Public Investors Arbitration Bar Association

July 3, 2013

VIA EMAIL

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: File No. 4-606; Duties of Brokers, Dealers and Investment Advisers (Request for data and other information)

Dear Ms. Murphy:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in the standards of conduct to which brokers and investment advisers are held when giving investment advice. We welcome this opportunity to provide further information related to the Commission's study of this issue.

We will provide information in response to the Commission's "Request for Data and Other Information Relating to the Current Market for Personalized Investment Advice". For clarity, we have included the requests to which we are responding below. We have responded to those requests where we believe we can provide the most relevant data.

2. Data and other information describing the types and availability of services (including advice) broker-dealers or investment advisers offer to retail customers, as well as any observed recent changes in the types of services offered. Provide information as to why services offered may differ or have changed. Have differences in the standards of conduct under the two regulatory regimes contributed to differences in services offered or any observed changes in services offered? If possible, differentiate by retail customer demographic information.

A survey of the websites for five of the largest broker-dealers and five of the largest registered investment advisory firms leads to the conclusion that both generally offer the same comprehensive financial planning and advice:

BROKER-DEALERS

(i) Merrill Lynch

Merrill Lynch's website is full of materials detailing the comprehensive financial services offered to prospective customers. Interestingly, nowhere on its website does it discuss order execution. Instead, there are a myriad of goals Merrill Lynch will assist with, including:

- Caring for My Family
- Preparing for Retirement
- Growing My Business
- Pursuing My Dreams
- Estate Planning and Philanthropy

See Exhibit 1. Merrill Lynch goes to great lengths to describe itself as a "Wealth Manager", not merely a securities broker that buys and sells securities or simply places orders. Merrill Lynch also includes numerous client testimonials on its website describing the substantial and personal relationship the clients have with their Merrill Lynch Financial Advisor. The website describes "access to world class market research and the industry's top financial analysts" and references the importance of finding the right financial advisor. Poignantly, the website includes a quote from Charles Merrill, who said in 1914, "The interests of our customers must come first." *Id.*

These current representations are not new. Before the financial crisis, Merrill Lynch represented itself as "Total Merrill" to its customer base. Attached as Exhibit 2 is a PowerPoint presentation which was shown at a Merrill Lynch conference on June 19, 2008, by Vice President Marilyn Pearson. This presentation was geared to Merrill Lynch financial advisors using inter-networking skills to expand their business. Importantly, the basis of the presentation is "Total Merrill", which, as the second page of the presentation illustrates, is far more than merely executing orders or even simply making investment recommendations. Instead, "Total Merrill" was an integrated concept designed to provide customers with comprehensive service, including advice, retirement planning, banking, credit and lending, and estate planning. In fact, "investments" is just one piece of this fully integrated, comprehensive service.

(ii) Morgan Stanley

Morgan Stanley is more bombastic about the impact it can have for its clients, proclaiming rhetorically in large, bold print: "**WHO CAN PROVIDE A HIGHER LEVEL OF FINANCIAL ADVICE BACKED BY THE BEST THINKING ON WALL STREET?**" Of course, the answer is Morgan Stanley. It also represents that it offers services to its customers similar to those offered by Merrill Lynch. Morgan Stanley states, "At Morgan Stanley, our dedicated Financial Advisors are ready to work closely with you. With a clear understanding of your unique circumstances, we'll find the right services and solutions to help meet your objectives today and tomorrow." *See* Exhibit 3. Morgan Stanley also touts its "access to Banking services" and represents itself as a "wealth manager", not simply a company that brokers securities transactions.

Morgan Stanley's website also details its "Wealth Planning" services, which include investing, managing risk, strategic borrowing, and setting objectives to plan "for the long term".

(iii) UBS

Much like its peers, UBS is not shy about the quality of the services offered to its customers. On its website, it states in bold: "**Advisors without peer. Advice without equal.**" *See* Exhibit 4. It goes on:

> At UBS, our clients are the focus of everything we do. And with access to the best resources and intellectual capital in the industry, our Financial Advisors are in the best position to help clients reach their goals. In addition to having exceptional credentials, experience and perspective, our Advisors know it's essential to listen to you and truly understand your goals in order to help you achieve the financial future you envision.

Id. UBS, like Merrill, has customer testimonials and video stories on its website which provide a provocative glimpse into how UBS will make your dreams come true. In fact, the website states: "At UBS, we can help you pursue all of your financial goals – including those that go beyond investing – to help you live the life you've always imagined." UBS represents its services to include retirement planning and investing along with education funding, estate planning, and charitable giving, all of which is presented as a "collaborative approach". Much like its peers, there is nothing on UBS' website which describes it as an order executor. In fact, nothing represented by UBS indicates it actually brokers transactions. Instead, it repeatedly represents itself as an advisory firm focused on providing planning and advice in all facets of someone's financial life.

(iv) Ameriprise Financial

The tenor of Ameriprise's website is somewhat different than the previous three firms. It clearly and unmistakably represents that it provides services far more substantial than simply executing orders or making investment recommendations. In fact, one of the key components of the "ongoing advisor relationship" is to "track ongoing progress". *See* Exhibit 5. Ameriprise's website includes client testimonials and videos which explain the important and substantial impact Ameriprise has had on their lives.

Ameriprise represents that it provides numerous services to its clients. These include investments, insurance/annuities, financial planning, credit cards, and lending services. Specifically, Ameriprise identifies several different investment products offered by the firm to its customers, including:

- IRAs & retirement plans
- Mutual Funds
- Stocks and ETFs
- Bonds
- Education savings
- Real estate and alternative investments
- Managed accounts
- Structured products
- Certificates
- Options
- Unit Investment Trusts (UITs)
- Syndicates, including closed-end funds and preferred stock

Id. at 4-5. Unlike the "big three" above, Ameriprise specifically identifies what investments it offers to its customer base. Importantly, it wraps this list up by calling attention to Ameriprise advisors as being "investment professionals". Nowhere on the website are Ameriprise advisors referred to as securities brokers or traders.

(v) LPL Financial Services

LPL Financial represents its financial advisors as "experienced professionals" who provide "objective guidance and advice". It also makes a specific point that LPL "does not offer any proprietary products ..." resulting in "unbiased investment products and strategies ...." *See* Exhibit 6. LPL also focuses on a "holistic approach to life planning":

> No matter where you are in life – just getting started or winding down a successful career – you have goals and dreams. Your advisor engages you in an ongoing conversation about your needs, goals, and objectives to create the life plan that's right for you.

Id. LPL goes even further, touting a neighborly approach:

> Your LPL Financial advisor more than likely lives and works in your community. And because your LPL Financial Advisor cares as much about your personal satisfaction as the performance of your portfolio, he or she serves as a true partner to help you live the life you desire.

Id. LPL also focuses on the support it provides to its financial advisors as a selling point to prospective customers. It emphasizes the training and management programs LPL advisors attend to stay on the cutting edge of the investment field. Like the "big three" above, LPL clearly represents itself as a fully engaged wealth management, life-planning partner.

Also, like Ameriprise, LPL identifies specific securities products it offers to its customers. These include:

- Mutual Funds
- Annuities and other tax-efficient investments
- Domestic and international securities
- Insurance
- Fee-based asset management programs
- Estate and financial planning
- Trust services
- Group retirement plans
- Exchange-traded funds (ETFs) and exchange-traded notes

Id. at 3. Importantly, LPL leaves the door open, stating, "From these and <u>other investment options</u>, your LPL Financial advisor can construct individual investment portfolios by using our unbiased research on the economy and a range of other investment-related topics." (Emphasis added)

REGISTERED INVESTMENT ADVISORS

(i) Fisher Investments

Fisher Investments, located in Woodside, California, represents on its website that as of April 1, 2013, it had over $46 billion in assets under management. It represents itself as a money manager. It does not proclaim to be a "wealth manager" or "life planner" like the large broker-dealers. It simply represents that it uses its talent, market insight, technology, and strategies to adjust its clients' portfolios accordingly.

The website identifies specific benefits to being a Fisher "private client". These include:

- Direct, Proactive Customer Service
- Regular Communications
- Fisher Forecast Seminars
- Investment Roundtables
- Fisher Friends Events
- Client Conference Calls
- Marketminder.com

See Exhibit 7. Fisher Investments is a fee-based, discretionary, investment advisor. It pretty clearly represents itself as such, leaving out much of the flowery hyperbole the brokerage firms use in their marketing and website pieces.

(ii) Aspiriant

Aspiriant was the nineteenth ranked investment advisory firm in 2012, having over $4 billion of assets under management. The Los Angeles-based firm represents on its website that it "employ[s] all the rigor of institutional manager selection and performance monitoring and analysis." *See* Exhibit 8. Much like Fisher, Aspiriant represents that it uses technology and market research to maximize performance.

Unlike Fisher, Aspiriant does represent that it performs more than just financial planning, purporting to perform "strategic planning" also. This includes:

- Budgeted expenses
- The amount and timing of family and charitable gifts
- Whether to continue employment or business involvement or to "retire"
- What investment returns and risks to pursue...or accept.

Id. at 4-5.

(iii) Oxford Financial Group

Oxford Financial Group is an Indianapolis-based investment advisor with over $10 billion in assets under management, making it the sixth largest investment advisor in 2012. Oxford represents that it provides services a bit broader than Aspiriant or Fisher, sounding more like one of the "big three" brokerage firms above.

Oxford's website is not shy. In touting its family office services, it states: "[t]he sole commitment of our Family Office Services group is to enhance the financial lives of our clients and to enrich family legacies. This means helping you to organize and deploy your wealth in ways that enable you and your family to lead lives that are happier, more harmonious and secure." *See* Exhibit 9.

Oxford also represents on its website that it offers "Alternative Investments" in addition to its investment services. These include:

- Private equity
- Private real estate partnerships
- Hedge funds
- Natural resources

Id. Oxford also offers a proprietary plan called Savile Row, which provides pooled investment vehicles.

(iv) Shepherd Kaplan, LLC

Shepherd Kaplan, LLC, is a Boston-based fee only investment advisory firm with over $7 billion in assets under management. Its website is straightforward and specifically identifies itself as a fiduciary. *See* Exhibit 10. It also identifies its role in providing alternative investments to its qualified investor clients, but stops short of identifying specific types of investments, merely stating it offers private equity and venture capital offerings.

(v) Ronald Blue & Co.

Ronald Blue & Co. is an Atlanta-based fee only investment advisory firm with over $6 billion in assets under management. On its website, Ronald Blue represents the firm to be a more comprehensive wealth management firm, not merely a "money manager". It identifies:

- Financial Planning
- Investment Management
- Tax & Business Services
- Estate Planning
- Philanthropic Counsel

See Exhibit 11. This level of service is quite similar to the services represented by the broker dealers above.

<u>**CONCLUSION**</u>

After reviewing the publicly available materials advertising the representations and services offered by both brokerage firms and registered investment advisors, there is an inevitable conclusion: Brokerage firms represent themselves as if they were fiduciary investment advisors.

3. **Data and other information describing the extent to which different rules apply to similar activities of broker-dealers and investment advisers, and whether this difference is beneficial, harmful or neutral from the perspectives of retail customers and firms. Also, provide data and other information describing the facts and circumstances under which broker-dealers have fiduciary obligations to retail customers under applicable law, and how**

> **frequently such fiduciary obligations arise. If possible, differentiate by retail customer demographic information.**

There are many differences in the rules applicable to broker-dealers and investment advisers. The most notable difference is the standard governing the provision of investment advice – brokers are held to a suitability standard under FINRA rules and investment advisers are held to a fiduciary standard under federal law. There are wide differences in state law regarding whether or not a broker is deemed a fiduciary.

Courts have routinely held that when an account is discretionary, the broker has a fiduciary duty to the client. In *Leib v. Merrill, Lynch, Pierce, Fenner & Smith*[1], the court specifically set forth the duties a broker owed the customer when the account is a discretionary account:

> Such a broker, while not needing prior authorization for each transaction, must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history, *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978); (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests (see in this regard, *Robinson v. Merrill Lynch, supra*) ; (3) keep his customer informed as to each completed transaction; and (5) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged, *Stevens v. Abbott, Proctor and Paine*, 288 F. Supp. 836 (E.D. Va. 1968).

However, apart from discretionary accounts, the discussion of the duties a broker owes to a customer gets more complicated. Courts have addressed the issue of the existence and extent of a fiduciary relationship between a broker and a customer differently. In *Marchese v. Nelson*[2], the court laid out the ways various courts have addressed this issue:

> Unlike the present case which involves nondiscretionary accounts, "the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense." *Leib v. Merrill, Lynch, Pierce, Fenner & Smith,* 461 F. Supp. 951, 953 (E.D. Mich. 1978) (interpreting Michigan law). Accordingly, numerous courts have held that the lodestar for determining the existence of a fiduciary relationship is whether the account is discretionary or nondiscretionary. *See, e.g., Refco, Inc. v. Troika Inv. Ltd.,* 702 F. Supp. 684, 687 (N.D. Ill. 1988) (interpreting Illinois law). In *Refco,* the court held that "[i]n general only a broker operating a discretionary account is viewed as a fiduciary." *Id.* at 686. The *Refco* court tempered its absolute view by acknowledging that "[e]ven in the most limited type of agency – the nondiscretionary account where the broker is simply called on to carry out its principal's orders – the concept of faithfulness to duty operates to preclude the agent's dealing to its own advantage rather than its principal's." *Id.* at 687 n. 9.
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> Similarly, in *Leib,* the court indicated that in a nondiscretionary account, the "broker is bound to act in the customer's interest when transacting business for the account; however, all duties to the customer cease when the transaction is closed." *Leib,* 461 F. Supp. at 952-53. Notwithstanding

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1 461 F. Supp. 951, 953 (E.D. Mich.1978).
2 809 F. Supp. 880, 893 (D. Utah 1993).

this apparently limited duty, the *Leib* court identified six duties associated with nondiscretionary accounts: (1) the duty to recommend stock only after becoming informed about the stock; (2) the duty to promptly carry out the customer's orders; (3) the duty to inform the customer of the risks involved in a transaction; (4) the duty to refrain from self-dealing; (5) the duty not to misrepresent any fact material to a transaction; and (6) the duty to transact business only after prior authorization from the customer. *Id.* at 953.

The Tenth Circuit, rather than using the nature of the account as the dispositive factor, balanced the nature of the account with the nature of the relationship between the parties. *Hotmar v. Listrom & Co.*, 808 F.2d 1384, 1386 (10th Cir.1987) (interpreting Kansas law). The *Hotmar* court, in finding no fiduciary relationship, analyzed whether the broker agreed to manage or otherwise control the account, or rather, whether he merely rendered advice. *Id.* at 1387. Finding no agreement by the broker to monitor his clients' nondiscretionary accounts, the court found no fiduciary relationship. *Id.*

Other courts have rejected the nondiscretionary-discretionary dichotomy, in favor of an analysis of the actual relationship. *See, e.g., Baker v. Wheat First Sec.*, 643 F. Supp. 1420, 1429 (S.D. W.Va. 1986) (interpreting West Virginia law); *Davis v. Merrill, Lynch, Pierce, Fenner & Smith,* 906 F.2d 1206, 1216-17 (8th Cir.1990) (interpreting South Dakota law). In so doing, the *Baker* court found a fiduciary relationship where the broker exerted "de facto control" over the account. *Baker,* 643 F. Supp. at 1429. To the *Baker* court, such de facto control existed when "'the client routinely follows the recommendations of the broker.'" *Id.* (quoting *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir.1980)).

The Eighth Circuit in *Davis* followed the rationale of the *Baker* court, concluding that a fiduciary relationship may exist in cases where the broker exerts de facto control over a nondiscretionary account. *Davis,* 906 F.2d at 1216-17. In reaching this result, the *Davis* court relied heavily on the fact that the aggrieved customer was an unsophisticated investor who never failed to follow her broker's recommendations. *Id.* at 1217. Even then, however, the court found it significant that the broker had made numerous unauthorized trades. *Id.*

Finally, other courts assume the existence of a fiduciary relationship even if the account is [non]discretionary [sic], and then analyze the facts to determine the scope of the duty and whether the broker breached the duty. *See, e.g., Romano v. Merrill, Lynch, Pierce, Fenner & Smith,* 834 F.2d 523, 530 (5th Cir.1987) (interpreting federal securities law). Applying this analysis, the *Romano* court found no breach where the customer, an alert and vigilant businessman, controlled his nondiscretionary account and made all decisions regarding activity in the account. *Id.* (citations omitted).

The cases discussed above illustrate four methods that courts employ in answering whether a fiduciary relationship exists between a broker and a customer with nondiscretionary accounts. Two of these methods involve an absolute rule: either finding no fiduciary relationship because the account is nondiscretionary, *see Refco, Inc. v. Troika Inv. Ltd.,* 702 F. Supp. 684, 687 (N.D. Ill. 1988), or finding a fiduciary relationship regardless of whether the account is discretionary, *see Romano v. Merrill,*

> *Lynch, Pierce, Fenner & Smith,* 834 F.2d 523, 530 (5th Cir.1987). Other courts, using a flexible approach, base the existence of a fiduciary relationship, not on the nature of the account, but on the nature of the relationship, and find a fiduciary relationship either if the broker has agreed to manage the account, *see Hotmar v. Listrom & Co.,* 808 F.2d 1384, 1386 (10th Cir.1987), or if the broker exercises de facto control over the account, *see Davis v. Merrill, Lynch, Pierce, Fenner & Smith,* 906 F.2d 1206, 1216-17 (8th Cir.1990).

In *Leib*, the court recognized that apart from discretionary and non-discretionary accounts, there exists a hybrid-type account. "Such an account is one in which the broker has usurped actual control over a technically non-discretionary account. In such cases, the courts have held that the broker owes his customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation."[3] *Leib* further set forth the factors the court should consider when determining whether the broker has usurped control over the account:

> In determining whether a broker has assumed control of a non-discretionary account the courts weigh several factors. First, the courts examine the age, education, intelligence and investment experience of the customer. Where the customer is particularly young, *Kravitz v. Pressman, Frohlich & Frost*, 447 F. Supp. 203 (D. Mass. 1978), old, *Hecht v. Harris, supra*, or naive with regard to financial matters, *Marshak v. Blyth Eastman Dillion & Co., Inc.,* 413 F. Supp. 377 (N.D. Okl. 1975), the courts are likely to find that the broker assumed control over the account. Second, if the broker is socially or personally involved with the customer, the courts are likely to conclude that the customer relinquished control because of the relationship of trust and confidence. *Kravitz v. Pressman, supra*; *Hecht v. Harris, supra*. Conversely, where the relationship between the broker and the customer is an arms-length business relationship, the courts are inclined to find that the customer retained control over the account. *Shorrock v. Merrill Lynch, supra*. Third, if many of the transactions occurred without the customer's prior approval, the courts will often interpret this as a serious usurpation of control by the broker. *Hecht v. Harris, supra*. Fourth, if the customer and the broker speak frequently with each other regarding the status of the account or the prudence of a particular transaction, the courts will usually find that the customer, by maintaining such active interest in the account, thereby maintained control over it. *Robinson v. Merrill Lynch, supra*.

The differing standards applicable to investment advisers and brokers in some jurisdictions is discussed in more detail below in response to Item 9.g.-h. The differences in the standards are generally harmful to retail customers who do business with brokers instead of investment advisers.

There are several circumstances other than purchasing broker recommended securities in an account in which it would be beneficial to retail customers for brokers to be subject to a fiduciary duty. Common situations that manifest how beneficial the fiduciary standard is include situations where the following occurs: 1) an investor follows a broker to a new brokerage firm; 2) the investor has a change in circumstances or objectives; 3) the investor changes brokers; and 4) the broker is aware of impending doom for a portfolio.

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[3] 461 F. Supp. at 954.

The investor following a broker to a new brokerage firm. This is probably the most common situation in which a fiduciary standard for brokers would directly benefit investors. Brokers commonly move to different brokerage firms over the course of a career and will try to get their clients to follow them when making such moves. When a broker sells investments that are unsuitable and then changes brokerage firms, it can place the investor's portfolio in supervisory limbo. Despite requiring the completion of account suitability documents at the new firm, the new firm commonly will do nothing to warn the investor that the portfolio previously purchased for the investor by the firm's new broker is grossly unsuitable for the investor. It will then justify the inaction by saying it is only responsible for trades made after the broker had transferred to it. The investments are then left to decline in value until the investor's nest egg is gone. Further, the initial firm, at which the investment purchases were made, will deny responsibility because it had no ability to supervise the broker, to recommend investment changes, or to discover the impropriety after the broker left. A fiduciary duty on the part of the broker and the new firm to inform the investor of an unsuitable portfolio, irrespective of whether the investments were recommended by the broker after he changed firms, would protect the investor.

The change of circumstances or objectives. When an investor's circumstances change, such as when the investor retires, becomes unemployed, or becomes disabled, the needs of that investor change. Likewise, investors can manifest a change in risk tolerance and objectives that causes the portfolio of that investor to no longer be suitable. This is a very common situation where a fiduciary duty benefits the investor. The lack of a fiduciary duty means that a broker does not need to inform an investor that the investor's portfolio is no longer suitable – no matter how strongly the information given the broker would indicate to the contrary. Typically, the change in circumstances will be deemed relevant only to new advice given. To make matters worse, investors commonly think their broker will volunteer such advice. Brokerage firms, through advertising and other marketing, give investors reason to believe that they are watching over investors' savings and guiding them through the transitions in their lives.

An example of how such a fiduciary duty benefits investors can be found in a recent case filed in the American Arbitration Association ("AAA") and settled prior to arbitration[4]. The case involved an individual who informed his registered investment adviser that he had developed cancer and stopped working and wished to live on income from his investments. Despite the significant life change, the investment adviser failed to advise the investor that his aggressive portfolio was inconsistent with such a life change. The fiduciary duty of the investment adviser meant that the adviser had the duty to do so. Without such a duty, the adviser could have kept his mouth shut and let the portfolio do little to help the investor sustain himself during this time when he was not working. The existence of a fiduciary duty in this case, arising because of the investment adviser status, gave the investor legal recourse. A broker may not have had similar obligations under the FINRA rules or applicable state law.

Investor changing from one broker to a new broker. When an investor comes to a new broker with a portfolio that requires some future action, the broker may fail or refuse to take any action. When losses subsequently occur, the new broker attempts to disclaim liability for losses by stating that the recommendation for the investment was not the broker's, but rather the prior broker's, and that the broker has no duty with respect to investments he did not recommend. The losses could be prevented if the broker were a fiduciary with a duty to disclose relevant information.

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[4] Names of the parties have been withheld due to the confidentiality provision of the settlement agreement between the parties.

The importance of fiduciary duties being applicable to brokers is demonstrated in another recent case in which an investor purchased a substantial variable annuity from her first broker. She then changed brokers and retired. Despite the request for income to sustain the investor during retirement and a need for stable investments, the new broker never advised the client to annuitize the annuity. Annuitizing would have furthered both objectives. When the investor questioned why the broker failed to take this action after years of doing business together, the broker responded that the investor should have done so on her own. Like many investors, the investor in this matter barely understood what a variable annuity was. Under a fiduciary standard, the broker and her firm could be held liable for not disclosing such important information.

In another case, a broker convinced an elderly investor to take a loan secured by the investor's portfolio that would be paid for by income from the portfolio. The investor's new broker did not make any payments on the loan and did not inform the investor that failing to pay the loan off could result in the investor's entire life savings being liquidated without notice. In this case, the investor was able to recover only because the new broker was found to be a fiduciary. Without such a duty, the elderly investor would likely be left with no recourse.

Not advising about impending disaster. When investors only get information at the time of the purchase of an investment, situations arise in many cases where the broker knows information indicating that a particular investment is about to implode but fails to take action or inform the investor. This circumstances occurs often in cases involving proprietary products that a firm does not want its customers to sell.

The many cases involving Morgan Keegan in the past five years exemplify this situation. Morgan Keegan was selling certain proprietary mutual funds as conservative bond funds. Ultimately, Morgan Keegan came to learn that a substantial portion of these funds were invested in collateralized debt obligations – an investment vehicle carrying substantial risk. Internal emails recognized those risks and the fact that individuals invested in such investments were not aware of the substantial risk. Despite the knowledge that the investors misunderstood the risk of holding the investments, Morgan Keegan never notified the investors of the substantial risk. Whether Morgan Keegan had a duty to warn depended in part upon whether the brokers and Morgan Keegan were fiduciaries of the investors. In *Warfel v. Morgan Keegan*, (FINRA No. 11-726 and U.S. District Court for the Middle District of Florida, 12cv1250), the FINRA arbitration panel found that a fiduciary duty existed and, as such, the Morgan Keegan broker had a duty to warn of the risk of continuing to hold the Morgan Keegan bond funds. Morgan Keegan was ordered to reimburse the claimant for his losses as the result of not being informed of such risk. This case should be contrasted with a large number of other cases in which the investors were not told of the risk of continuing to hold such investments and in which the arbitration panels found no fiduciary duty and, therefore, no liability on the part of the broker or the firm.

9. Data and other information related to the ability of retail customers to bring claims against their financial professional under each regulatory regime, with a particular focus on dollar costs to both firms and retail customers and the results when claims are brought. We especially welcome the input of persons who have arbitrated, litigated, or mediated claims (as a retail customer, broker-dealer or investment adviser), their counsel, and any persons who presided over such actions. In particular, describe the differences between claims brought against broker-dealers and investment advisers with respect to each of the following:

9.a. **The differences experienced by retail customers, in general, between bringing a claim against a broker-dealer as compared to bringing a claim against an investment adviser.** – For the time being, there is very little difference between bringing suit against licensed investment advisers or broker dealers, because most claims will end up in arbitration. It is commonly believed that the use of mandatory arbitration by investment advisers is widespread. A recent survey conducted by the Massachusetts Securities Division found that nearly half of registered investment advisers responding to the survey had pre-dispute mandatory arbitration clauses in their advisory contracts.[5]

Of course, nearly all claims brought by retail customers against broker-dealers are subject to mandatory arbitration, either through an express arbitration provision in the customer's account documentation, or as a result of FINRA rules. *See UBS Fin. Servs. v. W. Va. Univ. Hosps., Inc.*, 660 F.3d 643 (2d Cir. 2011).

9.b. **Any legal or practical barriers to retail customers bringing claims against broker-dealers or investment advisers.** – Retail customers must ordinarily bring claims against investment advisers in either state court or in arbitration. Save for claims for rescission of an investment advisory contract and restitution, the Investment Advisers Act of 1940 ("IAA") does not provide for a federal private right of action or jurisdiction. *See Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11, 18-19 (1979).

Most investment adviser arbitration takes place before private dispute resolution forums such as the AAA or JAMS. Traditionally, FINRA has not been used as an arbitration forum for disputes between investment advisers and their clients, because the advisers have not been FINRA members. However, FINRA has launched a pilot program, under which the forum may be used if the adviser and the customer submits a post-dispute agreement to arbitrate in the forum.[6]

There is a wide variation among these forums' procedural rules. For example, discovery may be limited to simply an exchange of documents, or may include pre-hearing depositions of all of the principals. Similarly, the forum rules may allow for pre-hearing, dispositive motions. The forums may be prohibitively expensive for some retail customers. Participants in AAA arbitrations may be required to share a pre-hearing deposit of as much $25,000. The neutrals are often retired judges who may or may not have significant securities experience.

FINRA arbitration, in contrast, is much more tailored to the retail customer than these other forums. Its discovery rules and procedures specifically focus on securities-related documents and information and require disclosure of certain

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5 *See* http://www.sec.state.ma.us/sct/sctarbitration/Report%20on%20MA%20IAs%27%20Use%20of%20MPDACs.pdf.

6 *See* http://www.finra.org/ArbitrationAndMediation/Arbitration/SpecialProcedures/P196162. To date, only a small number of investment advisers have made use of this pilot program.

documents. Pre-hearing dispositive motions are no longer allowed in FINRA proceedings, except in a few limited circumstances. The forum fees are significantly lower than in other forums. Finally, FINRA neutrals may not have the pedigree of private forum neutrals, but likely have more experience with arbitrating disputes within the securities industry.

Of course, litigants in arbitration have little recourse if an arbitrator returns a legally erroneous award. Litigants in court may seek appellate review of judicial errors.

Another legal barrier faced by retail customers is the satisfaction of a judgment or award in their favor. Under FINRA rules, industry parties must comply with an arbitration award or settlement related to an arbitration or mediation within 30 days or risk suspension or cancellation of that party's registration with FINRA. *See* FINRA Rule 9554. However, retail customers that litigate in court or in an arbitration forum other than FINRA must enforce any judgment like any other civil judgment – by levying and executing on property wherever it can be found.

9.d. **The amount of awards.** – Claims against brokers or broker-dealers are generally adjudicated in the FINRA arbitration forum. FINRA provides statistics as to how often investors are awarded monetary damages in arbitration claims against broker-dealers or brokers. From 2008 to 2012, customers have received some monetary damage recovery in a range of 42% to 47% of the cases for each year.[7] However, FINRA does not keep statistics as to what percentage of the damages claimed by investors are recovered through arbitration against broker-dealers.

Edward O'Neal and Daniel Solin performed a statistical analysis of arbitration awards against broker-dealers, with data from January 1995 to December 2004. *See* "Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare", Edward S. O'Neal, PhD., and Daniel R. Solin[8] (hereinafter "Mandatory Arbitration").

O'Neal and Solin sampled over 13,800 cases – 90% of those cases were from NASD arbitration and 10% were from NYSE arbitration. Mandatory Arbitration at 6. They found that the average "win rate" – where the investor was awarded at least some money – was about 50.7% over this ten year period. Mandatory Arbitration at 10. Of those investors who "won", their average recoveries ranged annually from 68% of the amount requested to 49% of the amount requested. Mandatory Arbitration at 11.

The percentage of requested damages recovered went down significantly depending on how much money was requested. For example, when the amount claimed was less than $10,000, investors who "won" received 76% of their losses back, on average. When the claims requested damages of between $100,000 and $250,000, investors who "won" only received 52% of

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7 *See* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/.

8 Available at http://smartestinvestmentbook.com/pdf/061307%20Securities%20Arbitration%20Outcome%20Report%20FINAL.pdf.

their requested damages. Even worse, for claims with damage requests of over $250,000, investors who "won" only received 37% of their requested damages. Mandatory Arbitration at 12. Thus, investors who brought larger claims were likely to recover less of their losses.

While this analysis by O'Neal and Solin was helpful to determine how investors fared against brokers and broker-dealers, no similar analysis has been performed on cases involving investment advisers. As such, it is impossible to compare the awards/recoveries against each other.

9.e. Costs related to the claim forum, as it affects retail customers, firms, and associated persons of such firms. – When an aggrieved investor sues a broker-dealer and its representatives, that investor is generally required to bring claims in FINRA arbitration, due to the fact that FINRA-member broker-dealers generally have an arbitration clause in their account agreements. The initial filing fees for claims filed in FINRA arbitration are $1,425 for claims with losses between $100,000 and $500,000; and $1,800 for claims with losses over $1 million. The parties are also required to pay forum fees for the initial pre-hearing conference, disputes over discovery and subpoenas, and the evidentiary arbitration hearing. The forum fees for the evidentiary hearing can be significant, ranging from a few thousand dollars, to $30,000, or even more. These forum fees can be a significant financial burden on investors who are required to arbitrate their claims.

Often, when an aggrieved investor sues an investment adviser and its representatives, that investor is required to arbitrate his or her claims, pursuant to an arbitration clause in the investment advisory agreement, in one of the following forums: a) AAA; b) JAMS; or c) even FINRA. The forum fees associated with AAA or JAMS are generally higher than FINRA forum fees and can be substantial for an aggrieved investor to have his or her "day in court." As discussed above, some forums, other than FINRA, have substantial deposit requirements.

However, some investment advisory agreements do not have any arbitration clause. The absence of an arbitration clause allows the investor to proceed in court. Court filing fees are typically much smaller and often range from $300 to $600 (including jury fees). There are also costs associated with serving process on a party for a court action (which an investor typically does not have to deal with in arbitration). Courts typically do not charge parties "trial fees", "forum fees", or other fees to appear before a judge or jury to determine the outcome of the case. Thus, investors who sue their investment advisers in court generally will have significantly lower forum fees associated with bringing a claim. However, there may be significantly higher costs associated with discovery and motion practice for claims filed in court.

Hence, the differences in forum costs associated with suing a broker-dealer or suing an investment adviser are dependent on the forum in which the case is litigated. The costs can vary significantly, depending on whether the investment adviser has an arbitration clause in its agreement, and, if so, which forum has been selected. Without such a clause, the forum fees for an aggrieved investor are significantly less.

9.f. Time to resolution of claims. – As with forum costs above, the difference between suing a broker-dealer or an investment adviser depends on the existence of an arbitration clause. One of the benefits to arbitration is that claims filed in an arbitration forum are generally resolved more quickly than those filed in court. Claims filed in FINRA arbitration, AAA, or JAMS are generally resolved in a range of one year to eighteen months. FINRA's website indicates that from 2011 to 2013, the average time from start to resolution of a FINRA arbitration claim ranged from 14.2 to 14.8 months.[9] However, cases that went to final evidentiary arbitration hearing had lasted, on average, from 15.9 to 17.7 months.

Claims that are filed in court can be resolved quickly, but generally take significantly longer to be resolved than claims filed in arbitration. The length of time to resolution is somewhat dependent on how busy the court dockets are, which varies from court to court. For example, a case in a rural court with a relatively light docket may proceed more rapidly than one in an urban court with a loaded docket. Additionally, court cases are subject to more motion practice and greater discovery (such as depositions, which are generally not allowed in securities arbitration). Discovery and motion practice can add time and expense to the resolution of the case in court.

The United States Government keeps statistics on how long it takes cases to proceed in the federal courts.[10] For each year ending in September, from 2007 to 2012, the median time from filing of a civil case to *trial* has ranged from 24.3 months to 25.5 months. However, these statistics only include cases that get that far – the median time from filing to disposition of a civil case has ranged from 7.3 to 8.9 months. While these statistics include all civil cases, they can be used to estimate the length of time an investor should anticipate for the resolution of his or her claims in court.

Thus, the differences between suing a broker-dealer or an investment adviser again depend on whether there is an arbitration agreement. An aggrieved investor that is suing an investment adviser in court may anticipate a greater length of time for the resolution of his claims.

9.g. The types of claims brought against broker-dealers (we welcome examples of mediation, arbitration and litigation claims);

9.h. The types of claims brought against investment advisers (we welcome examples of mediation, arbitration and litigation claims); and

9.i. The nature of claims brought against broker-dealers as compared to the nature of claims brought against investment advisers (e.g., breach of fiduciary duty, suitability, breach of contract, tort).

The nature of claims against broker-dealers and investment advisers is generally similar. The majority of claims made against either broker-dealers or investment advisers generally involve two types: a) that the broker or adviser misrepresented the risks or characteristics of a particular investment; and b) that the investment was unsuitable for the investor in light of the investor's financial resources, risk tolerance, investment objectives, age, and other characteristics. The former type of claim typically is asserted in numerous

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9 *See* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/.

10 *See* http://www.uscourts.gov/Statistics/FederalCourtManagementStatistics/district-courts-september-2012.aspx.

causes of actions, such as common law fraud, violation of a state securities statute, or violation of a state consumer fraud statute. The latter type of claim typically is asserted in causes of action for negligence or breach of fiduciary duty. The extent of the broker's or adviser's duty in a negligence or breach of fiduciary duty claim is what differentiates the two claims.

Investment advisers are fiduciaries under federal law and have extensive duties to their clients, including the duties to put the best interests of the client first and duties of fair dealing. *See S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) (describing the "delicate fiduciary nature of the investment advisory relationship"). On the other hand, the law varies from state to state concerning whether a broker owes his client a fiduciary duty. Courts in some states, like California, have found that brokers are fiduciaries and have the same duties as an investment advisor would. *See Duffy v. Cavalier*, 215 Cal. App. 3d 1517, 1533 (Cal. App. 1989); *see also Brown v. Wells Fargo Bank, NA*, 168 Cal. App. 4th 938, 960 (Cal. App. 2008) (stating that "A stockbroker is a fiduciary"). Courts interpreting the law of other states have determined whether a broker is a fiduciary on a case-by-case basis. For example, some courts have looked to who had *de facto* control over the account at issue (*see Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1216 (8th Cir. 1990)), or whether the client was unsophisticated (*see Patsos v. First Albany Corp.*, 741 N.E.2d 841, 849-50 (Mass. 2001)).

Because of the clear law regarding the fiduciary nature of the investment advisory relationship, proving liability on the part of an investment adviser in some jurisdictions can be more readily accomplished than proving liability on the part of a broker or his firm. Likewise, proof of a common law fraud claim against a broker who is a fiduciary under state law and investment advisers can, in some jurisdictions, be an easier task. For example, under Oregon law, common law fraud must be proved by only a preponderance of the evidence in a claim against a fiduciary,[11] whereas fraud must be proven by clear and convincing evidence against a non-fiduciary.[12]

Consumer protection statutes prohibiting unfair trade and deceptive practices are more likely to reach investment advisory services than securities trading. Some courts have held that securities transactions are not within the scope of such statutes. *See, e.g., Paine Webber Jackson & Curtis, Inc.*, 839 F.2d 1095 (5th Cir. 1988) (Louisiana Act not applicable to securities transactions); *Spinner Corp. v. Princeville Dev. Corp.*, 849 F.2d 388 (9th Cir. 1988) (Hawaii's "baby FTC Act" not applicable to securities). Other courts have held that securities claims are within the scope of these statutes. *See Onesti v. Thomson McKinnon Securities, Inc.*, 619 F. Supp. 1262 (N.D. Ill. 1985) (Illinois consumer fraud statute applicable to securities transaction since securities are merchandise); *Segal v. Goodman*, 851 P.2d 471 (N.M. 1993) (court upheld award of treble damages under New Mexico Unfair Practices Act for sale of unregistered securities).

However, the courts that have considered the issue have generally determined that the provision of investment services falls within these consumer protection statutes. *See Denison v. Kelly*, 759 F. Supp. 199 (M.D. Pa. 1991) (although securities are not "goods" within the meaning of the Pennsylvania Consumer

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11 *Lindland v. United Business Invs., Inc.*, 298 Ore. 318, 693 P.2d 20, 25 (Or. 1984).
12 *Dizick v. Umpqua Community College*, 287 Ore. 303, 599 P.2d 444, 448 (1979).

Protection Law, the Act is applicable to investment services); *Johnson v. John Hancock Funds*, 217 S.W.3d 414, 424 (Tenn. Ct. App. 2006) (investment counseling and advice is consumer transaction covered by Tennessee statute); *Strigliabotti v. Franklin Res., Inc.*, 2005 U.S. Dist. LEXIS 9625, *29-30 (N.D. Cal. Mar. 7, 2005) (California statute reaches scheme to overcharge investors in the management of securities).

9.j. **The types of defenses raised by broker-dealers and investment advisers under each regime.** – Broker-dealers and investment advisors raise many similar defenses in investor claims against them. Those defenses include the negligence of the investor, the sophistication of the investor, ratification, waiver, estoppel, and failure to mitigate. There are, however, defenses raised by broker-dealers and brokers which are not available to investment advisors. Most brokers and broker-dealers will contend that they owe no fiduciary duty to an investor. Rather, the only obligation that they contend they have is to make suitable investment recommendations and that their duties begin and end with the securities transaction. One case frequently cited by brokers and broker-dealers is *De Kwiatkowski v. Bear Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002). Brokers and broker-dealers also frequently assert that there is no private right of action for violation of rules of a self-regulatory organization. Because investment advisers owe an ongoing fiduciary duty to act in the best interests of their customers, and they are not governed by the rules of a self-regulatory organization, these defenses are not available to investment advisers.

12. **Data and other information describing the effectiveness of disclosure to inform and protect retail customers from broker-dealer or investment adviser conflicts of interest. Describe the effectiveness of disclosure in terms of retail customer comprehension, retail customer use of disclosure information when making investment decisions, and retail customer perception of the integrity of the information. Please provide specific examples. If possible, differentiate by the form of disclosure (oral or written), the amount of information the disclosure presents, and retail customer demographic and account information. Also, if possible, measure disclosure effectiveness by associated activity.**

The Commission's studies of the financial literacy of investors suggests that disclosure is insufficient to protect investors. *See* Office of Investor Education and Advocacy and U.S. Securities and Exchange Commission, "Study Regarding Financial Literacy Among Investors" (August 2012)[13] (the "Financial Literacy Study").

The Commission's Financial Literacy Study recognized that "American investors lack basic financial literacy. For example, studies have found that investors do not understand the most elementary financial concepts, such as compound interest and inflation. Studies have also found that many investors do not understand other key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns. Moreover, based on studies cited in a Library of Congress report, investors lack critical knowledge about investment fraud. Surveys also demonstrate that certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly

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[13] Available at http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.

educated, have an even greater lack of investment knowledge than the average general population."[14]

The Financial Literacy Study identified: "(i) methods to improve the timing, content, and format of disclosures; (ii) useful and relevant information for investors to consider when either selecting a financial intermediary or purchasing an investment product; and (iii) methods to improve the transparency of expenses and conflicts of interest."

It is important to note that mere disclosure is not sufficient to protect an investor or for a broker or investment adviser to satisfy his obligations to an investor. *See In re Dept. of Enforcement v. Gerald J. Kesner Lakewood, Co.*, 2010 WL 781456, *9 (N.A.S.D.R.); *see also In re Chase*, SEC Release No. 47476, 2003 WL 917974 ("Mere disclosure of risks is not enough. A registered representative must 'be satisfied that the customer fully understands the risks involved and is . . . able . . . to take those risks.'" (quoting *In re Patrick G. Keel*, SEC Release No. 31716, 1993 WL 12348)).

Disclosures must be set forth in plain English. If the risks or the conflict cannot be adequately expressed to be fully understood by the client, the disclosure is meaningless.

14. Data and other information describing the extent to which retail customers are confused about the regulatory status of the person from whom they receive financial services (i.e., whether the party is a broker-dealer or an investment adviser). Provide data and other information describing whether retail customers are confused about the standard of conduct the person providing them those services owes to them. Describe the types of services and/or situations that increase or decrease retail customers' confusion and provide information describing why. Describe the types of obligations about which retail customers are confused and provide information describing why.

In its original report to Congress, the "Study on Investment Advisers and Broker-Dealers" (the "SEC Study")[15], the Commission studied the extent to which retail customers were confused about the status of the person from whom they receive financial services. The Commission reviewed two studies which it sponsored, and a study conducted by Consumer Federation of America (the "CFA Survey").

Commission-sponsored Studies

(i) **Siegel & Gale Study:** Siegel & Gale, LLC, and Gelb Consulting Group, Inc., were retained by the Commission in 2004 to conduct focus group testing. The focus group participants had the same issues as those raised by investors in the publicly solicited comments, namely that they did not understand that the roles and legal obligations of investment advisers and broker-dealers can be different, and that the different titles used are confusing. The participants also did not understand terms such as "fiduciary".

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[14] *See* Federal Research Division, Library of Congress, Financial Literacy Among Retail Investors in the United States (Dec. 30, 2011). The Library of Congress Report is incorporated by reference in the Commission's Financial Literacy Study and is attached thereto as Appendix 1.

[15] "Study on Investment Advisers and Broker-Dealers", available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

(ii) **RAND Corporation Report**: The Commission retained RAND in 2006 to conduct a study of broker-dealers and investment advisers.

a) **Firm Analysis**: RAND found it difficult to identify with certainty the business practices of investment advisers and broker-dealers. RAND noted that it could be difficult for investors to understand the differences in the services provided by financial firms as the information was not presented uniformly, with some firms providing so much information it would be difficult to process and others providing scant information. RAND found that the firms believed investors tend to trust a particular firm without necessarily understanding the firm's services and responsibilities.

b) **Investor Survey**: Survey respondents and focus group participants reported that they did not understand the differences between investment advisers and broker-dealers, and found the titles used confusing. Focus group participants noted that "the interchangeable titles and 'we do it all' advertisements made it difficult to discern broker-dealers from investment advisers."[16] Participants also did not understand the legal duties owed to investors by investment advisers and broker-dealers. "The primary view of investors was that the financial professional – regardless of whether the person was an investment adviser or a broker-dealer – was acting in the investor's best interest."[17]

c) **RAND's Conclusion**: RAND came to the conclusion that the "financial services market had become more complex over the last few decades in response to market demands for new products and services and the regulatory environment."[18] Therefore, there has been a blurring of the distinctions between investment advisers and broker-dealers.

CFA Survey

Industry advocates and certain industry groups also conducted a survey. The results of the survey again suggest that investors do not understand the differences between investment advisers and broker-dealers, nor do they understand that there are differing standards of conduct related to each.

SEC Study Conclusion

The SEC Study found that, based on the comments, studies and surveys it had reviewed, investors do not understand the differences between investment advisers and broker-dealers. This misunderstanding is compounded by the fact that many retail investors may not have the "sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals."[19] The SEC Study concluded that, "it is important that retail investors be protected uniformly when receiving personalized investment advice or

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[16] *See* SEC Study, p. 98.
[17] *See* SEC Study, p. 98.
[18] *See* SEC Study, p. 99.
[19] *See* SEC Study, p. 101.

> recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. It is also important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard."[20]

* * *

Finally, we provide some comment with respect to the "Request for Data and Other Information Relating to Potential Areas for Further Regulatory Harmonization." We are supportive of harmonizing the regulations applicable to broker-dealers and investment advisers. To the extent the individuals are providing the same, or very similar, services to investors, they should be subject to the same regulations.

Specifically, brokers and investment advisers should be subject to the same advertising regulations. However, as noted above in response to Item 2, broker-dealer advertisements are very misleading to investors, despite the fact that their advertisements are regulated. Any regulatory scheme governing advertisements must ensure that the advertisements accurately describe the services offered by a broker-dealer, broker, or investment adviser and that the advertisements are consistent with the legal duties owed to investors. To the extent there are conflicts of interests, those conflicts should be prominently disclosed in advertisements; however, both brokers and investment advisers should endeavor to eliminate conflicts.

With respect to continuing education requirements, both brokers and investment advisers should be subject to such requirements. The materials used to satisfy the continuing education requirements should be retained by the firms to ensure that their representatives have received adequate training.

PIABA supports harmonizing the regulation of brokers and investment advisers and ensuring that brokers are held to the same stringent fiduciary duty. PIABA thanks the Commission for the opportunity to provide additional information on this very important issue.

Sincerely,

Scott C. Ilgenfritz

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[20] *See* SEC Study, p. 101.

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