The Institute for the Fiduciary Standard

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File Number 4-606

July 5, 2013

Mary Jo White
Chair
U. S. Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

RE: Rulemaking - Duties of Brokers, Dealers, and Investment Advisers

Dear Chair White:

The Institute for the Fiduciary Standard appreciates the opportunity to respond to the March 1, 2013 request for Information (RFI) seeking comment and information regarding the benefits and costs of the different standards of conduct when investment advisers and broker dealers provide investment advice to retail customers.

The Institute for the Fiduciary Standard (www.thefiduciaryinstitute.org), formed in 2011, provides research, education and advocacy regarding the vital importance of the fiduciary standard to investors receiving investment and financial advice.

These comments focus on the important findings in the 2008 Rand Report as the appropriate vantage point for viewing the necessity for stringent fiduciary duties. This important report provides independent and credible research regarding investor understanding of the different standards of care imposed on investment advisers and broker-dealers. Of particular interest to potential rule making is the discussion in the report of what investor "do not know." These comments summarize certain assumptions expressed regarding a possible uniform fiduciary standard of conduct, and the duty of loyalty. The RFI acknowledged that these assumptions may not necessarily reflect the policy views of the SEC. An Institute white paper analyzing these assumptions is attached.

Introduction

In the RFI announcement, the SEC notes the importance of what investors "do not know." Elyse B. Walter, then Chairman, states how "few investors realize that the standard of care they receive depends on the type of investment professional they use" and investors often "do not know" whether their investment professional is a fiduciary advisor or a broker subject to the lower commercial standard. This is an excellent perspective to view the necessity of rulemaking.

What Investors "Do not Know"

What investors "do not know" about their investment professional far exceeds their registration status. Research suggests what investors often "do not know" entails two of the most essential features that define any professional or commercial relationship. The first is what is the true cost for the services rendered, and the second is what investors get in return.

The single most authoritative "portrait" of the retail investor's weaknesses may be the 2008 Rand Report (Rand.) Rand is an SEC commissioned report that has been widely cited by regulators and in academic papers. Its methodology and general conclusions have been widely accepted.[1]

On the issue of true cost, Rand concludes that " focus group participants with investments acknowledged uncertainty about the fees they pay for their investments and survey participants also indicate confusion about fees." Among surveyed investors in Rand, 25% of respondents who reported using an advisor or broker also reported they pay $0 for these services. A similar research finding on fees is also revealed in a 2011 AARP study of 401 (k) plan participants, as 71% of participants reported they did not pay any fees, while 23% said they do pay fees.[2]

What do investors get for what they pay? Often investors believe they get far more (in terms of a higher standard of care) than the law requires of their brokers. 63% of focus group participants agreed that brokers "[a]re required by law to act in the client's best interest." Other research corroborates these findings. A 2010 survey of investors by InfoGroup reveals 76% of investors believe brokers are fiduciaries; 60% believe insurance sales people are fiduciaries.[3]

The Depth of Investors' Shortcomings:
Financial Education, the Need for Stringent Fiduciary Duties

"Financial education" initiatives are often advocated to ameliorate what investors "do not know." Yet, research suggests it is not clear these initiatives actually work. In the opinions of some observers and academics, the results are mixed or questionable at best.[4]

The key point is not whether financial education can remedy what investors "do not know;" it is whether the fiduciary duties are sufficiently stringent to mitigate investor shortcomings. Will they mitigate behavioral finance factors (heuristics or framing), or communications wrongly implying trusted advice is given (when it is not), or wrongly suggesting services are "free." Will incomplete or potentially misleading disclosure by brokers and advisors be addressed? [5]

The implications of what investors "do not know," their acute unawareness of or incapacity regarding their professional agreements, speak clearly and loudly to the need for stringent fiduciary duties; duties consistent with the risks these shortcomings present.

Background

A rich history of law, policy and experience provides a backdrop for extending the fiduciary standard to brokers rendering personalized investment advice to retail investors.

Fiduciary law exists to restrain the conduct of experts who render socially important services or advice in relationships of trust and confidence. Fiduciary duties serve to mitigate the knowledge gap or information asymmetry that separates the two parties. The fiduciary is obligated to be loyal, and avoid conflict of interest render advice in due care . The fiduciary must adopt the client's ends or objectives.[6] Fiduciary conduct facilitates investor *trust,* the central pillar on which capital markets and the market economy depend. .

"The strictness of fiduciary law conflict-of-interest rules depends mainly on the level of entrustors'(clients) risks from the fiduciaries abuse of trust." [7] Fiduciary duties increase as the knowledge gap widens, and the gap between brokers and retail investors is widely acknowledged as large. [8]

Yale Management Professor Daylian Cain, a leading researcher in the field, offers a sobering view of the academic research regarding how disclosed information is used when conflicts are present. Cain concludes, that conflicts are far more corrosive to independent advice, and disclosure far more ineffective, than is generally acknowledged. "Conflicts of interest are a cancer on objectivity. Even well-meaning advisors often cannot overcome a conflict and give objective advice. More worrisome, perhaps, investors usually do not sufficiently heed even the briefest, bluntest and clearest disclosure warnings of conflicts of interest." [9]

Dodd – Frank

The Dodd-Frank Act permits the SEC to adopt rules providing that the standard of conduct for broker-dealers and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the SEC may provide) shall be to act in the best interest of the customer "without regard to the financial or other interests of the broker, dealer or investment adviser providing the advice." The "the standard of conduct shall be no less stringent than the standard applicable to investment advisers." under section 206(1) and (2) of [the Advisers Act]."

The legislation also explicitly provides that compensation based on commissions, and the sale of proprietary or other limited range of products, "shall not, in and of itself, be considered a violation of such standard" Yet, the Dodd Frank Act also provides that SEC shall examine and where appropriate, "promulgate rules prohibiting or restricting certain sales practices or conflicts of interest and compensation schemes … that the Commission deems contrary to the public interest and the protection of investors."

Assumptions Regarding the Uniform Fiduciary Standard and the Duty of Loyalty

The RFI provides assumptions regarding the uniform fiduciary standard and the duty of loyalty. (As noted above, the RFI states these assumptions may not represent the views of the SEC.) The RFI picture of fiduciary duties is far more restricted and far less stringent than the fiduciary duties required by the Investment Advisers Act of 1940 Act. A more detailed analysis of these assumptions is included in the attached paper. In summary, the analysis concludes the RFI:

1. <u>Sharply restricts what is fiduciary advice; creates new ambiguity about the difference between fiduciary advice and sales communications.</u> Written or oral communications that are clearly "fiduciary advice" are narrowly defined. 'Facts and circumstances' exploration will be necessary to parse language and review materials to draw the line between fiduciary and non fiduciary communications. Thus, new uncertainty and ambiguity is created that is likely to confuse investors.

2. <u>Allows fiduciary duties be waived</u>. Fiduciary duties may be waived through contract provisions, marketing materials or disclosure, disclosure that does not require informed consent, to ensure the client is aware when duties are waived.

3. <u>Suggests that disclosure best addresses conflicts, omits noting that disclosure alone is insufficient to overcome prohibited conflicts</u>. Stressing disclosing conflicts at the exclusion of avoiding conflicts may be interpreted to suggest that disclosure is the best remedy. This interpretation is would be false. Further, the failure to affirm that irrespective of the disclosure the recommendation must remain in the best interest of the client, implies disclosure alone is sufficient, which it is not.

4. <u>Weakens disclosure requirements; omits mention of "informed consent"</u>
   It allows more casual disclosure and oral disclosure (disclosure that is more "efficient" for the firm to deliver) while, not requiring either "client consent" or "informed client consent" of material conflicts of interest (disclosure more effective for the client).

5. <u>Rebrands *conflicts*.</u> Conflicts are essentially rebranded. There is no mention of any harm associated with conflicts. It questions whether principal trading is always a conflict. It omits any mention of associated benefits of avoiding conflicts, and omits urging broker dealers and investment advisers to avoid conflicts. By these omissions, conflicts are implied to be benign.

6. <u>Redefines *loyalty*.</u> By minimizing the harm of conflicts, and stressing disclosure, it essentially urges that the duty of *loyalty* be redefined. Loyalty today means, essentially, "do the right thing." In this discussion it means "disclose doing the wrong thing."

Individually, each of these assumptions undermines the stringency of the UFS as compared to the Advisers Act. Together, these assumptions represent a profound departure from the Advisers Act. If adopted in rulemaking, fiduciary duties would be effectively removed for brokers and advisers giving investment advice to retail investors. The issue of whether such a uniform standard is consistent with the Dodd Frank requirement that the uniform standard be "no less stringent" than the Advisers Act is clear. It is not consistent.

Discussion

Rand and the RFI both affirm the importance of retail investor shortcomings.

Rand sets out key attributes of retail investors' perspectives; the RFI acknowledges these attributes. Rand's findings are explicit and authoritative, and establish a strong justification for stringent fiduciary duties. It documents investor shortcomings and misunderstandings about the very essence of their professional relationship with brokers– shortcomings that create for investors material risks. The RFI affirms the importance of investor "confusion" that is documented in Rand as a basis for rule making. The heart of the challenge for regulators is clear: it is mitigating the impact of investors misunderstandings, through restrictions on advertising and communications, or stringent fiduciary duties – or both.

RFI assumptions do not equate to a fiduciary standard under the Advisers Act, they equate to a lower commercial sales standard

The RFI assumptions do not establish a framework for a standard that is "no less stringent" than the Advisers Act. These assumptions narrowly define communications that are "fiduciary advice"; 'they require facts and circumstances' explorations to determine fiduciary versus non fiduciary advice; they permit fiduciary duties to be waived by contractual agreement, marketing materials or disclosure; they do not urge conflicts be avoided; disclosure alone is urged to address conflicts, investor consent or informed consent is not required, and more oral disclosure is permitted. Conflicts are effectively re-branded as less harmful, more benign, and *loyalty* is effectively redefined to mean disclosure.

RFI assumptions will have the unintended consequence of increasing uncertainty and ambiguity regarding what the fiduciary standard means and when it applies

The assumptions set out in the RFI, if embodied in rule-making, will likely increase investor misunderstandings, and additional uncertainty and ambiguity. This outcome appears likely as different communications will be defined as either "sales talk," or "education" or "advice." Clear lines of demarcations will often not be drawn and 'facts and circumstances' analysis will be required. Explaining and communicating this ambiguous situation to clients will be challenging.

Conclusion

The SEC is poised to neuter the fiduciary standard. The RFI assumptions categorically reject basic fiduciary principles and, instead, set out the basis for a lower commercial sales standard.

If the SEC proceeds to embody these assumptions in its rulemaking, it would clearly violate the Congressional mandate. It is very likely that a judicial evaluation of the rule will reach the same conclusion. After all, the SEC novel approach reject decades of precedent, research findings, and expert opinions. From the words of then Judge Benjamin Cardozo and the origins of the Advisers Act, to The Tully and Rand Reports, the record is clear. Investor weakness and shortcomings and conflicts of interest are as old as the human condition, and fiduciary duties have been designed to mitigate their impacts to help sustain investor trust and confidence. The Frank-Dodd Act recognized the danger to the financial market from the prevailing brokers' sales-talk that looks like advice. An SEC rule based on sales-talk even though it masquerades as "advice" will perpetuate the serious danger to the financial markets. This is not the first time "sales-talk" has significantly contributed to financial havoc. The SEC was charged long ago with ensuring that it will not happen again. It did in 2008, in part because investors' trusted conflicted sales-talk Congress mandated the SEC to ensure that this trust would be justified.

Furthermore, if the SEC go forth and adopts the RFI assumptions, it would depart from its very own heritage; a heritage that emerged from the 1929 crash and found its voice in the Advisers Act. In December 2008, former SEC Chairman, Arthur Levitt Jr., touched on this topic when he testified before the Senate about, among other things, the importance of the SEC's leadership and the agency as the "crown jewel of the financial regulatory infrastructure." [10]

> *For the past 75 years, the SEC has been the crown jewel of the financial regulatory infrastructure and the administrative agencies because its leadership, representing both political parties – like Kennedy and Douglas at the SEC's founding, and Ruder, Breeden, and Donaldson in recent times – understood the importance of public pronouncements and signals sent to the marketplace. They recognized the important role the SEC plays in maintaining investor confidence and in keeping our markets functioning. And they knew that being present and active often was the reassurance that investors needed. Looking forward, restoring trust in our markets will require rejuvenating the SEC. It is the only agency with the history, experience, and specific mission to be the investor's advocate.*

The SEC, according to Levitt, needs *rejuvenation*, to better fulfill its investor advocate mission. The Institute for the Fiduciary Standard agrees and also urges the SEC to both reject calls to depart from its heritage and to reject calls to adopt a lower commercial sales standard.

Respectfully,

Knut A. Rostad
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President
The Institute for the Fiduciary Standard
http://www.thefiduciaryinstitute.org/

CC: Commissioner Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes
Commissioner Daniel M. Gallagher

NOTES

1. "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers," http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf Rand set out to provide the SEC with "a factual description of the current state of the investment advisory and brokerage industries" and determine whether investors understand the differences between the relationships between investors and brokers or advisors.

2. http://assets.aarp.org/rgcenter/econ/401k-fees-awareness-11.pdf

3. http://www.bloomberg.com/news/2010-09-15/-clueless-u-s-investors-believe-brokers-have-fiduciary-duty-survey-says.html

4. Notwithstanding the huge efforts to improve investor financial literacy, there are basic questions about whether it works, with precious little independent credible research clearly demonstrating so. Wall Street Journal columnist Jason Zweig recently reviewed the financial education landscape and concluded it "is a colossal waste of time and money for everyone except the companies that sponsor it." http://blogs.wsj.com/totalreturn/2013/05/01/financial-literacy-month-is-soover/?mg=blogswsj&url=http%253A%252F%252Fblogs.wsj.com%252Ftotalreturn%252F2013%252F05%252F01%252Ffinancial-literacy-month

5. Brokerages have for years stressed their advisory services over their brokerage services and used titles to imply their advisory role is widely understood. Further, as noted by scholar Arthur Laby, in law, rendering *advice* means rendering *impartial advice*, "When one advises another, he is purporting to provide independent, impartial information in the best interest of the recipient." http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/02/LabySellingAdviceCreatingExpectations.pdf See at 768.

   A recent industry survey highlights RIA shortcomings in fee and expenses disclosures. http://www.riabiz.com/a/22621375/why-only-14-of-rias-volunteer-complete-pricing-information-to-clients-and-why-selective-fee-disclosure-is-not-a-winning-strategy

   Further, for examples of firms communicating offering "free" services, see, http://www.gao.gov/products/GAO-13-30

6. For a discussion of the fiduciary obligation as adopting the ends or objectives of the principal, see: Arthur Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 Buffalo Law Review, 99, 104—129.

7. Tamar Frankel, Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers, Boston University School of law Working Paper No. 09-36, August10, 2009, Revised February 17, 2010.

8. In the 1995 *Report of the Committee on Compensation Practices* (aka The Tully Report, for its Chairman, Daniel B. Tully), the report points out in clear terms the level and importance of investors' lack of knowledge of investment products and confusion derived from misunderstanding what's written in prospectuses. The report states that registered representatives and their clients are:

   "Separated by a wide gap of knowledge – knowledge of the technical and financial aspects of investing. The pace of product innovation in the securities industry has only widened this gap. It is a rare client who truly understand the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many. It also makes communication between a registered representative and investor difficult and puts too much responsibility for decision-making on the shoulders of RRs – a responsibility that belongs with the investor."

9. Professor Cain's remarks, and those of Rutgers law professor Arthur Laby, SIFMA General Counsel Ira Hammerman, and Financial Services Institute General Counsel, David Bellaire can be seem on the website of the Institute for the Fiduciary Standard at
   http://www.thefiduciaryinstitute.org/fiduciary-forum-2011

10. http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=7480cab6-cfb7-473a-a741-457ac59e3747

Fiduciary Reference

Analysis of Investment Fiduciary Issues

April 16, 2013

The SEC March 1 Release* assumptions about a possible uniform fiduciary standard and the duty of loyalty sharply restrict when fiduciary duties are applied. If these assumptions are adopted in rulemaking, fiduciary duties would effectively be removed for brokers and advisers giving investment advice to retail investors

Knut A. Rostad

Over the past four years, individual SEC commissioners and SEC staff have expressed various views regarding a possible uniform fiduciary standard (UFS). The March 1 release represents the first time the Commission has expressed views suggesting how it may approach this subject. This paper focuses on two parts of the SEC Release; 1) the SEC assumptions on a possible UFS, and 2) the discussion of the duty of loyalty.

Background

The SEC Release, among other matters, seeks to 1) request additional information generally regarding the costs and benefits of a potential UFS and 2) set out specific assumptions and parameters for such a standard. It notes the SEC seeks information "to assist the agency in considering whether to make new rules" regarding the standards of conduct for broker-dealers and investment advisers. SEC Chair, Elisse Walter, notes "few investors" realize advisers and brokers are held to two different standards, or whether, in fact, the intermediary they work with is an adviser or broker. The reason for seeking additional information, is to "better understand the relationship between standards of conduct and the experiences of retail customers." (See SEC Release page13)

Dodd Frank also provides pertinent parameters. It stipulates that if the SEC proceeds with rulemaking the UFS requires advice be "in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing advice." Dodd Frank further stipulates that the UFS "shall be no less stringent than the standard applicable to investment advisers under sections 206 (1) and 206 (2) of the Advisers Act." Also, commission compensation structures, proprietary products, and principal trading are not prohibited.

* http://www.sec.gov/news/press/2013/2013-32.htm

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The starting point for developing a new standard "no less stringent" than the Advisers Act of 1940 should be the Advisers Act, and section 202(a) (11) specifically, where the term "Investment Adviser" is defined. This definition is broad and includes, in part, "the business of advising others ….as to the advisability of investing … or promulgates analyses or reports concerning securities …" Further, the broker exclusion is explicit and narrow. Brokers are only excluded when their advice is "incidental" and is not compensated. (For further discussion, see Tamar Frankel's *Fiduciary Law*, (Oxford University Press; November, 2010.)

Potential Uniform Fiduciary Standard General Assumptions

The SEC Release sets out explicit assumptions regarding a potential UFS. Although it states these assumptions should not be presumed to represent the views of the SEC, the assumptions are noteworthy for at least two reasons. First, they are quite explicit and, second, they closely mirror many of the recommendations of the Wall Street lobby, The Securities Industry and Financial Markets Association (SIFMA) set forth in a July, 2011 letter to the SEC. https://www.sifma.org/issues/item.aspx?id=8589934675. Following are comments on four general assumptions set out in the SEC Release:

Assumption 1. Personalized Investment Advice. The SEC Release explains that not all advisor communications of opinions would be deemed "fiduciary advice." It sets out guidance that seeks to distinguish between the types of advice that would be deemed "fiduciary advice" as distinct from advice that would not be deemed "fiduciary advice." Overall, the UFS would only apply to "personalized investment advice about securities." "Personalized advice" would follow the broker-dealer definition of "recommendation" and the investment adviser's definition of advice that is "personalized advice." It would exclude advice that is deemed "impersonal investment advice." The BD "recommendation" is deemed a communication targeted to a particular customer explicitly regarding the purchase, sale, or trading strategy of a particular security or group of securities. As explained in the SEC 2011 "Study on Investment Advisers and Broker-Dealers" recommendations are generally "communications that constitute a 'call to action'" or those that might influence a client to initiate a "particular transaction" or a "particular trading strategy." (Study, page.124) http://www.sec.gov/news/studies/2011/913studyfinal.pdf

This naturally implies that generalized advice absent a "call to action" by a broker will not constitute a "recommendation," and therefore not be deemed "fiduciary advice." This generalized advice might best be called "non-fiduciary advice". For example, information and opinions regarding the merits or weaknesses of an employer-sponsored retirement plan, or regarding asset allocation models, would not be deemed a "recommendations" and thus would thus not be considered "fiduciary advice." (Study, page 125) Any "non-fiduciary advice" would not be required to be in the best interest of the client.

As noted above, "impersonal investment advice" would be deemed "non-fiduciary advice." According to the SEC, advice is deemed "impersonal," when provided by advisers in writing or orally and does not "purport to meet the objectives or needs of specific individuals or accounts." This definition leaves significant ambiguity, as delineation between "personal" and "impersonal" investment advice will "depend on the facts and circumstances." (Study, page 123)
In sum, the UFS "personalized investment advice" requirement sharply narrows what advice is clearly "fiduciary advice," and also creates questions about what other advice constitutes "fiduciary advice." It appears that only communications that recommend a transaction or advise on discretionary accounts would be clearly deemed "fiduciary

advice." Other advice would fall into a gray zone of uncertainty and ambiguity, with its fiduciary status depending on an exploration of the facts and circumstances.

Yet, despite introducing this new gray zone of uncertainty and ambiguity, there is no mention of how a broker should address it. There is no mention of a broker duty to clearly communicate to clients that some of his/her advice may be "fiduciary advice" and some may be "non-fiduciary advice," and there is no mention of a broker duty to explain the differences, why these differences are important to clients, and to ensure that clients understand these differences.

Assumption 2. "Retail" Investors. The UFS would only apply to "retail" investors. "Retail" investors are defined as investors who use these recommendations "primarily" for "personal, family or household purposes." This mean, for example, recommendations made to individuals regarding their business or non profit organization assets would not necessarily be required to be fiduciary advice and, thus, not be required to be in the best interest of the client.

Assumption 3. Different Business Models. The UFS would be designed to "accommodate different business models and fee structures" Consistent with Dodd Frank, broker-dealers would be permitted to receive commissions and compensation from principal trades. In setting out this topic, however, the SEC release makes a point that casts doubt on whether principal trading is presumed to be a conflict of interest. The release suggests, regarding principal trades and commissions, "At a minimum, a broker-dealer or investment adviser would need to disclose material conflicts of interest, *if any* (emphasis added), presented by its compensation structure." This language seems to suggest that commissions and / or principal trades should not explicitly be presumed to be conflicts of interest.

Assumption 4. Continuing Duty of Care. This discussion of the UFS assumes there is no general requirement of a continuing duty of care or loyalty after making explicit recommendations regarding the purchase, sale or trading strategy of specific securities.

This discussion includes two different issues which should be considered separately. The first issue is the scope of the engagement. It is fair and reasonable to align fiduciary duties with the scope of the engagement between the BD and the client. On this point there appears to be wide agreement. However, separate and distinct from defining the scope of the engagement is the question of whether fiduciary duties within the scope of the engagement may be waived or eliminated by a simple contract provision, or separately, through disclosure.

Fiduciary duties within the parameters of the scope of engagement, according to the SEC Release: "would depend on the contractual or other arrangement or understanding between the retail customer and the broker-dealer or investment adviser, including the totality of the circumstances of the relationship and course of dealing between the customer and the firm, including, but not limited to contractual provisions, disclosure and marketing documents, and reasonable customer expectations arising from the firms course of conduct."

This language presents major questions, two of which stand out. First, the language suggests that fiduciary duties may be restricted, perhaps effectively removed, with relative ease, without an informed consent requirement. Indeed, clients may not even be aware that fiduciary duties have been restricted or removed at all.

Second, as noted above regarding "personalized" advice, though there is an additional new gray zone of uncertainty and ambiguity created here, there is also no mention of any broker duty to address this ambiguity sand uncertainty. There is no mention of a duty to explain that his/her communications will include "fiduciary advice" and "non-fiduciary advice," and what this means to the client.

'Duty of Loyalty'

The 'duty of loyalty' is the very heart of the fiduciary standard under the Advisers Act. The explicit language in Dodd Frank (noted above) that a UFS must be in the "best interest" of the client "without regard" to the financial interest of the broker or the firm is essential to understanding the heavy burden that must be overcome when a conflict is not eliminated. Disclosure and client consent alone do not suffice. The conflict must not undercut the recommendation. The conflict must be managed such that the recommendation remains in the client's best interest, irrespective of the disclosure. This point underscores that disclosure is not a duty, but is a "relief from a duty of avoiding a conflict." (Frankel) A "relief" does not substitute for advice only serving the best interest of the client.

The importance of the duty of loyalty and the seriousness of conflicts of interest in the Advisers Act is underscored in a thoughtful speech by Carlo V. Di Florio, SEC Director, Office of Compliance Inspections in October (http://www.sec.gov/news/speech/2012/spch103112cvd.htm) Di Florio discusses the importance of conflicts in depth. He explains why conflicts of interest are so important to the SEC's exam program, why he views conflicts as "viruses that threaten the organizations well-being" and how "conflicts of interest can do great harm.... (and) a failure to manage conflicts of interest has been a continuing theme of financial crises and scandals since before the inception of the federal securities laws." Di Florio provides a vivid reminder of the inherent destructive nature of conflicts to firms and investors alike.

In this context the discussion on the 'duty of loyalty' assumptions and possible prescriptions the SEC may consider is of particular importance. Two assumptions stand out.

"Loyalty" and "Disclosure" The first assumption regards the meaning of "loyalty." As the term is used in this discussion, "loyalty" effectively takes on a very different meaning. It is described as "disclosure." The act of *disclosure* is deemed to fulfill the duty of "loyalty." The nature of the conflict – the conduct or recommendation being disclosed is not discussed. The option of avoiding the conduct is not even mentioned. The entire discussion regards disclosure, and includes the following:

*"we should facilitate **disclosures** to retail customers about the terms of their relationship," …"a general relationship guide akin to the new part 2a of form ADV"… the rule "would expressly impose certain **disclosure** requirements," …. "**disclosure** of all material conflicts of*

*interest" … "an overarching general obligation to **disclose** all such conflicts of interest" …. "this **disclosure** largely could be made through the general relationship guide," … "oral or written **disclosur**e … at the time of service … of any new material conflicts or any material change of an existing conflict."*

The entire focus in the SEC Release on disclosing conflicts at the exclusion of avoiding conflicts could be interpreted to imply that disclosure is clearly superior to avoiding conflicts, as an investor protection measure. This implication would be plainly false. Merely disclosing conflicts is neither superior to -- nor equivalent to -- avoiding conflicts, and it is not a duty. It is a "relief from the duty to avoid conflicts." The one instance where disclosure can provide meaningful protection from conflicts, is where there is truly informed and independent client consent, such that the client can fairly be deemed to understand the implications of the conflict. In any case, the conflict must be managed or mitigated such that the proceeding with the recommendation remains in the best interest of the client.

Weakening Disclosure. The second assumption entails weakening the disclosure requirement by simultaneously making disclosure more "efficient" for the firm to deliver and less effective for the client. This second assumption is evident from both what is explicitly stated and what is omitted. Explicitly, the SEC Release states the UFS "would treat conflicts of interest arising from principal trades the same as other conflicts of interest …. And make clear that it would not incorporate the transaction-by-transaction disclosure and consent requirements" as required of investment advisers.

Here, the SEC Release envisions a stark departure from established regulatory opinion that acknowledges principal trading as a material conflict of interest that merits a stringent disclosure requirement, towards a less serious conflict that merits a less stringent disclosure requirement.

What is omitted is also important. What is omitted in the SEC Release is any mention of a broker's duty to obtain client consent, or a duty to obtain *informed* client consent, or a duty to manage the conflict and ensure, irrespective of client consent, that the recommendation remains in the client's best interest.

Duty of Loyalty, Conflicts in Historic Context. The significance of embracing these two assumptions is better appreciated in a broader historic context. The SEC Release makes no mention of why conflicts of interest are today – and historically have been – considered major impediments to unbiased advice. There is no mention of how and why conflicts of interest can cause great harm to investors, much less that the Advisers Act of 1940 itself was, in large part, a response to widespread concerns about conflicts of interest and the need to protect investors from "misrepresentations of unscrupulous tipsters and touts." (See Arthur Laby's discussion, in *Selling Advice and Creating Expectations: Why Brokers Should be Fiduciaries,* pages 720-722.)

Further, there is no mention of the longstanding practice of the SEC urging advisors to avoid conflicts of interest. There is also no mention of any of the independent research that underscores the harms of conflicts to investors, or the general ineffectiveness of disclosure. Most fundamentally, there is no mention of why the fiduciary duty of loyalty exists, is

essential to inspiring investor trust in the capital markets and cannot be replaced by disclosure, due to the knowledge gap between investors and brokers or advisers. It is this point which was clearly noted in the 1995 Tully Report, named for Merrill Lynch Chairman Daniel P. Tully. The report noted, in unambiguous terms, how, it is a "rare client who truly understands the risks and market behaviors of his or her investments."
http://www.sec.gov/news/studies/bkrcomp.txt

In short, longstanding legal, academic and industry views – views articulated from Supreme Court justices and SEC Chairmen alike – of the harms of conflicts and vital role of loyalty, the limitations of investors – are not expressed in this release. These views have been omitted. They have been replaced with rules for disclosure.

These assumptions sharply restrict when fiduciary duties are applied to brokers or advisers rendering investment advice. If these assumptions are adopted in rulemaking, fiduciary duties will be effectively removed

The SEC Release provides guidance through its expressed assumptions regarding the UFS and the duty of loyalty. While (as noted above) the SEC Release states these assumptions may not represent the views of the SEC, their guidance matters.

The SEC Release provides a picture of fiduciary duties that are different in kind from and far more restricted and far less stringent than the fiduciary duties required by the Investment Advisers Act of 1940 Act. In a few short pages, this guidance effectively upends established legal precedent developed over 73 years. In summary, it:

> Sharply restricts communications clearly deemed fiduciary advice; creates new uncertainty about what may be fiduciary advice. It narrowly defines written or oral communications and circumstances that are clearly deemed "fiduciary advice," limiting much investment advice and excluding many investors from the fiduciary standard.
>
> In suggesting a 'facts and circumstances' exploration is necessary to determine whether communications constitute fiduciary advice, creates new uncertainty and ambiguity that is certain to confuse investors. Yet, the SEC Release does not address this issue. It does not require a broker explain the difference between fiduciary and non fiduciary language, and does not require a broker explain the importance of these differences to clients.
>
> Allows fiduciary duties be waived. It allows fiduciary duties to be waived through contract provisions, marketing materials or disclosure, disclosure that does not include informed consent, to ensure the client is aware when duties are waived.
>
> Suggests disclosure is the optimum action for addressing conflicts; omits acknowledging that disclosure and management of conflicts alone is insufficient. Discussing disclosing conflicts at the exclusion of discussing avoiding conflicts may be interpreted to suggest disclosure is the optimum course of action to address conflicts. This interpretation would be plainly false. Further, the failure to acknowledge and reaffirm that irrespective of the disclosure, the recommendation

must still be deemed in the best interest of the client, implies disclosure alone is generally or always sufficient.

Omits mention or discussion of the most rigorous disclosure requirement that can provide meaningful investor protection; instead weakens disclosure requirements. It allows more casual disclosure and oral disclosure (disclosure that is more "efficient" for the firm to deliver) while, not requiring either "client consent" or "informed client consent" of material conflicts of interest (disclosure which are more effective for the client).

Rebrands *conflicts*. It minimizes the stigmas associated with conflicts. It rebrands them. It questions whether principal trading is, in fact, always a conflict. It omits any mention that harms are associated with conflicts. It omits any mention of associated benefits or appropriateness of avoiding conflicts. It omits urging broker dealers and investment advisers to avoid conflicts of interest. By these omissions, conflicts of interest are deemed to be less problematic, less harmful.

Redefines *loyalty*. By minimizing the importance of conflicts, it effectively redefines *loyalty*. In its essence, the 'duty of loyalty' today means "do the right thing." In this discussion it means "disclose doing the wrong thing."

Individually, each of these assumptions – restricting the broad concept of advice implicit in the Advisers Act, permitting the waiver of fiduciary duties, framing disclosure as the optimum measure of loyalty, and omitting the strongest disclosure requirement (of informed consent) – could materially undermine the stringency of the UFS as compared to the Advisers Act fiduciary standard.

Together, these assumptions represent a profound departure from the Advisers Act. If adopted in rulemaking, fiduciary duties would be effectively removed for brokers and advisers giving investment advice to retail investors. The issue of whether such a uniform standard is consistent with the Dodd Frank requirement that the uniform standard be "no less stringent" than the Advisers Act is clear. It is not.