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June 4, 2013

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

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OFFICE OF THE SECRETARY

RE: File Number 4-606, Comments on Duties of Brokers, Dealers, and Investment Advisers

Dear Secretary Murphy,

I am writing to comment on the Securities & Exchange Commission's ("SEC" or "Commission" above-cited Release regarding the agency's request for quantitative and qualitative data for rulemaking purposes.

My firm, Donald W. Nicholson & Associates, is registered with the Commission as an investment adviser ("RIA") with $111 million in assets under management as of the last reporting period. Nicholson & Associates provides financial planning and portfolio management services to clients primarily in the Philadelphia-Wilmington area. I would describe my firm, which includes me, my son, and one administrative person, as a traditional "Main Street" independent advisory firm. We act in a fiduciary capacity to all of our clients consistent with the duties of loyalty and care articulated so well in the SEC's January 2011 fiduciary study.[1]

Our compensation model is fee-only. We are paid only by our clients in the form of a percentage of assets under management, hourly, or fixed fees such as a retainer. This method of compensation allows us to avoid many of the conflicts of interest associated with myriad forms of indirect and incentive compensation received by broker-dealer firms. The principles-based regimen under which we operate also allows us to spend considerably more time working directly with our clients to help them meet their financial objectives rather than be burdened by the costly rules-based approach utilized by FINRA that, based on personal observation over many decades, offers less in the way of investor protection than the Investment Advisers Act of 1940 ("Advisers Act") and is fraught with conflicts of interest that have contributed over the years to systemic risk problems and the American public's loss of confidence in the financial services industry.

Unfortunately, some of the assumptions made in the Commission's request for data on a uniform fiduciary standard and regulatory harmonization for broker-dealers and investment advisers suggest an eventual rules-based system for investment advisers that would undermine the existing fiduciary standard of care and cause a commensurate loss in investor protection. Moreover, the costs of regulation under these assumptions would likely force me to close my business, merge with another

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[1] *See* staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers* ("2011 SEC Study"), January 2011, *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf (last visited June 2013).

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firm, or concentrate on the high net worth market, thereby eliminating the availability of "choice" of business model for middle and lower-income investors.

For example, if the SEC were to impose FINRA's suitability requirements on investment advisers *without* first adopting a traditional fiduciary standard underlying the broad obligations of an adviser to its clients, the result would be significant gaps in investor protection.

Currently, investment advisers must make a reasonable investigation to avoid developing recommendations for their clients based on inaccurate information.[2] Moreover, we must follow a six-step financial planning process that includes extensive data collection, analysis and consideration of alternative courses of action before making any recommendations to my clients. This extensive, but flexible, vetting process under CFP Rules of Conduct comports well with the implied suitability standard for an investment adviser. In both instances, I have a fiduciary duty of utmost good faith to act in the best interests of my client.

On the other hand, if I were to be subject to specific harmonization rules without a fiduciary standard, such as a suitability rule adapted from FINRA's Rule 2111, I would have fewer suitability factors to consider, no overarching duty of loyalty to act in the best interests of my client, and new check-list and supervisory functions that would serve no useful purpose other than distract me from working directly on client issues. Nor does my small business have the same resource capacity as large financial services firms to absorb or pass along such costs to my clients (much less write off multi-million dollar enforcement actions as a cost of doing business).

FINRA's prophylactic and highly detailed rules are riddled with exceptions and contradictions that ultimately work to the firm's benefit, not the client's. In an FAQ[3] to its updated suitability requirements, FINRA states that the broker must act in the "best interests of the client," but offers nothing in the rule itself to confirm that a fiduciary standard exists, or any evidence of legislative authority for an SRO to adopt such a standard on its own. Nor does FINRA's vague 'best interests" standard in a question-and-answer format provide sufficient guidance. The adviser's fiduciary duty, in contrast, would require him or her to fully and fairly disclose third-party compensation received as a consequence of a recommendation (and consider whether there is a better alternative), while a broker is able to avoid disclosure and fully comply with Rule 2111 while making a conflicted recommendation because oftentimes there is no explicit disclosure requirement of compensation incentives that may result in biased advice.[4]

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[2] *Id.* at 22.

[3] *See* FINRA FAQ on Rule 2111, http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf (last visited June 2013).

[4] *See*, e.g., SR-FINRA-2011-018, *Proposed Rule Change to Adopt NASD Rule 2830 as FINRA Rule 2341* (Investment Company Securities) in the Consolidated FINRA Rulebook, *available at* *http://www.finra.org/Industry/Regulation/RuleFilings/2011/P123528* (last visited June 2013).

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Nor do the FINRA suitability requirements apply to all broker-dealer customers, such as certain institutional customers, or to a nondiscretionary account where there is no trading activity involved. In contrast, the adviser's fiduciary duty, and implicit suitability standard, applies to any and all client relationships.

It is, in fact, quite surprising that in the Release the SEC leaves open the possibility of moving forward with regulatory harmonization without *first* adopting a uniform fiduciary standard of care.[5] When one looks at the history of the SEC's rulemaking process for investment advisers, the rules usually flow *from* the fiduciary duty, such as the disclosures of conflicts of interest (the Brochure Rule), proxy voting policies (Proxy Rule), and safeguarding client assets (the Custody Rule). All of these rules are based on a duty of loyalty or care. In contrast, FINRA relies on a commercial transaction standard of conduct, which is best described as an arms-length duty of good faith and fair dealing between two parties of comparable standing.

If the SEC did move forward first with rules harmonization and failed to adopt a fiduciary standard for both, the result would be two inconsistent standards of care for personalized investment advice that would continue to dilute investor protection and prolong consumer confusion over the core question of whether the retail advisor is legally required to act in the client's best interest or not.

Historically, courts have generally held a fiduciary duty to be imposed on the party in which the other has placed its trust and confidence, or in which the property is held or managed by the former. As a consequence, in *SEC v. Capital Gains,*[6] the U.S. Supreme Court held that the Investment Advisers Act of 1940 reflects a congressional recognition of the delicate nature of an investment advisory relationship as well as 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.[7] This seminal decision is the basis for the fiduciary culture and related best practices that I and many other investment advisory firms have aspired to over the 70-plus years that the Advisers Act has been in effect.

In practical terms FINRA rules do not work to fully protect investors, even under the ill-conceived experiment called the Merrill Lynch rule,[8] which permitted fee-based brokerage advice to customers as a way to better align brokers' interest with their customers.[9] The failure of this program was confirmed by FINRA in a broad sweep of participating firms that resulted in $7.4 million in fines and $9.5 million in restitution to brokerage customers for 'reverse churning' and 'double-dipping' – in which

[5] "While this release addresses both a potential uniform fiduciary standard of conduct and regulatory harmonization more generally, and at times, discusses and requests comment relating to the potential interrelationship of the two, harmonization beyond a uniform fiduciary standard of conduct could be considered separately." *See Duties of Brokers, Dealers and Investment Advisers (Request for Data and Other Information* (the "Release"), March 1, 2013, at 12, *available at* http://www.sec.gov/rules/other/2013/34-69013.pdf (last visited June 2013).

[6] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).

[7] *Id.*, at 190-192.

[8] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, 69 Fed. Reg. 51,620, n. 4, Aug. 20, 2004.

[9] *See* Daniel Tully, Chairman and Chief Executive Officer, Merrill Lynch & Co., *Report of the Committee on Compensation Practices, available at* http://www.sec.gov/news/studies/bkrcomp.txt (last visited June 2013).

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the non-fiduciary broker received a commission for investment products in which as asset management fee was also charged.[10]

The lesson to be learned from this non-fiduciary advisory program is obvious, at least to those of us who have been in the business a long time. Had there been a fiduciary culture in place at these firms, in which brokers did not have to contend with divided loyalties between the firm, the broker, and the customer, and the firm maintained a prudent process that concentrated on serving the best interests of the customer, rather than the firm's production benchmarks, this unfortunate abusive practice may have been avoided. Instead it appears that the main process emphasized by brokerage firms is a compliance culture designed to *protect* the firm from liability, not to *help* the customer. This compliance culture, while commendable in some ways, is the product of a rules-based playbook, not a fiduciary standard. I am not aware of any systemic 'reverse churning' problems ever having been found or reported by the SEC or state regulators in connection with independent investment advisory firms, hence the important distinction to be made in reviewing the pros and cons of a rules-based versus principles-based approach to regulatory harmonization.

I would like to stop at this point to close and reflect that over the many decades that I have been in business as an investment adviser, I have tried to live up a fiduciary standard of conduct, and expect that others who provide the same services should be subject to an identical standard as well. Indeed, the overall framework for investment advisers has worked extremely well over the years and was not a source of any of the problems in 2008 that prompted Congress to re-examine systemic risk in the financial services industry and eventually adopt Dodd-Frank. My final thought is that if the Commission is able to objectively and fairly review and compare quantitative data between broker and advisor regulation, it will find that a principles-based fiduciary framework is the superior option. A uniform, principles-based fiduciary standard no less stringent than the current standard applied under the Advisers Act will cost less, provide more choice to investors, and continue to offer enhanced consumer protection as evidenced by its effectiveness over the past seven decades.

I am happy to respond to any questions or comments that you may have.

Sincerely,

DONALD W. NICHOLSON & ASSOCIATES, LTD.

BY: Donald W. Nicholson

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cc: The Honorable Robert Casey
The Honorable Patrick J. Toomey

[10] *See* FINRA sweep report to SEC, http://www.sec.gov/comments/4-606/4606-2861.pdf (last visited June 2013).