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December 4, 2014

Brent Fields, Secretary
Rick Fleming, Investor Advocate
United States Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549

My Comments And Four (4) Key
Proposals For Financial Regulatory Reform

Dear Mr. Fleming and Mr. Fields,

I submit this comment letter with respect to the Investment Advisory Committee's Recommendations on accredited investor status in Regulation D private offerings; the Uniform Fiduciary Duty Standard for Broker-Dealers no less stringent than the standard for investment advisors; and the undersigned's four (4) key proposals for heightened professionalism in our capital markets and financial services industry that I believe will result in more effective financial regulatory reform and investor protection. My proposals are as follows:

{I} Heightened professionalism for distinct professional groups such as investment advisers and broker-dealers will come about where each professional group sets its own standards in a self-regulatory organization ("SRO") focused upon the unique aspects of their professional activities pursuant to SEC oversight and approval of their rule-making and standard setting. This is why it is now appropriate to have an investment advisor SRO comparable to FINRA for '40 Act Investment Advisers and not have that function absorbed by FINRA. {II} Implementation of independent private sector compliance auditing to close time and resource gaps that exist, and will always exist in respect to the SEC and the SRO organizations in connection with their examinations is now essential to expand and achieve more in-depth exam coverage and achieve more meaningful reform. {III} The arbitration, mediation, and claims processes has to be reformed by allowing any party in an arbitration to have the right to a reasoned award and an internal appeals process within the SRO that will achieve greater transparency for enforcement, rule- making, and the sound and principled development of the federal and state securities laws. The claims process is the best practical source of information of what is going wrong and what needs to be done to correct it in respect to the main street investor.

In cases of massive fraud and systemic flaws that significantly affect many investors, a broader approach of collective remediation to achieve fair investor compensation comparable to the Prudential Bache Limited Partnership Class Action Settlement process that took place in the 1990's should be an approach to consider. I and a number of other securities lawyers had an opportunity to serve in the capacities of mediator-arbitrator in that process that sought to cover legitimate investor loss that SIPIC by law did not cover.

{IV} Also essential will be mandatory professional liability insurance for the smaller firms that do not have the capacity to self-insure from their own capital resources and that will cover investor losses when the investment professional breaches his or her professional group's promulgated standards resulting in economic harm. Such mandatory professional liability insurance will also provide an additional dimension of self-regulation and risk management in the insurance underwriting process. Firms with too significant compliance risks will be uninsurable and in consequence not qualified to do business. A high risk and uninsurable firm will not get insurance and lose their registration status <u>unless</u> prompt corrective measures are taken and insurance then obtained.

The foregoing is a more holistic approach to financial regulatory reform that should give greater protection to the main street investor. Please have this comment letter submitted to each of the Commissioners, appropriate persons on the Staff, and the Investor Advisory Committee.

I. **<u>Accredited Investor Status</u>**

On October 9, 2014 the Investment Advisory Committee made their recommendations regarding the definition of the Accredited Investor. The Committee premised its recommendations on the following assumptions. The

Securities Act of 1933, according to the Committee did not spell out the distinction between public and private offerings. In 1953 in respect to the private offering exemption the Supreme Court of the United States held the exemption "'should turn on whether a particular class of persons affected needed the protection of the Act'" and a private offering was an offering restricted'" to those who are shown to fend for themselves'". The Committee therefore concluded that the principal issue was to determine what individuals or class did not need the protection of the 1933 Act.

The Committee recognized "a closer analysis reveals that a significant percentage of individuals who currently qualify as accredited investors are <u>not</u> in fact capable of protecting their own interests". (Emphasis Added). Access to information equivalent to what would be included in a registration statement and a statutory prospectus, and the ability to bear the economic risks related to the transactions in issue are <u>now</u> purportedly the two (2) key components of the private offering exemption. Traditionally private offerings were offered to a more limited group of investors who had access to the material information equivalent to what the investor had, who invested in a public offering through a registration statement filed with the SEC and a statutory prospectus delivered contemporaneously with the offer and sale to the investor.

The Committee approved the adjustment of the Regulation D, Safe Harbor Exemption to inflation and excluding from net worth the investor's primary residence. However, the income and wealth criteria do not equate with financial sophistication or the ability of the investor "to fend" for himself or herself. In sum the Committee in reference to Rules 506(b) and 506(c) noted that, "the Commission is currently acting on incomplete information .... {in} developing policy with regard to Rule 506".

Rule 506 (b) currently is a valid safe-harbor exemption if there is an unlimited number of accredited investors and no more than thirty-five (35) non-accredited but sophisticated investors whereas the Rule 506(c)'s exemption will not be invalidated if the securities offering takes place by means of general solicitation provided that <u>all</u> the investors (whether sophisticated or not) who actually invest <u>must</u> be accredited investors. Issuer verification is required to sustain the Rule 506 exemption.

The Committee recommended however, that an "independent third party" should perform the verification procedures and "the third party verifier would need to be subject to appropriate standards, with regard to accuracy, privacy, and information security". In essence, the Committee expressed their support for the development of independent private sector compliance auditing. Further "'{s}ome degree of regulatory oversight or at least accountability would be needed to ensure adherence to those standards' **<u>and an entity could emerge with a business based specifically on providing those verification procedures.</u>**" (Emphasis Added).

The Supreme Court of the United States in <u>SEC v. Ralson Purina</u>, 346 U.S.119, 73 S. Ct 981,97 L. Ed. 1494,(1953) addressed the roots of the distinction between private and public offerings. The Supreme Court held that the exemption from the registration requirements afforded to transactions by an issuer not involving any public offering is to be construed in the design of the '33 Act to promote full disclosure of the information necessary to informed investment decisions. The absence of or access to such information renders the exemption unavailable.

The key language in the Supreme Court's opinion is as follows:

"The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private exemption is in light of the statutory purpose since exempt transactions are those to which "there is no practical need for.{registration}. {T}he applicability of { the private offering exemption} should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction '**<u>not</u>** involving a public offering.'" (Emphasis Added).

Reading the above language demonstrates to the undersigned that there are certain fallacious assumptions regarding Regulation D, Rule 506. The private offering exemption defines the level playing field in unambiguous terms of full disclosure and nothing else. Accredited Investor status is the importation of the broker-dealer suitability rule and the know your customer obligation of the investment professional in the making of recommendations to customers in solicited transactions where the broker-dealer must not only disclose material facts about the issuer and the security but ascertain the investor's investment objectives and his or her capacity to accept the economic risk of loss presented by the transaction.

Account and portfolio diversification is an integral component of suitability and the broker's satisfaction of the know your customer obligation. It is one of the primary tests to determine the investor's ability to take economic risks.

The nature of the security and the company invested in can be and most often is secondary to the dollar amount of the trade and the percentage the security is of the customer's portfolio. This is certainly not of nor cannot be of concern to the issuer and whether it will meet the criteria for a private offering exemption, a safe harbor or otherwise. The suitability and know your customer obligation should stay with the broker-dealers and other professionals serving the investor because here is where the customer gets "personalized investment advice". An *a priori* definition of an accredited investor will not give reasonable assurance that the individual investor will be suitable or protected against undue risk. The criteria can and should be used as a guide by a broker and/or placement agent but not as a necessary and required condition for the exemption.

Further the exemption should not be lost to the issuer if a strict test is not satisfied. Even if there are transactions that arguably could cost the issuer its exemption, the exemption should not be lost if the issuer or its agents in good faith and with reasonable due diligence did not know or reasonably under the circumstances could not know all the exemption requirements were not satisfied. Even if there are transactions that arguably would cause the issuer to lose the exemption this should not defeat the issuer's exemption if the good faith and reasonable due diligence requirements are satisfied but only accord those investors who were sold securities in a non-exempt transaction a right of rescission. Accredited investor status is a suitability concept that can only be effectively determined in the course of the investment professional providing personalized investment advice to the individual investor.

Arbitrary limits such as those presented by Rule 506(b) do not work and can be unfair. Hypothetically if one purported Rule 506(b) accredited investor in fact is not in fact an accredited investor and thirty-five (35) non-accredited but sophisticated investors have already invested, what happens in respect to the validity of the exemption? This is why professional and principle based judgment should govern instead of the application of a strict mechanical test.

With the heightened professionalism mandated by Dodd-Frank, Issuers and/or their placement agents and other surrogates, also as a result of Dodd Frank are now required to engage in reasonable verification procedures. The Investment Advisory committee, as stated above, is favorably disposed to independent private sector compliance auditing, which should be made more pervasive than just validating the private offering exemption in a Regulation D, Rule 506 offering. If such compliance auditing is put in place the exemption is more likely to be sustained along with a sound implementation of the capital raising function and enhanced investor protection.

The exercise of professional judgment properly and contemporaneously documented and not strict and mechanical testing is more likely to not compromise but enhance investor protection, provided it is subject to audit. This is the case not merely in the Rule 506 context but in respect to the customer-broker relationship generally. Currently in place in the industry are new account opening information disclosure (e.g. option disclosure), new account cards, and customer verification of the information obtained from and provided by the customer at the time the account is opened, trade confirmation with disclosure regarding the nature and amount of the broker-dealer compensation, and monthly account statements and activity letters for the customer's activity review of what is taking place in his or her account, also providing with the trade confirmation a basis and timely opportunity to object so in-house compliance can timely address the legitimacy of the trade(s) and activity in the account. These customary and required records were intended to and do present an audit trail to properly test the broker-dealer 's compliance with the applicable rules and regulations and whether the investment professionals were and are acting in the public customer's best interest.

II. A Uniform Fiduciary Duty Standard

The Uniform Fiduciary Duty Standard for Broker-Dealers no less stringent than Investment Advisers has been a priority item on the agenda with apparently no real progress. In the undersigned's view there has been and is basic confusion that is manifested in a dialogue of semantics. There is not proper focus upon the differing professional conduct rules or the reasons for those differences and when the professional group should be governed by the same operative standards. In discussing the issues presented by the Uniform Fiduciary Duty Standard, the Committee presented its analysis and recommendations, as follows:

"The Investor Advisory Committee believes that personalized investment advice to retail customers should be governed by a fiduciary duty regardless of whether that advice is provided by an investment advisor or a broker-dealer. The Committee believes that the fiduciary duty for investment advice should include, first and foremost, an enforceable-based obligation to act in the best interest of the customer. In approaching the issue, the SEC's goal should be to eliminate the regulatory gap that allows broker-dealers to offer investment advice without being subject to the same fiduciary duty as other investment advisers but not to eliminate the ability of broker-dealers to offer transaction specific advice compensated through transaction based payments."

The Committee has proposed further rule making pursuant to Section 913(g) of the Dodd Frank Act including narrowing the 1940 Act Broker-Dealer exclusion from the Act "while providing a safe harbor for broker-dealers who do not engage in broader investment advisory services or hold themselves out as providing such services."

The critical area from the Committee's point of view is transaction based recommendations. The Committee in respect to fiduciary duty recommended," the Commission should fulfill its Dodd-Frank mandate to examine and where appropriate promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

The flaw in the Committee's analysis is there cannot be uniformity where investment professionals are serving in different roles and rightfully so because different functions require rules especially sensitive to the particular roles in which the investment professional is serving. A fiduciary duty in the securities and financial services context is triggered when the broker has possession, custody, and control of the funds or securities of the client-customer or the client customer is substantially dependent upon the broker because of age or otherwise.

This can happen for example when the broker has written discretionary authority or one (1) day time and price discretion. When the broker actually takes an order as the customer's agent there is a fiduciary obligation to the customer by the broker to get best execution because the customer in that context has ceded control and decision making on the trade to the broker. Broker-Dealers also have fiduciary obligations to the customers with respect to custodial services and the protection of the rules (whether promulgated by the SEC or SRO) cannot be waived in advance as prescribed by Section 29(a) of the Securities Exchange Act of 1934 ("'34 Act"). An equivalent and uniform fiduciary duty by the broker with respect to discretionary and non-discretionary accounts does not and cannot exist because it is the customer and not the broker that ultimately calls the shots with the latter type of account..

The suitability rule does not necessarily provide the customer less protection as the Investment Advisory Committee seems to imply. The broker in respect to a solicited trade has to make a recommendation off of a written information base about the security recommended and the amount purchased. Further the recommendation has to be consistent with the stated investment objectives of the customer at the opening of the account and at varying times in the customer-broker relationship. The Know Your Customer Rule obliges the broker to make inquiry of the customer with respect to investment objectives of the customer. The recommendation made has to be reasonable not only in terms of the nature of the security and the trade but the customer's objectives. Suitability is about informed choice of the customer upon the broker's recommendations. In the last analysis most investors while they desire the broker's sound guidance want to have the ultimate say with respect to their money and securities and that entails not going along with the broker's recommendation if they choose.

Brokers, who are performing services with discretion have fiduciary obligations no more, nor less than the investment adviser and the adviser representative that has assumed responsibility for the management of the account with no obligation to consult on a trade by trade basis with the customer. The above distinctions are settled both in the trade practices of the securities industry and the law and do not need to be changed.

Whether broker or investment adviser representative, the investment professional should now be viewed no less a professional than the lawyer or accountant and operate pursuant to textually clear conduct rules that will be pragmatically crafted to best meet the needs of the investor in the specific context. Certainly lawyers and accountants do not operate from a uniform fiduciary duty standard, especially with respect to privileged communications and client confidences.

Traditionally brokers and broker-dealers (while maybe not understood to be fiduciaries in all contexts) have to act in accord with high ethical and competency standards. Implicit in their contractual relationship with their customer-clients by virtue of the nature of the business and services involved is a covenant of good faith and fair dealing and in cases of broker-dealers the industry over the years has given recognition to and accepted Ezra Weiss' Shingle Theory which states that a broker and his or her firm must serve the customer in accord with high standards of ethics and competency. Their "shingle" is a representation that they are acting and will act in that manner. Moreover the prevalent terminology "just and equitable principles of trade" also signifies that broker-dealers and brokers are already required to act in accord with high ethical and competency standards no less stringent than the investment adviser and investment adviser representative.

In the last analysis we do not need more nomenclature but must give to the operative professional conduct rules specific, textually clear, and meaningful content so the interests of investors can be effectively protected in specific contexts. The function of viable rule making is to provide educative notice to those subject to the rules, whereas terms such as "fiduciary duty" and "just and equitable principles of trade" are terms of aspiration that operate in the interstices of regulation. Pragmatic and clearly crafted rules minimizing the interstices have to be and should always be the prime focus.

III. Independent Private Sector Compliance Audits

Traditionally Broker-Dealers and Investment Advisers have been subject to SEC, New York and American Stock Exchange, NASD and FINRA, and State Securities Regulatory inspections and examinations. The regulators have consistently claimed that they do not have the resources and manpower to conduct the examinations with a regularity and frequency to catch more systemic problems and fraud. In addition to more funding and as the Investment Advisory Committee suggested with respect to verification of "accredited investor" status, we should now think in terms of independent private sector compliance auditing that will supplement and complete regulatory and self-regulatory coverage. The accounting profession has developed the special procedures engagement that can serve as a model for developing this special type of auditing beyond the traditional financial statement audit.

The Accountant's Attestation Standard 201 outlines the Agreed–Upon Procedures Engagement as follows:

"An agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on subject matter. The client engages the practitioner to assist specified parties in evaluating subject matter or an assertion as a result of a need or needs of the specified parties. Because the specified parties require that findings be independently derived, the services of a practitioner are obtained to perform procedures and report his or her findings. The specified parties and the practitioner agree upon the procedures to be performed by the practitioner that the specified parties believe are appropriate. Because the needs of the specified parties may vary widely, the nature, timing, and extent of the agreed-upon procedures may vary as well; consequently, the specified parties assume responsibility for the sufficiency of the procedures since they best understand their own needs. In an engagement performed under this section ...., the practitioner's report on agreed-upon procedures should be in the form of procedures and findings."

Further the technical expertise of other professions might be required to professionally participate in the engagement. In the financial services and capital market contexts, contingent liabilities, going concern qualifications, materiality, legal issues mixed with accounting and economic consequences such as the broker-finder distinction in the offering and capital raising contexts are on occasion present and the agreed upon procedures engagement allows the accountant to work with counsel or compliance experts to complete their report and findings..The authoritative literature states:

" The ... {accountant} practitioner's education and experience enable him or her to be knowledgeable about business matters in general, but he or she is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. In certain circumstances, it may be appropriate to involve a specialist to assist the practitioner in the performance of one or more procedures. The following are examples.

▪··An attorney might provide assistance concerning the interpretation of legal terminology involving laws, regulations, rules, contracts, or grants."

Already in place is a framework to develop independent private sector compliance auditing in a more organized and larger scale that will rectify the regulatory and self-regulatory coverage gaps not merely in situations such as those presented by Regulation D, Rule 506 offerings but the customary compliance risks attached to the broker-dealer and investment adviser business including by way of example, whether brokers are meeting their responsibilities pursuant to the know your customer obligation when opening an account; whether unauthorized and excessive trading activity is occurring in the public customer's account; whether the customer is receiving best execution on orders being placed on his or her behalf; whether compensation is being accurately disclosed and is fair in terms of industry standards and in accord with applicable rules and regulations, and in respect to the investment advisor whether performance representations of the investment adviser that induce clients to select the services of the particular adviser are not merely accurate but fairly presented.

The Agreed- Upon Procedures Model will also allow more and better focus on the endemic risks of the particular firm by reason of its history and the nature of its particular business. Developing the appropriate model will entail cooperative effort by the legal and accounting professions along with those who have served as compliance professionals and in regulatory and self-regulatory organizations. The excuse for not discovering fraud and detecting other problems because of limited manpower and funding is not justifiable when independent private sector compliance auditing can and should be made adaptable on an ongoing basis.

IV. Professional Liability Insurance For The Investment Professional

Recently it was announced FINRA is considering mandatory professional liability insurance. If the goal is setting and carrying out better professional standards and fair victim compensation when the standards are breached, professional liability insurance coupling together the underwriting process with compensation to the victim will not only achieve better loss prevention because insurability will be a condition of doing business for the broker-dealer, investment advisor and their representatives; but will also provide more reasonable assurance for fair compensation to the victims. Instead of the primary basis for investor recovery being intentional fraud or fraud with a reckless mindset, it will be professional malpractice in not complying with the professional standards developed pragmatically that give a greater clarity to those responsible to comply with the standards.

Most especially the underwriting process will be risk sensitive to the prospective firms and representatives in their due diligence in the writing of the policy. See the undersigned's article in the Securities Arbitration Commentator, Volume 2006,No.6, A Guide To Professional Liability Insurance For The Investment Professional and my analysis as to why such insurance will be beneficial to financial regulatory reform and investor protection.

V. **Reform Of The Mediation-Arbitration Process**

Securities Arbitration since 1987 has been virtually mandatory because within every operative customer-broker agreement there is a pre-dispute clause that requires the customer to agree to arbitration in the event a dispute with the broker-dealer arises in the course of the relationship and these clauses have been deemed enforceable because the Federal Arbitration Act {"FAA"} as a matter of public policy favors arbitration. While securities arbitrations are supposed to be the functional equivalent of lawsuits, they are not with their relaxed standards regarding evidence; the absence of a reasoned award comparable to a judicial opinion explaining the basis in law and fact for the decision rationale and award unless both sides agree; and no appeal process within the forum. Moreover, the courts both state and federal will only upset a published arbitration award if the party making the challenge shows, corruption, bias, and fraud or a manifest disregard of law by the arbitrators.

Section 921 of Title IX of Dodd-Frank authorizes the Commission to promulgate rules to allow the customer to override the pre-dispute arbitration clause. While securities arbitration for the public customer in today's environment can be expensive and burdensome so can civil litigation and more so. Giving the customer alone a choice to arbitrate or litigate does not advance financial regulatory reform or investor protection, especially for the main street investor.

What must be done is to reform mediation, arbitration, and the claims processes, so the customer will more often than not choose arbitration. If the broker-dealer provides informative and separate disclosure about the arbitration process; the customer should be able to voluntarily choose in an informed manner to arbitrate or litigate at the opening of the account stage . Further, the customer's opening of the account **cannot and should not** be conditioned in any way on whether the customer chooses arbitration or litigation should a claim arise. **Only** if an independent and informed choice is made should the pre-dispute clause be enforceable and the policy of the FAA favoring arbitration be given legal effect.

Additionally any party in an arbitration without the consent of the other party should have the right to have a reasoned award published fully explaining the basis for the award on the facts and law. Further if either party legitimately believes the award was wrongly decided they should have a right to appeal within the forum with the same right to and scope of review that they would receive in court.

The reforms outlined above, the undersigned believes will more effectively sustain the principled development of the securities laws, and be more informative to rule making. Concrete cases involving the individual customer and the broker can and will also better facilitate enforcement, either because of more informative reviews of the regulators that will warrant them making further inquiry or the arbitrators' referral will trigger such inquiries more effectively. Without denigrating economic analysis and consumer testing, the best way to measure the law's impact is the transparency of the concrete case resolved by arbitration. The FINRA mediation-arbitration process currently is significantly underutilized in facilitating rule making and enforcement.

Conclusion

Now essential to financial regulatory reform is a better framework and more effective coordination and development of the fundamental components of the market and its regulatory and claims processes. Heightened professionalism for broker-dealers and investment advisers will be brought about by the members of these and other professional groups pragmatically setting clearer professional standards within their own SROs (including an investment adviser SRO) with SEC oversight and approval. Whether sound procedures and practices are established and implemented, will be most likely determined by independent private sector compliance auditing that will supplement the SEC and SRO inspection coverage that will also better trigger effective enforcement and informed rule-making.

In respect to legitimate investor loss resulting from professional malpractice, the primary standard for investor recovery will now and should be whether the investment professional violated professional standards resulting in harm, even if the violation of the standards were not intentional or reckless. Personalized investment advice will have to rise to the level of a professional standard of due care for the services rendered and the professional will be held accountable if he or she does not comply and cognizable harm to the investor results.

Whether the operative professional standards are working collectively in the best interest of the individual and main street investor will be more transparent and informative to regulators and self-regulators through a more open, fair, and time and cost efficient arbitration claims process that will not only fairly compensate the investor for loss resulting from professional malpractice and other wrongful conduct but also better serve the remedial purposes of the securities laws in identifying and correcting systemic flaws.

I hope this letter will add in a positive way to the constructive dialogue now taking place regarding financial regulatory reform and enhanced investor protection.

Respectfully,

Norman B. Arnoff

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