ASSOCIATION OF INDEPENDENT INVESTORS

29 April 2013

VIA ELECTRONIC MAIL

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

Re: Request for Data and Other Information; Duties of Brokers, Dealers, and Investment Advisers;
Release 34-69013; File 4-606

Dear Ms. Murphy,

The Association of Independent Investors[1] appreciates the opportunity to comment on the Commission's request for data and other information regarding the duties of brokers, dealers and investment advisers.

The Commission's request includes input on alternative approaches to a uniform standard of care. Our comments will focus on an alternative approach that we believe will offer the best investor protection and preserve investor choice.

A Uniform Fiduciary Standard is Not the Solution – Ban Dual Registration

We are against the Commission adopting a universal fiduciary standard. The Commission can end this ongoing debate once and for all by putting an end to what is known as dual registration, the practice in which brokers and investment advisers (advisers) are cross licensed. We believe that brokerage and advisory activities should be separated and clearly defined to investors, with no overlap.

The underlying regulatory framework that governs these two different functions is very sound as it was laid out nearly 80 years ago. The problem is not with the regulations, but rather that the industry has manipulated these regulations to fit their business models, and regulators have been willing to go along for the ride.

[1] The Association of Independent Investors Corporation is a not-for-profit organization exclusively dedicated to promoting the interests of independent investors (non-professional investors) by improving investor literacy through investor education and awareness campaigns. For more information please visit our web site: www.aiinvestors.org.

The financial services industry has been chipping away at this regulatory structure since the day it became law. Make no mistake, the blurring of the regulatory line that separates brokers, dealers and investment advisers is exclusively driven by the industry's bid to maximize its profits, profits that come directly out of the hide of investors.

In the eyes of investors today, there is very little transparency regarding who does what and who, if anyone, is genuinely looking out for the investors' best interests. The distrust of the financial services industry is greatly compounded when you put dual registrations into the mix.

Background

The basic laws that govern the securities industry today date from the 1930s and reflect the depression era shift from *caveat emptor* to an environment of disclosure and investor protection. At issue here are the two different pieces of legislation:

- The Securities Exchange Act of 1934 (1934 Act) created the Securities and Exchange Commission (Commission). The 1934 Act empowers the Commission with broad authority over all aspects of the securities industry. Brokers and dealers are regulated by the 1934 Act, however the Commission has delegated nearly all aspects of the regulation of brokers and dealers to the Financial Industry Regulatory Authority[2] (FINRA). FINRA is a non-government, self-regulating organization.

- The Investment Advisers Act of 1940 (Advisers Act) regulates investment advisers and firms that are compensated for advising others about securities investments. The Commission has retained regulatory authority over investment advisers who have at least $100 million of assets under management, or who advise a registered investment company. State securities regulators regulate advisers with assets under management of less than $100 million.

Importantly, brokers and advisers have very different legal obligations when dealing with their clients. Under the 1934 Act, brokers are held to the "suitability standard" whereas advisers have been deemed by the courts to owe their clients a "fiduciary duty."

At the time that these laws were enacted, these industry participants and institutions fit neatly into their respective boxes, i.e. brokers and dealers were subject to the 1934 Act, and the Advisers Act governed advisers.

[2] FINRA was formed in 2007 when the New York Stock Exchange enforcement arm was consolidated with the National Association of Securities Dealers (NASD). FINRA, a private corporation, is a self-regulatory organization operating under the authority of the Commission and oversees and enforces rules that govern broker-dealer activity. FINRA also operates the dispute resolution system (arbitration) for addressing disputes between broker-dealers and their clients

What Changed?

In 1975 Congress passed the Securities Acts Amendments of 1975 that brought sweeping changes to the securities industry. A major change was ending fixed trade commissions, a practice that had been in place for over 180 years. On May 1, 1975, negotiated trade commissions, or discounted commissions, became law.

The broker-dealer business model came under attack from newly formed discount brokerage firms. Full service brokerage firms were able to hold the line on commission pricing for years by adding value, e.g. providing research, offering cash management accounts, and claiming superior trade execution, etc.

The advent of ultra deep discount commissions in the 1990s (any trade for $9.99) made it more difficult for full service broker-dealers to hold the line on commission rates. Facing the demise of the commission-based brokerage model, brokerage firms were forced to find new revenue sources. They set their sights on the lucrative fee-based advisory business.

However, offering fee-based advisory accounts falls under the Advisers Act and brokers are governed by the 1934 Act. To provide their advisory services the brokerage community initially relied on an exemption in the Advisers Act. Under the exemption, brokerage firms claimed that their advisory activities were "incidental to their brokerage business" and that the advisory fees don't constitute "special compensation."

Recognizing that the fee-based advisory business was highly profitable and much more stable than their declining commission-based model, the brokerage industry set out to change these Congressional Acts to suit their new business model. The timeline for brokers getting the green light into the fee business went like this:

- In 1995, the Commission initiated a study of compensation practices at brokerage firms. The study recommended the adoption of fee-based brokerage accounts. Daniel Tully, who was then the Chairman and Chief Executive Officer at Merrill Lynch, was appointed by the Commission to chair the study committee. The report became known as the Tully Report.

- In 1999, the Commission, relying heavily on the Tully Report, proposed a rule that exempted brokers from certain provisions of the Advisers Act, opening the door for brokers to freely offer fee-based accounts. This rule became known as the Merrill Lynch Rule. The Merrill Lynch Rule became a de-facto regulation until the Commission formally adopted it in 2005.

- In 2007, a Federal Appeals Court struck down the Merrill Lynch Rule, stating that the Commission exceeded its authority[3], sending the issue into a regulatory tailspin.

[3] Financial Planning Association v. SEC, 375 U.S. App. D.C. 389, 482 F.3d 481, March 2007.

Today, brokers have bypassed the regulations and continue to offer fee-based advisory accounts through "dual registration," whereby the broker-dealers (via common ownership) and their representatives are registered as both brokers and advisers. But with dual registration many issues still remain unresolved. What standard of care (suitability or fiduciary) applies to these dually registered representatives?

Suitability & Fiduciary

The issue at hand involves the different obligations that brokers and advisers have to their clients. With brokers increasingly offering advisory accounts, the line between brokers and advisers has been blurred, resulting in meaningful confusion for investors and regulators.

Fiduciary Standard

The fiduciary standard as applied to investment advisers is not uniformly defined. In common law, a fiduciary duty is considered the highest standard of care and a fiduciary is expected to be extremely loyal to the person to whom he owes the duty. A fiduciary must not put his personal interests before the duty and must not profit from his position as a fiduciary, unless the client consents.

Recognizing that conflicts between investment advisers and their clients are often unavoidable, investment advisers are required to fully disclose conflicts of interest and are expected to manage any known conflict to the benefit of the client.

Most people are surprised to learn that the word "fiduciary" doesn't appear in the Advisers Act.[4] The fiduciary standard for investment advisers was born in common law when in 1963 the United States Supreme Court held[5] that the Investment 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."

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' his clients."

In its purest form, a fiduciary is mandated to protect the interest of others. But, in the investment world you aren't getting a pure fiduciary.

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[4] Richards, Lori A. "Fiduciary Duty: Return to First Principles." Eighth Annual Investment Adviser Compliance Summit. Washington, D.C. Feb. 27, 2006.

[5] S.E.C. V. Capital Gains Research Bureau, 375 U.S. 180, 1963

Cost to Investors - Fiduciaries are Expensive

Brokers and dealers are attracted to the advisory business for one very simple reason, the fees. Advisory account fees are almost always calculated as a fixed percentage of the value of the customer's investable assets, generally about one percent. On the surface, these fees may seem nominal, but when you include various hidden fees and expenses, and the fees are put into the proper perspective, investment management is extremely expensive (see "*Like a Street Corner Shell Game, Asset Management Fees are Deceptive*" http://aiinvestors.org/aiiviewpoint/?p=62).

The rule of thumb with advisory accounts is that the actual investment function is outsourced, generally to mutual fund managers. So the fees charged by the investment manager are in addition to the fees paid to the broker or adviser. According to the Investment Company Institute, the average expense ratio for an actively managed equity mutual fund was 1.45% in 2010[6].

Assume an advisory account generates a return of 10% and the investor is paying fees and expenses of 2.5% of the value of the investor's account (1% to the adviser and an additional 1.5% to the mutual fund). The investor actually pays out 25% of his return in fees and expenses. If the return was only 5% (with the same fee and expense assumptions) the investor is paying a whopping 50% of his return in fees.

When fiduciary advisory fees are put into the proper perspective of what investors are actually paying for, *the investment return*, they are not benign.

The actual investment advice (which is for the most part generic) is front end loaded, meaning that at the time the advisory account is sold to the investor, the assets are invested. For the most part there is very little change to these portfolios, yet the investors continue to pay these fees indefinitely.

Assuming $100,000 is invested in a fiduciary advisory account with a return assumption of 7% and fees of 2.5% paid annually, over a 20-year period:

- **The investor will pay $82,396.00 in fees.**
- **The principal balance will increase only by $133,221.00.**

If the fiduciary's fee is eliminated, and the 7% annual investment return is generated using a low cost index fund (charging a fee of .05%) over a 20-year period:

- **The investor will pay $2,180.00 in fees.**
- **The principal balance will increase by $283,117.00.**

[6] Investment Company Institute (2011) *2011 Investment Company Fact Book* (51st edition) p.66.

Over the past five years the S&P 500 was up 4.8% (total return). Applying the same retail advisory account fee assumption to an initial $100,000 investment:

- **The investor would have paid $13,683.00 in fees.**
- **The principal balance would have increased only by $11,385.00.**

In this example, using actual real returns, over the past five years the adviser, or "fiduciary," made 20% more than the investor did, who is assuming all the risk. The reality is that as a result of the convoluted pricing structure, most investors have no idea how they actually pay for their investment returns (see *"A License to Steal – An Inside Look at How Advisers and Planners Deceive Their Clients"* http://aiinvestors.org/aiiviewpoint/?p=191).

This pricing structure is unique to the investment industry. Asset based pricing is akin to an accountant charging a fixed percentage of his client's income (or worse, his net worth) every year to prepare a tax return. Or paying an attorney a yearly percentage of the value of one's estate, in exchange for preparing a simple will that is rarely, if ever, updated.

The punitive nature of the retail advisory account fee structure runs totally contrary to the fiduciary duty the broker or adviser owes to the client. How do they get away with it? They get away with it because the fees are disclosed in the fine print.

Fiduciary Conflicts of Interest – The Devil is in the Fine Print

There is a misperception in the market place that when a financial professional acts as a fiduciary all conflicts of interest between that professional and the investor have been eliminated – this is untrue. Judge Benjamin Cardozo famously summed up fiduciary duty in law in a 1928 court decision. He said: *"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… the level of conduct for fiduciaries [has] been kept at a level higher than that trodden by the crowd."*[7]

However, in the trodden crowd of financial services, fiduciary duty has become a game of merely disclosing the conflicts of interest, not eliminating them. In other words, the conflicts, or potential conflicts, are alive and well, they're just buried deep in the fine print. And once the conflicts are disclosed, it's fair game, so buyer beware. We suspect that Judge Cardozo wouldn't approve that the essence of fiduciary duty can be so easily watered down.

Fiduciary Duty – Investor Protection or Marketing Gimmick?

A year ago we addressed this issue in an article titled "*Will the Real Butchers Please Stand Up*?" (http://aiinvestors.org/aiiviewpoint/?p=76). We highlighted a clever promotional whiteboard animation titled "Brokers vs. Fiduciaries" that was published by HighTower

[7] Meinhard V. Salmon, 249 N.Y. 458; 164 N.E. 545; 1928 N.Y

Advisors, a Chicago based registered investment adviser.

The HighTower video describes brokers as cleaver wielding butchers. The video implies that the butchers would be content if you eat nothing but red meat until you keel over with clogged arteries, comparing them to brokers. On the other hand, the video portrays fiduciaries (presumably referring to investment advisers) as dietitians who thoughtfully prescribe a balanced diet and want to see you live forever.

Anyone who watches the video (which can be seen on YouTube) will be surprised to learn that HighTower is affiliated, through common ownership, with HighTower Securities, a broker-dealer. That's right, these dietitians own a butcher shop. And, according to HighTower's Form ADV, "*HighTower may have an incentive to recommend programs that generate revenue for HighTower and its affiliated broker/dealer over other programs*…"

It's our opinion that the more an investment adviser touts his or her fiduciary standing as some sort of seal of approval, then the more closely investors need to read the fine print. The devil, or in this case, the butcher, is alive and well in the detail.

Rules vs. Concepts

Fiduciary duty as we know it today is a legal concept rooted in common law (unlike the suitability standard which is based on regulatory rules) and that is the magic of it. The courts, where judges have the ability to hold the investment professionals' feet to the fiduciary fire, generally resolve disputes between investment advisers and investors. Good investment advisers understand this and tend to play it safe; they don't want their fate to rest in the hands of a judge who actually understands the concept of fiduciary duty.

A universal fiduciary standard is going to be defined by regulators, and therefore it will be rules-based. Once you lay out a new set of rules, participants immediately find loopholes, and Wall Street loves loopholes. It's our view that once all the loopholes are factored in to a new universal fiduciary standard, investors will receive even less protection than they currently do under the already watered down existing standard.

Suitability Standard

Under NASD rule 2310, a broker making a recommendation to a retail customer must have grounds for believing that the recommendation is suitable for that customer with respect to his portfolio, financial situation, and needs. Above and beyond the suitability standard, brokers are bound by many other rules and regulations, including disclosure requirements, that also protect investors.

There is a prevailing misperception that the suitability standard doesn't offer investors adequate protection; we disagree. The suitability standard offers investors very good protection, but it has suffered at the hands of FINRA, the brokerage industry's self-regulatory organization

(SRO), the fox that was supposed to be watching over the hen house (see *"FINRA – An Ineffective Regulator"* http://aiinvestors.org/aiiviewpoint/?p=151).

In a 2010 letter to Congress, the Project On Government Oversight stated that FINRA had an "abysmal track record" with respect to investor protection and highlighted the "incestuous relationship between FINRA and the securities industry."[8] The Commission needs to address the problems at FINRA and perhaps rethink the SRO approach.

Brokerage Model – A Cost Effective Alternative

Not everyone needs or wants a fiduciary. Fiduciaries by nature are highly risk adverse. Imagine for a moment if back in the early 1960s, when a young Warren Buffett decided that he wanted to buy shares in Berkshire Hathaway, his broker told him that as a fiduciary he would recommend against investing directly in common stock, and instead steered him into a mutual fund.

We aren't suggesting that everyone can be the next Warren Buffett, nor is buying underlying equities the right thing for most investors. However, the brokerage model represents a cost effective alternative where investors have the flexibility to invest their money as they see fit while managing their investment risks and costs.

One of the most important rules of investing is that of risk vs. reward, the greater the risk investors are willing to take, the greater the potential rewards. Likewise, if the mandate is to be highly risk adverse, then investors shouldn't expect to realize traditional equity returns.

Abandoning the suitability model is the regulatory equivalent of the dumbing down of individual investors. The Commission needs to resist the temptation of trying to take all of the risk out of the markets, as doing so also removes the returns.

Conclusion - Ban Dual Registration and Clean up FINRA

Congress never intended for the regulatory boundaries that separate brokerage activities from advisory activities to become blurred. With dual registration, these regulatory worlds collide and investors are forced to navigate a minefield of inherent conflicts of interest.

We believe that the Commission should ban dual registration. Brokers and dealers should stick to their traditional brokerage businesses and stay out of the advisory business. If they would prefer being in the advisory business, then they should do so, but they can't do both.

The fiduciary standard is a good standard, but as we've illustrated it has its own imbedded weaknesses and it doesn't protect investors as advertised. Of grave concern to us is

[8] Project On Government Oversight, "Letter to Congress Calling for Increased Oversight of Financial Self-Regulators," February 23, 2010

the fact that the essence of fiduciary duty can be so easily "disclosed away" in the fine print, a fact that never seems to enter into the debate.

We believe that if properly enforced, the suitability standard can offer investors solid protection, and in some cases superior protection than the fiduciary standard. The suitability standard is a cost effective alternative that allows investors to control the level of risk that they are willing to take.

If the Commission adopts a universal fiduciary standard then they are effectively picking one business model over another, and we don't think that government regulators should be in the business of picking winners and losers. The Commission needs to separate these businesses, clean up the FINRA mess, and then let the investor decide which business model is the best for him.

We appreciate the Commission's consideration of our comments. Please feel free to contact me if we may provide additional information concerning these or other issues.

Sincerely,

-S- Andrew J. Haigney
Andrew J Haigney
Executive Director