  - Also see the Mutual Find Cost Calculator http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm

  - One can also see the fees of a particular fund by reading that fund's prospectus.

NASD Conduct Rule 2310

2310. Recommendations to Customers (Suitability)

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;

(2) the customer's tax status;

(3) the customer's investment objectives; and

(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

(c) For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

Case Law:

- Suitability is determined by the appropriateness of the investment for the investor, not simply by whether the salesman believes that the investor can afford to lose the money invested.

  - David Joseph Dambro, Securities Exchange Act Release No. 32487 (June 18, 1993) 54 SEC Docket 968, 973, citing Arthur Joseph Lewis, Securities Exchange Act Release No. 29749 (October 8, 1991), 45 SEC Docket 1803, 1806.

- Control may be established where a customer, although not granting his broker a formal power of attorney, so relies upon the broker that the latter is in a position to control the volume and frequency of transactions in the account.

    - John M. Reynolds, Securities Exchange Act Release No. 30036 (December 4, 1991), 50 SEC Docket 624, 626.

- A broker must "make a customer-specific determination of suitability and…tailor his recommendations to the customer's financial profile and investment objectives."

    - Douglas Jerome Hellie, Securities Exchange Act Release No. 29468 (July 23, 1991), 49 SEC Docket 635, 638, quoting F.J. Kaufman and Company of Virginia, Securities Exchange Act Release No. 27535 (December 13, 1989), 45 SEC Docket 120, 125-126.

- [W]hether or not [the customer] considered the transactions in her account suitable is not the test for determining the propriety of [the salesman's] conduct. The proper test is whether [the salesman] "fulfilled the obligation he assumed when he undertook to counsel [the customer], of making only such recommendations as would be consistent with [her] financial situation and needs."

    - Eugene J. Erdos, Securities Exchange Act Release No. 20376 (November 16, 1983), 29 SEC Docket 226, 230-231, aff'd 742 F.2d 507 (9th Cir. 1984), quoting Philips & Co., 37 S.E.C. 66, 70.

- As a fiduciary, a broker is charged with making recommendations in the best interests of his customer even when such recommendations contradict the customer's wishes. Thus, even if the committee suggested that Reynolds engage in aggressive and speculative trading, Reynolds was obligated to counsel them in a manner consistent with the fund's financial situation.

    - John M. Reynolds, Securities Exchange Act Release No. 30036 (December 4, 1991), 50 SEC Docket 624, 630.

- Representatives have "a duty to proceed with caution; to make recommendations only on the basis of the concrete information that the [customer] did supply and not on the basis of guesswork as to the value of other possible assets."

    - Eugene J. Erdos, 47 S.E.C. 985, 988 (1983), *aff'd* 742 F.2d 507 (9th Cir. 1984).

- Even where a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. D.B.C.C. v. Guevara, 1999 NASD Discip. LEXIS at *17. *Also see* D.B.C.C. v. Vaughn, *supra,* John Reynolds, 50 S.E.C. 805 (1992) (regardless whether the customers wanted to engage in aggressive and speculative trading, the representative was obligated to abstain from making recommendations that were inconsistent with their financial situation); Gordon Scott Venters, 51 S.E.C. 292,294-95 (1993)

- *See John M. Reynolds,* 50 S.E.C. 805, 809 (1992). (Regardless of whether the customer [had a risk tolerance of medium], the broker was obligated to abstain from making recommendations that were inconsistent with the customer's financial situation.)

- Recommending and directing unsuitable trades combined with an intent to deceive, manipulate, or defraud constitutes common law fraud in the State of New York, *see CPC International Inc., v. McKesson Corporation*, 70 N.Y.2d 268, 285, 514 N.E.2d 116, 124 (1987), and is a violation of §

10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, *see, Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.* 132 F.3d 1017, 1032 (4th Cir. 1997).

- *Also see* NTM 96-32, *Members Reminded to Use Best Practices When Dealing With Speculative Securities*; NTM 96-60 (Sept. 1996), *Clarification of Notice to Members 96-32* ("…in particular, a transaction will be considered to be recommended when the member brings a specific security to the attention to the customer through any means, including, but not limited to direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages).