July 1, 2013

Response to the Securities and Exchange Commission, on Release No. 34-69013; IA-3558; File No. 4-606, Duties of Brokers, Dealers, and Investment Advisers, requesting data and other information

Thank you for the opportunity to comment on the SEC's request for data and information on the standards of conduct and other obligations of broker-dealers and investment advisers. My letter addresses just one aspect of the fiduciary duty, the obligation to disclose all material information, including the seller's "financial interest" in a particular transaction. In focusing on this issue, I do not intend to imply that disclosure alone would satisfy the fiduciary duty. On the contrary, an adviser's fiduciary obligations are far more extensive and include, first and foremost, an obligation to act in the best interests of the client. However, disclosure of financial interest will take on increased importance if brokers and dually registered advisors are deemed to be fiduciaries.

My comments discuss that retail customers of brokers, dealers and dually registered investment advisers suffer a critical disadvantage in the advisory relationship because the broker-dealer or dually registered adviser is under no obligation to disclose his/her "financial interest" in the securities and insurance transactions[1] that the customer enters into as a result of the advice received. There are some disclosure obligations imposed upon brokers, but there is no requirement to disclose, specifically, all compensation received in conjunction with the sale of a product. This is a serious regulatory shortcoming in the protection of retail customers under the existing system that regulates the provision of personalized investment advice. I believe that this deficiency must be addressed either prior to, or in conjunction with, modifying the current

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[1] **A Note about Insurance Products**

Just as Americans don't distinguish between brokers and financial advisers, they also don't distinguish between who they consult to purchase securities and who they work with concerning insurance products.

While the Agency's jurisdiction does not cover insurance products, note that the above comments regarding the imbalance of power in the financial transaction also easily apply to the marketplace for insurance and annuity products. In fact, most broker-dealers are licensed to sell these products in addition to securities. Because such products also have a risk/return component, from the standpoint of the consumer, it would be helpful if the SEC could work with state insurance agencies to achieve similar material facts disclosure for insurance products.

application of the fiduciary standard within the financial services industry. If possible, it would be desirable to address this deficiency by rule or statute.

Background for these Comments

As background, I have been advising clients on personal financial matters as a financial planner (CFP®) since 1984. In the early 1980s I was one of the founders of the National Association of Personal Financial Advisors (NAPFA)[2] and I currently serve on its Board of Directors. The thoughts expressed in this letter, however, are my own. My comments derive from a career providing personal financial planning advice on a fee-only basis to individuals and families. The firm I started in 1984, The Family Firm, Inc., has long-standing relationships with its clients and has assisted many clients in achieving financial security.

Based on 29 years of experience, I believe that one of the primary goals of every person in America is to achieve financial security; a goal that often takes an entire working career to achieve. Over the years I have observed that this objective has faded from reach for the majority of Americans. The ever-widening income gap between the "haves" and "have-nots", the shift away from employer-provided income in retirement, the ever-increasing complexity of financial products, the frequency and severity of stock market disruptions such as in 2000 (Y2K) and 2008 (the mortgage loan and derivative crises) --- all have added to this problem.

While the above dislocations have harmed investors, from my perspective, the situation has been compounded by an institutionalized lack of transparency in our financial services industry. The result is that retail investors are not informed consumers and do not have the important data necessary to make financial decisions that are in their own best interests. This imbalance of knowledge and information between the two primary parties to a securities transaction results in a distortion that operates to the detriment of the retail investor and to the benefit of the broker, dealer, and dually registered representative.

The Problem

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[2] The National Association of Personal Financial Advisors is a professional membership organization for financial advisors whose compensation is generated only from fees charged to the client rather than from commissions or other forms of compensation.

As pointed out in the SEC's request, in today's world investment advice and the sales transaction generally go hand in hand. Investments are typically made in the context of major life questions. Even those brokers who are primarily working to solicit a transaction connect with the investor based on the *advisability* of the transaction (Do you need life insurance?, Do you want to save for your child's college education?) And when the relationship is specifically advisory (investment management services, financial planning), product sales also commonly result. However, in either situation, the securities (and insurance) transactions that result are opaque to the customer. Regulations do not require that the investor be furnished information concerning the remuneration to the broker, dealer or dually registered investment adviser (i.e. the "financial interest" of the adviser) that will result from the transaction.

<u>My comments are not focused on the "costs" to the customer, but, instead, they are specifically related to the "financial interest" of the adviser, broker, broker-dealer or dually registered adviser</u>. The relationship between the broker's "financial interest" in the transaction and the customer's "cost" is indirect and confusing, even to the most sophisticated investment professionals. For instance, in a mutual fund sale where the broker earns a percentage of the back-end sales load plus a part of the annual 12-b(1) fee, the transaction could be presented as "free" to the customer, but it <u>will</u> result in lower returns to the customer, compared to a transaction that is not similarly burdened. Thus, the exact "cost" to the customer is not easy to quantify.

There are several damaging consequences of this situation:

1) Retail customers cannot make informed investment, insurance or related financial decisions.

2) Retail investors and customers of dually registered advisers are not aware that the undisclosed financial interest of the broker, dealer or dually registered investment adviser may have a detrimental effect on the returns they will reap from the investment or insurance product.

3) When there is no transparency of the extent of the adviser's "financial interest", the magnitude of self-interest cannot be adequately evaluated by the retail customer; this has the potential to amplify over time to the detriment of the financial well-being of the investor;

4) It is difficult for the customer to evaluate or negotiate what *services* the broker-dealer provides for the remuneration earned when the investor is not aware of the specific financial remuneration to the broker, dealer or dually registered investment adviser.

5) Because of the absence of this information, comparisons across brokers and between registered advisers and broker-dealers are impossible.

6) Retail investors are not aware that their broker, dealer or dually registered investment adviser may be operating under incentives to recommend their employer's products in lieu of a better product that they cannot sell (agency restricted). Investors should know the extent to which their advisers/brokers are restricted (or incentivized) to sell their employers' products.

All other factors being equal, when consumers do not have complete information and their advisors are not fiduciaries they are the disadvantaged party in the transaction; returns generated under such a system are likely to be lower than those achieved by investors in a more transparent, fiduciary arrangement. In the registered investment adviser scheme, the adviser has no incentive to select investments other than those with both the best features and lowest possible costs for the customer. This is a direct consequence of the fiduciary duty, to work in the client's best interest, that exists for the registered investment adviser.

The Need for Material Facts Disclosure

This lack of transparency can and must be corrected. A fiduciary standard of conduct, as outlined in Section 913 of the Dodd Frank Act, "shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice". Without disclosure of the financial interest and agency restrictions of the broker, dealer or dually registered investment adviser, the customer is unable to evaluate the conflicts of interest under which the adviser is operating and the distortions described above flourish. I refer to this as "material facts disclosure" -- the specific disclosure of the <u>dollar amounts</u> that the adviser and the adviser's firm earn as a result of the transaction or the relationship as well as the agency restrictions.

There is rationale for this transparency. As noted in the Commission's request for comment, the Supreme Court has construed Advisers Act Sections 206(1) and 206(2) as requiring an investment adviser to fully disclose to its clients all material information that is intended "to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested." Material facts disclosure is completely consistent with the intent of the Supreme Court's ruling in SEC v. Capital Gains Research Bureau, Inc. and in harmony with extending the mantle of fiduciary care to brokers and dealers. Without disclosure of the adviser's specific financial interest, the fiduciary cloak is a sham.

Currently all dually registered advisers are only required to disclose a statement that material conflicts exist, not the actual extent of the material conflict. So for instance, a written statement in a regulatory filing or brochure such as: "XYZ Advisers are compensated by commissions on the sale of securities, mutual funds and insurance products", would comply with disclosure requirements under current regulations. This is insufficient. Disclosure" should mean ***written disclosure of all material facts of the engagement, including disclosure of the dollar amounts of compensation, currently and over time, that result from the engagement.*** Such disclosure would assist the retail customer in assessing the full value of advisory services that may be a part of the engagement.

As it stands today products are designed to look as though they are low cost, or even free, to the investor. But we know this is not true. The investor pays the price, often a very steep one, either up front (reduced dollars invested) or over time in reduced performance (returns handicapped by on-going management fees, 12-b(1) fees, back-end and surrender charges, etc.) This is why it is imperative to require disclosure of specific remuneration to the broker-dealer and the broker/dually registered adviser, as opposed to focusing disclosure requirements solely on the "cost" to the investor. The customer's true cost in the financial world may not be easily quantifiable. The "material fact" is the broker, dealer or investment adviser's financial interest in the transaction.

Complexity in compensation practices is not inevitable; it is a choice that the industry makes. If compensation practices are too complex to be disclosed clearly, the answer is to simplify and streamline the compensation practices, not use that complexity as an excuse to avoid disclosure that would benefit the consumer, or to swamp the consumer with that complexity in order to further confuse them. For compensation disclosure to achieve the goal of assisting consumers, it has to be easily understandable by a lay person. Complex disclosure, such as the industry might be eager to make in order to further bewilder the consumer, would be a disservice to the goals of the legislation.

Simple and easy to understand compensation disclosure might look like Exhibit 1 and Exhibit 2.

Exhibit 1

Trade Confirmation

Trade Date: 7/15/2013
You bought: JP Morgan Core Bond Fund A (PGBOX)
Amount: $ 75,000.00
Net Invested $ 72,187.50

Compensation to:	At Purch	Annually	At Sale
Joe Advisor	$ 1,968.75	$ 900.00	$ -
Best Advisors, Inc.	843.75	225.00	-
Total	$ 2,812.50	$ 1,125.00	$ -

Exhibit 1 shows a sample trade confirmation that describes the compensation the individual advisor (Joe Advisor) earns as well as the amounts earned by Joe's firm, Best Advisors, Inc. at the point of purchase, annually, and at the point of sale.

Exhibit 2

Best Advisors, Inc. Brokerage Statement

Period Ending: August 31, 2013

Summary of Advisor Compensation

			Cumulative Year to Date					
			To: Joe Advisor			To: Best Advisors, Inc.		
		Amount	At Purch	Annually	At Sale	At Purch	Annually	At Sale
Bought	Fidelity Invest Grade Bond Fund	$ 10,000	$ -	$ 21	$ -	$ -	$ 14	$ -
Bought	MFS Variable Annuity	150,000	3,600	55	-	2,400	25	-
Bought	JP Morgan Core Bond Fund A	75,000	1,969	900	-	844	225	-
Sold	IBM	12,560	-	-	35	-	-	10
	Total	$ 247,560	$ 5,569	$ 976	$ 35	$ 3,244	$ 264	$ 10

Exhibit 2 shows a sample page of a brokerage statement that the client would receive from Best Advisors, Inc. It illustrates hypothetically the compensation the individual advisor and the advisor's firm would receive at purchase, annually and at sale for transactions made year to date as of August 31, 2013.

The (non)Burden of Providing Full Material Facts Disclosure

What burden would such regulatory requirements impose? Within the industry there is likely to be concern that such detailed disclosure cannot be done due to the complex ways in which investment and insurance products are structured. However, this information is already tracked for accounting, payout, and tax purposes and is reported internally by financial services companies. By requiring such accounting uniformly of all brokers and dealers, without regard to customer status (retail, business, non-profit), the costs to implement would likely be reduced. Why shouldn't businesses and non-profits also have access to this information?

The timing and evidence of disclosure to the investor/customer should be included at both the start and the end of a transaction. Up front, the disclosure should start with a uniform *menu*--a listing of products with the "financial interest" of the broker, dealer; it should end with a uniform *receipt* --a list of products purchased stating clearly the amounts received or expected to be received (at point of purchase, annually, and at point of sale) by the broker, dealer, or dually registered investment adviser as a result of the transaction. Providing both the *menu* and the *receipt* is neither insurmountable nor difficult. The uniform "menu" could be provided via the firm's website, listing specific products and the financial interest of the broker and dealer computed on input from the customer or using a uniform dollar investment, searchable by product name, ticker, and by category (e.g. insurance, equities, bonds, mutual funds). The uniform "receipt" could be achieved, as illustrated above, on the client's trade order confirmation and monthly brokerage statement based on actual customer transactions. Since this data must be furnished to brokers for tax reporting purposes, perhaps the SEC might seek comment from the industry on whether such data is also tracked by customer. A rule that requires "material facts disclosure" would merely compel that this information be made available to the customer. A uniform standard must be required so that consumers can easily evaluate the information across service providers. I have every confidence that this challenge can be met and am planning to engage with some broker dealers to address this task.

On principle alone, material facts disclosure might strike the financial services industry as heretical. However, registered investment advisers routinely disclose their "financial interest" to the customer via the contract for the engagement and periodic invoicing. Extending the fiduciary brand to brokers, dealers and dually registered investment advisers without requiring disclosure of the material facts of the engagement, perpetuates a deception on Americans who currently do not see all of the compensation their broker or dually registered advisor receives as a result of the engagement.

Material Facts Disclosure Benefits our Securities Markets

Our opaque system of financial transactions also means that the financial products that consumers buy are routinely mispriced. Mutual funds with the same level of risk and return should be aligned with regard to expected return. Yet, bond funds of similar duration and bond quality can produce vastly different results for the investor. For example, a comparison of three actual bond mutual funds with similar portfolio characteristics and risk measures: JP Morgan Core Bond A (PGBOX), JP Morgan Core Bond A Load Waived (PGBOX.lw), and Fidelity Series Investment Grade Bond Fund F (FIBFX) indicates that investor returns in the highest fee fund (PGBOX) were lower by a cumulative 7% over ten years as compared with the lowest fee fund (FIBFX). Furthermore, investors in two *identically structured* JP Morgan Bond Funds (PGBOX and PGBOX.lw), whose only difference is the embedded fees, experienced nearly a 3.75% return differential over ten years. (See Appendix A)

This flies in the face of our understanding of how free markets should work. If I take the same amount of risk, I should receive the same approximate return. It is a principle of economics that investments with the same risk, deliver approximately the same return. In other words, a long-term investor in a money market fund does not expect bond fund-like returns. Similarly, investors in bond funds with the same level of risk, all other things equal, expect to receive the same level of return. This does not happen because of the broker/advisor's undisclosed compensation. The investor is completely unaware of this disparity. An institutionalized and sanctioned lack of transparency says to the investor: “take the same risk as other investors, but earn less return". In the US, investors are completely unaware and routinely harmed by this deception.

The problem is not that payments to the broker or dually registered advisor are built into the product. It is that investors do not know, and cannot determine, the extent to which their returns are hampered by the financial incentives that some products carry.

The risk/reward relationship, an axiom for investing in any free market, does not hold true for the retail investor. Because of this imbalance in knowledge between the parties, the self-regulating nature of the markets (the "invisible hand"), a concept on which our free market system is grounded, is undermined. A free market, in which competition on product features and product pricing generates efficiencies and benefits for all parties in the transaction, does not exist today in the financial services industry.

Do not expect that consumers will know how to use this new “material facts” information immediately. But by requiring the specific disclosure of the material compensation facts in the relationship, and aided by the free flow of information across the Internet, the free market will be allowed to work for the benefit of American investors. The marketplace will shine a light on costly inefficient products and service relationships, advisers will have to explain their choices, companies will change product cost structures in order to compete for investor dollars and, after a time, the industry as a whole will operate more efficiently. The degree of opposition to this idea only reflects the extent to which financial companies currently enjoy the financial advantage of the current dislocation.

Should the US emulate Australia or Great Britain?

Is disclosure of material compensation and agency relationships possible in the US? One alternative is to take the path of Great Britain and Australia and ban financial advisers from receiving any commission compensation whatsoever. However, given that customers often view brokers as advisers (and brokers position themselves as such), is it practical to take apart these functions via an enhanced regulatory scheme? The SEC appears to be asking the same question. Disclosure of the broker's financial interest in the entire engagement (i.e. the advice and the transaction) would bring the transparency that customers need to suitably evaluate a fiduciary engagement without causing major disruption to the existing regulatory scheme.

The suggestions above support the free market and simply extend to the financial services industry a concept that is standard in most every other corner of American commerce.

In Conclusion

I believe the suggestions discussed in these comments achieve the following goals that are described in the Dodd Frank Act and are of particular concern to the Commission:

- To preserve retail customer choice without decreasing retail customers' access to existing products, services, service providers or compensation structures;
- To assure that customers receive the same or substantially similar protections when obtaining the same or substantially similar services from financial professionals;
- To apply a standard that "shall be no less stringent than the standard applicable to investment advisers under Sections 206(1) and 206(2) of the Advisers Act when providing personalized investment advice about securities"; and

- To describe a positive impact on competition, capital formation and efficiency in the US financial markets.

Thank you for the opportunity to provide these comments and to reflect on what could lay the groundwork for future application of the fiduciary standard across all areas of the financial services community.

Sincerely,

Mary A. Malgoire, CFP®
Founder
The Family Firm, Inc.

Appendix A

Effect of Expenses/Advisor Compensation

on Returns in a $2,000 investment

in Three Bond Mutual Funds

Over Ten Years

Initial Investment $ 2,000

JP Morgan Core Bond A		Year	Year End Balance	Expenses
Initial Load	3.75%	1	1,925.00	14.25
Annual Expense	0.74%	2	1,910.76	14.14
Ticker	PGBOX	3	1,896.62	14.03
		4	1,882.58	13.93
		5	1,868.65	13.83
		6	1,854.82	13.73
		7	1,841.10	13.62
		8	1,827.47	13.52
		9	1,813.95	13.42
		10	1,800.53	13.32
Change due to expenses/advisor compensation				(199.47)

JP Morgan Core Bond A Load Waived		Year	Year End Balance	Expenses
Initial Load	0.00%	1	2,000.00	14.80
Annual Expense	0.74%	2	1,985.20	14.69
Ticker	PGBOX.lw	3	1,970.51	14.58
		4	1,955.93	14.47
		5	1,941.45	14.37
		6	1,927.09	14.26
		7	1,912.83	14.15
		8	1,898.67	14.05
		9	1,884.62	13.95
		10	1,870.68	13.84
Change due to expenses/advisor compensation				(129.32)

Fidelity Investment Grade Bond Fund		Year	Year End Balance	Expenses
Initial Load	0.00%	1	2,000.00	7.00
Annual Expense	0.35%	2	1,993.00	6.98
		3	1,986.02	6.95
		4	1,979.07	6.93
		5	1,972.15	6.90
		6	1,965.24	6.88
		7	1,958.37	6.85
		8	1,951.51	6.83
		9	1,944.68	6.81
		10	1,937.87	6.78
Change due to expenses/advisor compensation				(62.13)

		Balance in Year 10
Lowest Cost Fund	FIBFX	1,937.87
Highest Cost Fund	PGBOX	1,800.53
Percent difference		-7.09%
Same portfolio Low fee	PGBOX.lw	1,870.68
Same portfolio High fee	PGBOX	1,800.53
Percent difference		-3.75%