FiduciaryPath

July 5, 2013
The Honorable Mary Jo White
Chairman
U.S. Securities and Exchange
Commission
100 F Street NE
Washington, D .C. 20549

Re: Duties of Brokers, Dealers and Investment Advisers: Request for Data and "Other Information; File No . 4-606 ; Release No . 34-69013 ; IA-3558 (the " Release")

Dear Chairman White:

I write in response to the Securities and Exchange Commission's request for data and information relating to potential rulemaking under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the " Dodd-Frank Act"). I have more than 30 years of experience in the investment industry, am an Accredited Investment Fiduciary Analyst, and founder of FiduciaryPath -- consulting on fiduciary best practices and conducting Centre for Fiduciary Excellence (CEFEX, www.CEFEX.org) assessments of firms' investment fiduciary practices. I am a founding member of The Committee for the Fiduciary Standard and the Institute for the Fiduciary Standard. This letter reflects my personal views and not those of any other organization. I write today only for myself and on behalf of investors.

I support the views in the comment letters of Massachusetts Secretary of the Commonwealth William Galvin[1], John C. Bogle[2], and a group letter from the Investment Adviser Association, AICPA, NAPFA, CFA, Fund Democracy FPA, CFP Board and NASAA[3]; and the Mercer Bullard Testimony[4] before the House of Representatives – Subcommittee on Capital Markets and Government Sponsored Enterprises, May 23, 2013.

Section 913 of the Dodd-Frank Act empowers the SEC to adopt a uniform fiduciary standard of conduct for investment advisers and Broker-Dealers when providing personalized investment advice to retail investors. Key requirements of Section 913 are that financial professionals providing advice shall act in the best interest of the customer *without regard to the financial or other interest of the broker, dealer, or investment adviser giving the advice; and that such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under Sections 206(1) and (2) of the Investment Advisers Act when providing personalized investment advice about securities*. As noted in the Release, the issue of making broker-dealers subject to a fiduciary standard has been the subject of considerable debate and study over several years, including a RAND Corporation study in 2008 [5] and an SEC Staff Report in 2011 [6]. In fact, concern regarding harm to investors by Broker-Dealer compensation practices was voiced by a prominent BD executive in 1995 in The Report of The Committee on Compensation Practices A/k/a The Tully Report [7].

Dodd-Frank Section 913 also empowers the SEC to prohibit practices that cause investors harm.

I applaud the SEC's efforts to understand the implications of applying the authentic fiduciary standard, as applied under the Investment Advisers Act, to brokers, and have been privileged to participate in many thoughtful meetings with the Commissioners and Former Chairman Mary L. Shapiro and Staff at the SEC to discuss the practical application of the fiduciary standard.

However, the March Request for Data falls seriously short in its discussion of application of a "universal" fiduciary standard. In fact the standard as described in the "Request" is not fiduciary but little more than a gussied up suitability standard. There is little discussion of actually placing investor's interests before the interests of the Broker-Dealer (BD) and Registered Representative (RR). There is no requirement discussed to control investor costs and to disclose all costs, hidden and overt, under the table or over the table. The proposed "universal" standard, with disclosure of the harm instead of avoidance of harm does little more than perpetuate the status quo of systematic harm to investors by those "advisors" currently exempted from fiduciary duty.

Asking the Wrong Question?

In addition, and with utmost respect, I believe the SEC is asking the wrong question. The Request for Data asks what the cost of applying the fiduciary standard will be, to the BDs. I believe the question should be: *What is the cost to <u>investors</u> of delaying requirement for the fiduciary standard for advice from Broker-Dealer and insurance Registered Representatives?*

One fiduciary consultant and writer posits in *Fiduciary News*'[8] that according to two academic studies, "It Pays to Set the Menu: Mutual Fund Options in 401(k) Plans,"[9] and "Broker Incentives and Mutual Fund Market Segmentation,"[10] from NBER, ***the cost to investors is more than $1 billion for every month of delay.***

Disclosures – Important But No Substitute for Authentic Fiduciary Duty

Disclosures, by themselves, do not substitute for truly placing investors' interests first at all times, acting with prudence, knowledge and due care, avoiding conflicts of interest, managing unavoidable conflicts in the investor's interest, and disclosing all material facts (including all costs to the investor) and controlling investor costs in the first place.

Investors deserve better. Investors deserve an SEC that acts on its mandate of investor protection. Investors, the majority of whom are saving to fund their own retirement –

often in captive 401(k) investments at their company and IRAs – must have advice that is in their best interest in order to fulfill that goal of retiring with dignity. The typical hidden, undisclosed and high fees that continue to be the status quo will not allow investors to achieve this, even if they allocate assets brilliantly, because these costs are a proven drag on performance. The missed opportunity cost of “advice” that is not fiduciary is devastating America’s future.

Unfortunately, part of the harm investors are experiencing now was created by the SEC itself in prior actions and current inactions:

The Broker-Dealer Exemption – The Broker-Dealer Exemption for Fiduciary Advice has done irreparable harm to investors. It is baffling that even after a successful lawsuit by the Financial Planning Association resulted in the Courts overturning the Exemption, the SEC still permits it. If the SEC enforced the Court-sanctioned repeal of the Broker-Dealer Exemption for Fiduciary Advice, thereby requiring BD Registered Representatives to act as a fiduciary when providing advice, even in the course of a sale, that would be enormously beneficial to investors.

Titles – The titles permitted by SEC for BD Registered Representatives – Financial Advisor, Financial Consultant, Wealth Manager, Investment Counselor – and all variations on this meaningless theme – convey to the investor advice that is in their best interest, knowledge, gravitas. This is a tragic issue for investors. Simply by re-taking the reins on titles, ensuring that BD reps are titled as salespersons would help investors understand better what the relationship with the financial intermediary is. Call a salesperson a salesperson – it used to be that if one was a Registered Representative, that was your title. Not Advisor. Not Consultant. Not Counselor or Planner or Wealth Manager. If one is an Investment Adviser, or an Investment Adviser Representative, require their legal titles also, properly, legally identifying who is a salesperson and who is a fiduciary.

Separate Sales and Product Manufacturing from Advice – There is no reason that sales of products cannot be separated from advice from a fiduciary on an overall portfolio, ongoing and with monitoring. Separate the product manufacturing and sales organizations from the advisory organizations as in separation of Church and State – and you really start to have a solution to the investor and retirement crisis in America.

Separating product manufacturing and sales from fiduciary advice, and requiring titles to reflect function and legal relationship also takes care of the "investor choice" argument from BDs and Insurers. Investors could then "choose" in a fair and open way – not in a way that obfuscates the true motives of sales versus the intent of advice in the client's best interest, from a fiduciary. In a recent survey of BD representatives and Registered investment Advisers in the field, from fi360 and AdvisorOne[11], participants agree:

• 97% say investors don't know the difference between Broker-Dealer Registered Representatives and investment advisors
• 71% say the titles "advisor," "consultant," and "planner" imply that a fiduciary relationship exists
• 59% say titles are a clear way to differentiate product sales from advice
• 64% favored separating products/sales from advice -- separate firms with clearly differentiated purposes –

Further, participants indicated that extending the fiduciary standard:
• Would not cost investors more for advice (82%).
• Would not price investors out of the market for advice (71%).
• Would not limit access to advice or products (65%).
• Eight out of ten believe that disclosures alone are not sufficient to manage conflicts of interest

And finally,
• 97% say investors don't understand the differences between brokers and investment advisers.
• 85% say the gap in professional knowledge between investors and advisors makes fiduciary advice much more important for ordinary investors
• Almost two-thirds of all participants report to have a fiduciary relationship with their clients
• 71% say a uniform fiduciary standard "no less stringent" than what is currently required of registered investment advisers would raise the credibility of financial service providers

While examples of the harm the SEC requests are difficult to quantify, there are a few well documented examples that point to the insidious harm that investors do not even know in concrete terms they are experiencing – for example, the high mutual fund costs in insurance-based and BD-based retirement plan platforms cause leakage of Participant assets and performance that materially impact the ability of millions of Americans to retire, not even in luxury, but just to retire, period. Until it is too late.

A Look at 401(k) Fees

The Department of Labor demonstrates the harm of fees that accompany non-fiduciary, suitability-based “advice” this way[12]:

> Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.

More Examples of Harm

There are other examples of the harm that high investor costs that accompany non-fiduciary, suitability-based advice and product sales (often in the guise of “*advice” provided by BD Registered Representatives in the course of making a sale).*

In this article, from *AdvisorOne*, “Securities America Isn’t the Only BD That Sold Provident, Med Cap, List Shows,” by Janet Levaux[13]” a list of BDs that allegedly sold private placements improperly, and were named in a class-action lawsuit. This is just one example of high commission or fee, high-risk securities. “A lawsuit brought by Milo Segner against Provident Royalties included the following defendants:

- Advisory Group Equity Services Ltd.
- AFA Financial Group LLC
- American Portfolios Financial Services Inc.
- Asset Management Strategies LLC
- Ausdal Financial Partners Inc.
- Barron Moore Inc.
- Boogie Investment Group Inc.
- Brookstone Securities Inc.
- Callaway Financial Services Inc.
- Calton & Associates Inc.
- Capital Financial Services Inc
- CapWest Securities Inc.
- Chester Harris & Co.
- Community Bankers Securities LLC
- Crescent Securities Group
- David Harris & Co. Inc.
- DeWaay Financial Network LLC
- Eagle One Investments LLC

- Empire Financial Group Inc.
- Empire Securities Corp.
- E-Planning.com Securities Inc.
- First Allied Securities Inc.
- Gk Securities LLC
- Grant Bettingen Inc.
- GunnAllen Financial Inc.
- Harrison Douglas Inc.
- Independent Financial Group
- INVEST Financial Corp.
- Investlinc Securities LLC
- Investors Capital Corp.
- J.P. Turner & Co. LLC
- Kaiser & Co.
- Lighthouse Capital Corp.
- Main Street Securities LLC
- Matheson Securities LLC
- Milkie Ferguson Investments Inc.
- National Securities Corp.
- Newbridge Securities Corp.
- NEXT Financial Group Inc.
- Okoboji Financial Services Inc.
- Private Asset Group Inc.
- Provident Asset Management
- QA3 Financial Corp.
- Questar Capital Corp.
- Securian Financial Services Inc.
- Securities America Inc.
- Securities Network LLC
- SII Investments Inc.
- Sterling Enterprises Group Inc.
- Summit Brokerage Services Inc.
- United Equity Securities LLC
- United Securities Alliance Inc.
- Waterford Investor Services Inc.
- Wedbush Morgan Securities Inc.
- WestPark Capital Inc.
- WFP Securities Corp.
- Williams Financial Group Inc.
- Workman Securities Corp"

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More on alleged improper or misleading sales of securities in these articles which I authored: *AdvisorOne*, "Securities America Sued for Misleading Investors, "[14] and "Montana Sues Securities America for Misleading Investors," *AdvisorOne* [15].

Additional examples of investor harm come from a what-not-to-do article in the January 2010 publication *Boomer Market Advisor*, "How Sales Prevention Saves Us,"[16] by Loyall Wilson:

> "There are times when the only way to effectively manage risk is to prevent a sale, trade or strategy. If you had a similar situation to that of the following examples, you'll be glad they did. Consider some of the worst of 2009:
>
> **Auction rate securities:**
>
> - "Wells Fargo To Repay Clients Who Held Auction Rate Securities," *Wall Street Journal*, November 18, 2009
> - "FINRA Announces Agreements with Three Additional Firms to Settle Auction Rate Securities Violations," FINRA News Release, September 2, 2009
>
> **Unsuitable private placements, including Medical Capital Holdings, Inc. and BBC Equities LLC.:**
>
> - "Financial advisers face more questions from clients wary of turmoil," *Crain's Cleveland Business*, November 16, 2009
> - "SEC Halts $50 Million Offering Fraud and Ponzi Scheme in Detroit Area," SEC Press Release, July 28, 2009
> - "Medical Capital Notes Class Action Lawsuit Filed for Investors," AboutLawsuits.com, November 30, 2009
>
> **Unsuitable tenant in common (TIC) investments, including DBSI, Inc.:**
>
> - "Idaho TIC Sponsor Sued for Securities Law Violations," Idaho Department of Finance News Release, January 15, 2009."

Aside from the allegations of misleading investors or fraud, was the due diligence on the securities that the BDs sold in the examples above even up to suitability?

On July 15, 2010, minutes after Dodd-Frank passed, I was in the room at a SIFMA conference in New York, and heard the leader of SIFMA at the time, John Taft, who was then also head of a large bank BD, sneer about the fiduciary standard and ask the panel and audience how they should "water down, dilute...dismember the fiduciary standard of care."

I heard, in the next breath, a SIFMA member saying his BD firm and others would not be able to stay in business if they were not able to sell "high-commission alternative" products— under a fiduciary standard of conduct. See "Senate Votes Yes on Financial Reforms," *AdvisorOne*[17].

In other words, if they had to put their clients' best interests first, they couldn't sell these "products." That seems like a shaky business model to start with and maybe this is the time to revisit that particular business model. If you can't stay in business without gouging customers, maybe the SEC should examine that.

One has to ask if they could not sell these securities under a fiduciary standard of care, then, in the interest of investor protection, why are those securities permitted to be sold to retail investors in any case? *And if proper disclosures are made, and understood by the customer, what customer would actually buy them?*

Maybe it is time to revisit that part of the BD model, on a long-term rather than a short-term basis. If BDs looked at the model from a client-centric point of view they could see a way to attract more assets under management and smooth out earnings over the long term by charging a fee for AUM or an hourly fee like a lawyer or accountant, both of whom have a fiduciary duty to their clients, and dropping the high, hidden cost model.

Should Commissions be Prohibited?

Commissions are not prohibited under the fiduciary standard in Dodd-Frank, and the low-cost option is not necessarily always the best choice. But controlling investors' expenses and disclosing the total costs to them (including shelf space, or any other layers of costs), is required. And if an investment costs more, there needs to be a reason why that product is better for the investor – not just because it is enriching the BD or Registered Representative. It is imprudent to waste investors' money. So a higher-cost option would have to be justified by the facts and circumstances, and the reasons for choosing it would need to be documented.

The 2012 ban on commissions by the UK Financial Services Authority *has resulted in a reduction of investor costs of 50 basis points*. Dodd-Frank did provide that the SEC with the mandate do away with practices that are harmful to the investor. Does it make sense to follow the UK in this ban?

Long-term, strategic thinking about what is right for investors, who provide a great deal of support for capital formation in America, is required here. Many individuals are now required to invest in order to provide for their own retirement nest eggs via defined contribution plans.

The argument that the fiduciary standard must not "change the BD business model" should be moot at this point. Some things in the BD business model can, and must, change. Using “advice” that is in the Registered Representative’s and the BD’s interest instead of the client’s is not only not fiduciary, some would argue that it isn’t even up to the much weaker suitability standard. Put another way: if an investment is the right type to be “suitable” – for example an equity fund or a bond fund -- but the cost and/or risk are so much higher than a comparable, lower cost, better performing fund (let’s say, same portfolio in the fund, just lower fees so less drag on performance) ***then is the higher cost fund actually suitable?***

Would an investor buy the higher cost one of all the costs were disclosed? Of course not. So, either the BD and Registered Representative are not properly disclosing the entire cost (including under the table, over the table, kickbacks, revenue sharing, commissions, fees) to the investor, or the investor is being misled. Is that suitable?

Some at BDs say the fiduciary standard cannot be workable for brokers because there are no rules, only principles. Principles-base regulation works well for fiduciaries, allowing them to adopt established best practices. But principles make it flexible enough to adapt to differing investor needs, goals, time horizon, risk tolerance and other factors. Best practices are set down for anyone to see in “Prudent Processes for Investment Fiduciaries”[18] handbooks written by fi360 and the Centre for Fiduciary Studies.

Respectfully submitted,

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

Sources:

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2. John C. Bogle SEC Comment Letter, July 2013 http://www.sec.gov/comments/4-606/4606-3097.pdf

3. Investment Adviser Association, AICPA, NAPFA, CFA, Fund Democracy FPA, CFP Board and NASAA -- SEC Comment Letter, May 2013 http://www.sec.gov/comments/4-606/4606-3063.pdf

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7. Report of the Committee on Compensation Practices – The Tully Report, 1995 http://www.sec.gov/news/studies/bkrcomp.txt

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