July 5, 2013

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Duties of Brokers, Dealers and Investment Advisers, File no. 4-606

Dear Ms. Murphy:

Thank you for requesting comments concerning whether the Commission should issue rules relating to the duty of care to be imposed upon brokers, dealers and investment advisers. Since most retail customer complaints are subject to mandatory FINRA arbitration, and FINRA does not allow arbitrators to prepare written opinions or even to document the bases of their decisions, there is a dearth of information about the imposition of standard of care being imposed upon broker-dealers, as a practical matter, under current law. Therefore, it is impossible to assemble quantifiable information on this issue. I nevertheless submit these comments.

The issue of standard of care has been a concern ever since I began my career as a securities lawyer in the 1980's. I have occupied the following roles in my career: SEC Enforcement Staff attorney; securities litigation defense and compliance attorney for a private law firm; FINRA arbitration chairperson; securities fraud investigator; mortgage fraud investigator; investment adviser compliance examiner for state regulator; investor; and angel investor. Therefore, I can examine this issue from each of these perspectives. My opinions are rooted in my practical experiences confronting these issues as a lawyer and as an investor.

The views I express in this letter are only my own and do not reflect the views of my employers.

Brokers should be held to a fiduciary duty. Dealers cannot be held to a fiduciary duty, and should not be permitted to hold themselves out as fiduciaries.

Brokers and dealers ought to be held to separate standards of care. A broker should be held to a fiduciary standard, and ought to therefore be permitted to advertise that it puts the customer's interests first. A dealer, on the other hand, cannot be a fiduciary because its role as a seller means that it is inherently self-interested. Dealers cannot be held to a fiduciary standard, and therefore should not be able to advertise themselves as such.

It is true that in its Request for Data and Other Information ("RFD"), the Commission states that investment advisers are fiduciaries to their clients, while, in contrast, a broker-dealer is not uniformly considered a fiduciary to its customers.[1] However, many state courts and the Commission itself have traditionally deemed broker-dealers to be fiduciaries.[2] The Commission has also reported that investors assume all financial services professionals are obligated to put the client's best interests first.[3]

In my experience, investors do not perceive that their broker-dealer's interests are adverse to their own. Indeed, most clients do not even understand the difference between a principal trade and a brokered transaction. An individual registered representative may try to explain the difference to the customer, but the customer, believing the representative is required to protect the customer's best interests, may not feel obligated to understand. In fact, most customers seek professional advice precisely because they do not have the time or interest to educate themselves fully as to the securities business and its elaborate lexicon. They believe they can trust their representative, as an expert, to handle this for them—as a fiduciary agent.

Yet it is virtually impossible for a dealer, selling from inventory, to be a fiduciary. By its very nature, a sales transaction is adversarial: one party is seeking to make a profit at the expense of the counter-party. If the seller were obligated to put the counter-party's interests first, the seller could not, in good conscience, charge the buyer a premium. This is precisely why investment advisers are generally prohibited from selling to clients from proprietary or personal accounts. The adviser is then free to make recommendations solely based on the needs of the clients. It follows that dealers (as opposed to brokers) cannot reasonably, or logically, be held to a fiduciary standard.

Brokers, on the other hand, can be held to such a standard, because they are merely brokering the trade for a commission. The brokerage commission represents the transaction cost. Brokers' interests do not conflict with customers' interests, so it is possible for brokers to act as fiduciaries.

Broker–dealer registered representatives are exempt from the registration requirement for investment advisers, as long as their advice is "solely incidental" to brokerage services and they don't receive special compensation for providing investment advice.[4] Brokers provide investment advice on both an ongoing and episodic basis.[5] Registered representatives are actually giving investment advice, without being held to the same standard an adviser would be. Worse, as a practical matter, it has become increasingly difficult to establish whether that advice is "solely incidental" and whether it is being separately compensated in some indirect manner. Dual registration makes this almost impossible to determine, something to which any investment adviser examiner can attest.[6]

It is time to dispense with the fiction that brokers are not being compensated for providing investment advice, or that their advice is an unimportant adjunct to brokerage services. The broker's advice is critical to the individual retail investor. The advice should be disinterested, to the greatest extent possible.

Brokers and dealers should therefore be treated differently with regard to standard of care. Dealers should be prevented from holding themselves out as agents or fiduciaries for customers. Dealers should be required to clearly disclose, in connection with each principal transaction, that they are selling a product from inventory for profit, as a seller, not as a fiduciary or an agent, and that the customer must not rely on the seller to look out for his interests. Transactions by the dealer must be separate from transactions by the broker and the distinction must be made clear to the customer. Dealers should not be permitted to hold themselves out as occupying a position of trust and confidence as to customers.

Unfortunately, all broker-dealer firms currently hold themselves out as occupying a position of trust and confidence with regard to the client.[7] Any rulemaking should deal with this glaring problem.

If a firm portrays itself as a fiduciary, the client should be allowed to rely on that portrayal. Since dealers cannot truthfully conform to a fiduciary standard, they should not be permitted to claim they are fiduciaries. Brokers, on the other hand, should be permitted to do so, and then should be held to that standard vis a vis their clients.

Holding brokers to a fiduciary standard will facilitate capital formation by shoring up investor confidence in the markets. Preventing dealers from holding themselves out as fiduciaries will protect investors from misunderstanding the role of the dealer.

The fiduciary standard should govern the broker-client relationship, not just a single transaction.

In the RFD, the Commission incorrectly equates full disclosure with avoidance of conflict.[8] The language of Capital Gains,[9] the seminal case establishing fiduciary duty for investment advisers, indicated that a fiduciary's first duty is to avoid a conflict of interest. [10] Only if the conflict is unavoidable may a fiduciary engage in the conflicted activity—as long as full disclosure is made to the client. The Commission itself echoed this approach to conflict of interest in its Information for Newly Established Investment Advisers, Investment Advisers are Fiduciaries.[11] This approach is applied in other areas of fiduciary law including ERISA, trust law and real estate law.[12] Full disclosure means disclosure of all material information required to enable the client to make an informed decision whether to enter into, or continue, the advisory relationship with the firm.[13]

In the RFD, the Commission implies that it is authorized to consider imposing a lesser standard on investment advisers.[14] In fact, Dodd-Frank emphasized that the standard should be no less stringent than the standard under existing law. The existing standard is commonly described as an ongoing duty of care, one that is not confined to a single securities transaction. Even if the Commission were permitted to reduce the existing standard, I would urge it not to do so.

As an angel investor, a regulator and a former defense attorney, my view is that the fiduciary duty should not be watered down to a set of rules. The duty to a client should be holistic and should extend beyond one specific transaction. The duty should not be limited by the boundaries of the firm or the individual trade. It should extend beyond just securities, to all sorts of investments. This is what the investing public believes and expects, and this system benefits capital formation, in that it allows investors to feel secure in investing and to have trust and confidence in the markets. Moreover, a holistic standard protects not only client, but also the investment firm and the individual registered representative, by establishing a clear standard for all parties, while allowing for the application of common sense to unique factual circumstances.
A fiduciary standard is necessary because FINRA cannot be expected to adequately protect investors' interests.

FINRA recently announced profits for 2012 of $10.5 million dollars.[15] FINRA charges its members too much, and it no longer holds itself out as a deputy for the SEC (and the taxpayers). A review of FINRA's enforcement cases for the last quarter reveals an often-ignored truth: FINRA' s primary allegiance is to the firm, its member, and only secondarily is it acting to protect investors—only because to prevent unlawful activity protects the firm from resulting losses.[16] To rely on FINRA's enforcement of its rules for members is to forget that the Commission, and Congress's, primary allegiance should be to the investing public. Protecting investment firms from exposure to civil liability is only important as a secondary matter, to the extent that it harms commerce as a whole. Protection of broker-dealers should not be the government's primary aim.

A vast majority of investment advisers support imposition of a fiduciary duty on broker-dealers, including the following groups: FPA; IIA; NAPFA; and the CFP Board. AARP and the AICPA. These groups have also expressed concern over the possibility that the standard for investment advisers could be weakened. Obviously, the investment adviser industry does not resent the fiduciary standard but, on the contrary, embraces it.

On all other points, agree with the comments submitted by Professor Laby, including those contained in his scholarly articles, which he submitted with his comment letter.

Sincerely,

NAME WITHHELD

[1] See RFD at 3–4.
[2] See RFD, n. 3. See also Arthur B. Laby, Fiduciary Obligations of Broker-Dealers and Investment Advisors, 55 Vill. L. Rev. 701, 720 (2010) ("Notwithstanding the conventional wisdom that brokers generally are not fiduciaries, historically, many courts and commentators took the opposite view. A fiduciary standard for brokers has a long tradition.").
[3] Securities & Exchange Commission, "Executive Summary," Study on Investment Advisers and Broker-Dealers, As Required b Section 913 of the Dodd Frank Wall Street Reform and Consumer Protection Act v (January 2011) [4] Certain Broker-Dealers not Deemed to be Investment Advisers, Investment Advisers Act Release No. 2376, n. 23 (April 12, 2005), available at http://www.sec.gov/rules/final/34-51523.pdf.
[5] RFD at 5.
[6] Id.
[7] For one example, see Feltl & Company, "Products & Services," http://www.feltl.com/individual-investors/products-services.php (last visited July 6, 2013) ("Many other brokerage firms dictate what investments their brokers may sell, often pushing funds and products that those firms have created for mass-marketing to the public. At Feltl and Company, we believe in the individual approach."). The FINRA website currently cautions that, "Registered representatives are primarily securities salespeople and may also go by such generic titles as financial consultant, financial adviser, or investment consultant." See FINRA, "Selecting Investment Professionals," http://www.finra.org/investors/smartinvesting/gettingstarted/selectinginvestmentprofessional/p117278 (last visited July 6, 2013). However, currently, broker dealers are not required to disclose that they are merely salespeople and have no duty to place the customer's interests ahead of their own.
[8] See RFD at 29.
[9] SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963).
[10] Id, at 191–92.
[11] Information for Newly Established Investment Advisers, Investment Advisers are Fiduciaries,,, http://www.sec.gov/news/press/2007/2007-140.
[12] See generally, Lorna A. Schnase, An Investment Adviser's Fiduciary Duty [13] Amendments to Form ADV, Investment Adviser's Act Release no. 3060, 3 (2010).
[14] RFD at 6.

[15] Finra Reports $10.5M Profit in 2012, Wall Street J., June 28, 2013, Wealth Management.
[16] See FINRA July 13 Quarterly Report of Recent Disciplinary Actions (demonstrating that most frequent violations involved failure by an individual sales representative to advise the employing firm of outside activities).