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[Via email to rule-comments@sec.gov](mailto:rule-comments@sec.gov)  
Brent J. Fields, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: **File Number S7-07-18, Regulation Best Interest  
File Number S7-08-18, Form CRS Relationship Summary;  
Amendments to Form ADV; Required Disclosures in Retail  
Communications and Restrictions on the use of Certain Names or  
Titles**

Dear Mr. Fields:

Thank you for the opportunity to comment on the SEC's proposal to adopt Regulation Best Interest as well as the accompanying proposal. We are writing this comment on behalf of the Securities Arbitration Clinic at St. John's University School of Law (the "Clinic"). The Clinic is part of the St. Vincent De Paul Legal Program, Inc., a not-for-profit legal services organization. The Clinic represents aggrieved investors with small claims, often less than \$50,000 and is committed to investor education and protection. Accordingly, the Clinic has a strong interest in the rules governing the standards of conduct of brokers and investment advisers.

Generally, the Clinic is supportive of the proposal to adopt higher standards for brokers and brokerage firms. However, the Clinic believes that the SEC should consider certain modifications and enhancements to further protect investors.

## **The Proposed Standard Does Not Adequately Address Inappropriate Financial Incentives**

Regulation Best Interest echoes FINRA's Suitability Rule. Both standards require a broker to take three steps when making a recommendation to a customer; the only difference being that Regulation Best Interest replaces the term "suitable" with "best interest."<sup>1</sup> The three proposed steps a broker must take include (1) having a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (2) having a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (3) having a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.<sup>2</sup>

Although FINRA's suitability rule does not explicitly state that a recommendation be in a customer's best interest, it has consistently been interpreted to mean as much.<sup>3</sup> FINRA cases and notices have highlighted the idea that a "broker's recommendation[] **must** be consistent with [their] customer's best interests."<sup>4</sup> Even further, in a question and answer notice, FINRA reiterated the fact that when acting in a customer's best interest, the broker is prohibited from putting his or her own interests before the customer's.<sup>5</sup> Yet, brokers continue to put their own interests ahead of their customers.

Neither FINRA, nor Regulation Best Interest, definitively define "best interest."<sup>6</sup> FINRA and the SEC rely on cases to shed light on whether brokers place their own interests before those of their customers.<sup>7</sup> Such instances may include a broker that: (1) recommends a product over another to receive larger commissions; (2) recommends mutual funds "designed 'to maximize his commissions rather than to establish an appropriate portfolio' for his customers;" (3) recommends a customer purchase promissory notes for money to use in the broker's business; (4) recommends customers use margin to purchase large numbers of securities to increase the broker's commission; (5) recommends "new issues being pushed by his firm so that [the broker] could keep his job; or (6) recommends speculative securities which pay higher commissions due to

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<sup>1</sup> FINRA Suitability Rule 2111 and SEC, *Regulation Best Interest Proposal* ("Best Interest Proposal"), available at <https://www.sec.gov/rules/proposed/2018/34-83062.pdf>.

<sup>2</sup> FINRA Suitability Rule 2111.

<sup>3</sup> Regulatory Notice 11-02, *Know Your Customer and Suitability* at n.11 ("FINRA Notice 11-02"), available at <https://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf>; FINRA Rule 2111 (Suitability) FAQ at 7.1 ("FINRA FAQ 7.1"), available at [https://www.finra.org/industry/faq-finra-rule-2111-suitability-faq#\\_edn2](https://www.finra.org/industry/faq-finra-rule-2111-suitability-faq#_edn2).

<sup>4</sup> FINRA Regulatory Notice 11-02 at n.11 (quoting *In re Faber*, Sec. Exch. Release No. 49216, 2004 SEC Lexis 277, at \*23-24 (Feb. 10, 2004)).

<sup>5</sup> FINRA FAQ 7.1.

<sup>6</sup> FINRA Suitability Rule 2111; FINRA Regulatory Notice 11-02; Best Interest Proposal.

<sup>7</sup> FINRA FAQ 7.1.

pressure by his firm to sell such securities.<sup>8</sup> These examples, however, are not dispositive. Many of these cases involve "cost-related issues."<sup>9</sup> Despite this, FINRA, and the SEC through Regulation Best Interest, refuse to mandate a broker "choose the single best investment, the least expensive investment or the least remunerative investment."<sup>10</sup> They merely assert cost as one factor to consider.<sup>11</sup>

Moreover, Regulation Best Interest provides contradictory guidance. Regulation Best Interest explicitly states a broker violates the duty by recommending a more expensive alternative; however, upon closer examination, the Regulation allows the broker to provide justification for choosing the more expensive alternative over the least costly.<sup>12</sup> Ultimately, a broker is not completely prohibited from selling an investment with a higher expense, while a seemingly identical investment is available for the customer at a fraction of the cost.

This guidance is troubling because FINRA has found that brokers often place their own interests ahead of their customers'.<sup>13</sup> Brokers are often presented with incentives to recommend one product over another, creating conflicts of interest. The SEC in 1995 released a report recognizing the discrepancy between broker compensation and products sold in relation to whether a broker rendered candid advice, or advice that "maximiz[ed] commission income."<sup>14</sup> Though the SEC emphasized the importance of the investor's, broker's, and brokerage firm's needs aligning, some of the incentives the SEC was concerned about are still utilized by brokers and firms (and still harming investors) more than twenty years later.<sup>15</sup>

Brokers often put their own interests before their customers because of financial incentives as demonstrated by the following enforcement actions:

**Department of Enforcement v. Escarcega:**<sup>16</sup>

In 2016 FINRA found a broker, David Escarcega, made unsuitable investments to twelve of his customers after "an unsolicited letter" asking the customers to invest in

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<sup>8</sup> FINRA FAQ 7.1.

<sup>9</sup> FINRA FAQ 7.1; Best Interest Proposal.

<sup>10</sup> FINRA FAQ 7.1; Best Interest Proposal.

<sup>11</sup> FINRA FAQ 7.1; Best Interest Proposal.

<sup>12</sup> Best Interest Proposal at \*3.

<sup>13</sup> FINRA 2015 Regulatory and Examination Priorities Letter (2015), available at <http://www.finra.org/industry/2015-exam-priorities-letter>.

<sup>14</sup> SEC Committee on Compensation Practices, *Report on Broker-Dealer Compensation* (April 10, 1995) ("Tully Report"), at \*8 available at <https://www.sec.gov/news/studies/bkrcomp.text>.

<sup>15</sup> *Id.* In 1995 the SEC raised concerns of the use of contests to stimulate sales and incentives for selling proprietary investment products, which are two incentive practices mentioned in Regulation Best Interest. Best Interest Proposal. FINRA noted similar conflicts of interest issues in 2013. FINRA, *Report on Conflicts of Interest* (Oct. 2013) ("FINRA Conflicts Report"), available at <https://www.finra.org/sites/default/files/Industry/p359971.pdf>.

<sup>16</sup> Department of Enforcement v. Escarcega, FINRA OHO No. 2012034936005 at \*1, 4 (Feb. 29, 2016), [http://www.finra.org/sites/default/files/OHO-Escarcega-2012034936005-022916\\_0.pdf](http://www.finra.org/sites/default/files/OHO-Escarcega-2012034936005-022916_0.pdf).

Debentures was discovered.<sup>17</sup> Many of Escarcega's customers were retired.<sup>18</sup> Of the twelve unsuitable recommendations, eleven of those customers were retired at the time of the investment and nine were over seventy-years old, the youngest being sixty-one years old.<sup>19</sup> All twelve customers selected conservative investment objectives at the opening of their accounts.<sup>20</sup> Most of the investors were inexperienced investors, having only an "average" understanding of investing generally.<sup>21</sup> Although Escarcega admitted to knowing the risks in investing in Debentures, he still recommended it to his customers.<sup>22</sup> Escarcega likely made these recommendations as he received five percent commission for the seven-year Debentures, earning ninety-percent of the issuer's payout, while Escarcega's firm earned the remaining ten percent.<sup>23</sup> In total, Escarcega received \$52,270 in commission from the sale of the Debentures, while his customers lost money.<sup>24</sup>

**Department of Enforcement v. Evans:**<sup>25</sup>

In 2011, Kale Evans was held responsible for making unsuitable recommendations after convincing a seventeen-year old to open a joint account and investing her father's life insurance money with Evans.<sup>26</sup> Evans' client had no prior investing experience or other financial means, yet Evans opened the account as a margin account and appointed himself as a joint owner with right of survivorship.<sup>27</sup> Evans thereafter made all trading decisions without consulting his client, though assuring the client that he would transfer the money to a "'savings account' with no risk of loss."<sup>28</sup> At various times Evans withdrew money from the account and deposited a majority of the

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<sup>17</sup> *Id.* Escarcega's firm was one of the broker-dealers found to be selling GWG Debentures. GWG is a company that operates "almost entirely through the issuance of debt." GWG began offering debentures as a way to raise money. Debentures required a minimum \$25,000 investments and yielded maturity dates from six months to seven years with an interest rate ranging from 4.75 percent per year for six months or 9.5 percent per year for seven years.

<sup>18</sup> *Id.* at \*6, 8. Escarcega sold the Debentures to thirty-five customers and claimed to provide them with the prospectus which stated that debentures were long term investments suitable for "persons of adequate financial means who have no need for liquidity in this investment." GWG informed investors that it would be "difficult or impossible . . . to resell the debentures." Ultimately, an investor would not get their "principal back before maturity unless he becomes disabled, files for bankruptcy, or dies."

<sup>19</sup> *Id.* at \*23.

<sup>20</sup> *Id.* Ten of the investors had "balanced/conservative growth" as their investment objective, while the remaining two investors checked "preservation of principal/income," the most conservative objective available.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at \*24.

<sup>23</sup> *Id.* at \*6.

<sup>24</sup> *Id.*

<sup>25</sup> Dep't of Enforcement v. Evans, No. 20006005977901, 2011 FINRA Discip. LEXIS 36, at \*1 (NAC Oct. 3, 2011) (holding Evans violated NASD Rule 2310 of suitability).

<sup>26</sup> *Id.* at \*5–6. NASD Rule 2310 was the former suitability rule and was used as a model for FINRA Rule 2111. FINRA Regulatory Notice 11-02 at \*2. NASD Rule 2310 required a broker make a recommendation in his client's best interest just as FINRA Rule 2111 does. *Id.* at \*3 n.11.

<sup>27</sup> *Id.* at \*9.

<sup>28</sup> *Id.* at \*10–11.

money into other accounts that were owned by him and his wife and transferred some of the money to his creditors.<sup>29</sup> The client lost approximately \$400,000 of her father's \$500,000 life insurance policy, while Evans benefitted.<sup>30</sup>

***In re Sathianathan:***<sup>31</sup>

Raghavan Sathianathan, a former broker for Morgan Stanley and Salomon Smith Barney Inc., was found to have made unsuitable recommendations.<sup>32</sup> In 2000, Sathianathan opened an account with a customer who he knew "had no prior investment experience and [whose] [] 'level of sophistication was almost zero.'"<sup>33</sup> Despite Sathianathan's knowledge of the customer's experience, previous moderate risk tolerance, and disinterest in aggressive risk tolerance, Sathianathan indicated the customer was interested in an aggressive risk tolerance and speculation on the account application.<sup>34</sup> The account steadily increased until Sathianathan's recommended the customer purchase Class B shares of various mutual funds, admitting that such was done to earn higher commission rates and drive up the amount of assets under his control.<sup>35</sup> At the time the Class B shares were purchased, Sathianathan credited the account with shares the customer did not own, overvaluing the account.<sup>36</sup> Sathianathan ultimately received \$66,000 in commission for this transaction.<sup>37</sup> Sathianathan additionally recommended investing in index warrants issued by Sathianathan's firm, whose prospectus called for a "high degree of risk," and on which Sathianathan received six percent commission.<sup>38</sup> Less than six months later, as a result of holding a declining stock, margin calls, and liquidation of mutual funds, the customer lost about \$680,000 and an additional \$44,000 from the contingent deferred sales charge from the sale of the Class B shares.<sup>39</sup> This is a common incentive in which brokers pay more for mutual fund investments absent better fund performance in order "to push high load shares, shares of funds that pay for 'shelf space' (i.e., featured presence in brokers' recommendations) or of propriety funds sponsored by the broker's firm, which are naturally more profitable for the firm."<sup>40</sup>

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<sup>29</sup> *Id.* at \*15–17.

<sup>30</sup> *See id.* at 19.

<sup>31</sup> *In re Sathianathan*, 2006 SEC Lexis 2572, No. 54722, at \*1 (Nov. 8, 2006) (holding Sathianathan violated NASD Rule 2310 of suitability).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at \*6.

<sup>34</sup> *Id.* at \*6–7.

<sup>35</sup> *Id.* at \*8–10.

<sup>36</sup> *Id.* at \*9.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at \*10.

<sup>39</sup> *Id.* at \*11.

<sup>40</sup> *See In re Sathianathan*, at \*1; *see also* Langevoort, *supra* n.44 at 448.

**Noble Capital Markets and Nicolaas Petrus Pronk:**<sup>41</sup>

Noble Capital Markets and one of its brokers, Pronk, were alleged to have recommended almost one million shares of a company's stock without disclosing conflicts of interests to their customers.<sup>42</sup> It was alleged that the firm and broker made these recommendations with an intent to "profit from the firm's undisclosed investment banking relationships with the company."<sup>43</sup> The firm received compensation from the company for promoting the stock.<sup>44</sup> Further, the firm provided "additional compensation" for its brokers for "promoting, recommending and selling the company's stock," creating incentives for the brokers to recommend this to customers as opposed to other investment opportunities.<sup>45</sup>

**Wedbush Securities Inc.:**<sup>46</sup>

In 2016 Wedbush Securities Inc. was fined for insufficient risk management controls and supervisory systems.<sup>47</sup> FINRA also found that the firm had created certain financial incentives awarding their brokers "with monthly compensation based on market access customers' trading volume" that the firm ultimately failed to effectively oversee.<sup>48</sup> The firm's promotion of financial incentives and failure to supervise could have resulted in "manipulative trading" at their customers' expense.<sup>49</sup>

**Deborah Anne Ames:**<sup>50</sup>

A broker in Ohio allegedly received "unwarranted incentive compensation" by paying her customers' premiums on life insurance policies that were issued by an affiliated company of the broker's firm.<sup>51</sup>

These are just a small sampling of the enforcement actions resulting from brokers allowing conflicts of interest to skew their investment advice in their own favor. One way Regulation Best Interest attempts to limit the harm caused by these conflicts of interest is to require broker disclosures.<sup>52</sup>

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<sup>41</sup> FINRA, Disciplinary and Other FINRA Actions at \*1 (Dec. 2017) ("Disciplinary and Other FINRA Actions"), available at [https://www.finra.org/sites/default/files/publication\\_file/December\\_2017\\_Disciplinary\\_Actions.pdf](https://www.finra.org/sites/default/files/publication_file/December_2017_Disciplinary_Actions.pdf).

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.* at \*1–2.

<sup>46</sup> FINRA, Disciplinary and Other FINRA Actions at \*25 (Feb. 2016) ("2016 FINRA Actions"), available at [https://www.finra.org/sites/default/files/February\\_2016\\_Disciplinary\\_Actions.pdf](https://www.finra.org/sites/default/files/February_2016_Disciplinary_Actions.pdf).

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at \*26.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at \*28.

<sup>51</sup> *Id.*

<sup>52</sup> Best Interest Proposal. The proposal requires a broker or dealer to "establish[], maintain[], and enforce[] written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and . . . establish[], maintain[], and enforce[] written policies and procedures reasonably designed to identify and

It is important that the SEC provide additional guidance as to when disclosure of conflicts is appropriate and what would constitute adequate mitigation of conflicts of interest. Disclosing possible conflicts of interest does not necessarily dissuade brokers from acting in their own best interest. Moreover, it is unlikely to adequately warn a customer against relying on the broker's experienced and knowledgeable advice. Studies show that disclosure mechanisms are largely ineffective.<sup>53</sup> The SEC's Financial Literacy Study reported that most American investors lack basic financial knowledge.<sup>54</sup> Thus, even if a broker was to disclose a conflict it is unlikely the customer will understand the true nature and consequences of the broker's conflict.

FINRA and the SEC has made clear that mere disclosure is not sufficient to satisfy the broker's obligation or to protect the customer.<sup>55</sup> A broker is required to ensure the customer fully understands and is fully aware of the risks involved in the broker's conflict.<sup>56</sup> However, it may not be possible to ensure such understanding because of the issues with disclosure discussed above.

Disclosure is only effective if it "communicates the desired substance to the customer,"<sup>57</sup> however, as studies and case law suggest, disclosure does not prevent customers from relying on biased advice. Moreover, financial incentives create conflicts often enticing brokers to put their own interests above their customers and go largely undetected by their firms,<sup>58</sup> despite present supervisory systems. Thus, rather than merely requiring disclosure and mitigation of conflicts of interest, it would be more effective to prohibit certain of these financial incentives.

Further, there must be significant consequences if a firm or broker subordinates a client's interests to his own. While the success of mitigating or eliminating conflicts of interest is attributed to a firm's supervision and oversight,<sup>59</sup> enforcement acts to signal to the firms the seriousness of violating rules. Unfortunately, sanctions attributed to suitability violations have become simply a firm's cost of doing business. If a broker or firm does not suffer harsher consequences, no matter the rule implemented, there will not be effective compliance. Most sanctions are fines that barely make a dent in a firm's profits and permanent suspension is rare, though a broker may face temporary suspension. This is so even for "repeat offenders."

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disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations."

*Id.*

<sup>53</sup> See SEC Office of Investor Education and Advocacy, *Study Regarding Financial Literacy Among Investors* (August 2012) (the "Financial Literacy Study"), available at <http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf>.

<sup>54</sup> *Id.*

<sup>55</sup> *Dep't Enforcement v. Lakewood, Co.*, 2010 WL 781456, \*9 (FINRA 2010); *In re Chase*, SEC Release No. 34-47476, 2003 WL 917974, \*4 (SEC 2003).

<sup>56</sup> *Lakewood*, 2010 WL 781456, \*9; *In re Chase*, 2003 WL 917974, \*4.

<sup>57</sup> Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 446 (2009).

<sup>58</sup> See *supra* n.17-52.

<sup>59</sup> FINRA Conflict Report and 1995 SEC Report.

Below are examples of minor sanctions brokers and firms recently faced when acting contrary to a client's best interests without admitting or denying the alleged wrongdoings:

**Noble Capital Markets, Inc. and Nicolaas Petrus Pronk:**<sup>60</sup>

In the case discussed above, Noble Capital Markets, Inc. was fined \$225,000, while the broker, Pronk, was fined \$25,000.<sup>61</sup> Pronk was additionally "suspended from association with any FINRA member for eight months."<sup>62</sup> Pronk was further required to pass Series 7 and 24 qualification exams and was suspended from practicing until he passed following the initial eight months suspension.<sup>63</sup>

**Wedbush Securities Inc.:**<sup>64</sup>

As discussed above, Wedbush Securities was fined \$1,800,000 in 2016 for encouraging their brokers to engage in possible "manipulative trading[s]" by awarding monthly compensation for voluminous trades.<sup>65</sup>

**Morgan Stanley:**<sup>66</sup>

In 2010 Morgan Stanley was fined \$800,000 "for failing to make public disclosures required by FINRA's rules governing research analyst conflicts of interest" and "failing to disclose the availability of independent research in customer account statements."<sup>67</sup>

**Fifth Third Securities, Inc.:**<sup>68</sup>

In May of 2018, FINRA fined Fifth Third Securities \$6,000,000 "for failing to appropriately consider and accurately describe the costs and benefits of variable annuity exchanges" as well as making unsuitable recommendations in regard to these variable annuities.<sup>69</sup> In making these recommendations, Fifth Third Securities violated a 2009

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<sup>60</sup> Disciplinary and Other FINRA Actions at \*1, available at [https://www.finra.org/sites/default/files/publication\\_file/December\\_2017\\_Disciplinary\\_Actions.pdf](https://www.finra.org/sites/default/files/publication_file/December_2017_Disciplinary_Actions.pdf).

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> 2016 FINRA Actions at \*25, available at [https://www.finra.org/sites/default/files/February\\_2016\\_Disciplinary\\_Actions.pdf](https://www.finra.org/sites/default/files/February_2016_Disciplinary_Actions.pdf).

<sup>65</sup> *Id.*

<sup>66</sup> FINRA Fines Morgan Stanley \$800,000 for Deficient Conflict of Interest Disclosures in Equity Research Reports and Public Appearances by Research Analysts, FINRA Newsroom (Aug., 10, 2010) ("FINRA Fines Morgan Stanley"), available at <http://www.finra.org/newsroom/2010/finra-fines-morgan-stanley-800000-deficient-conflict-interest-disclosures-equity>.

<sup>67</sup> *Id.*

<sup>68</sup> FINRA Sanctions Fifth Third Securities, Inc. \$6 Million for Cost and Fee Disclosure Failures and Unsuitable Recommendations Related to Variable Annuity Exchanges, FINRA Newsroom (May 8, 2018) ("FINRA Sanctions Fifth Third Securities, Inc."), available at <http://www.finra.org/newsroom/2018/finra-sanctions-fifth-third-securities-6-million-va-exchange-violations>.

<sup>69</sup> *Id.* Fifth Third neither consented nor denied the charges, but merely accepted the sanctions. *Id.*

settlement with FINRA in which it made similar unsuitable variable annuity recommendations to customers.<sup>70</sup>

Customers unequivocally rely on their broker's advice and believe their brokers are always acting in their best interests.<sup>71</sup> Regulation Best Interest would better serve investors if concrete parameters are used making it clear to brokers how to act when recommending a particular investment to their customers. As evident from FINRA's suitability rule, vague definitions allow brokers to act on their own behalf, leaving investors vulnerable. To ensure investor protection, violations of Regulation Best Interest cannot become another cost of doing business. To ensure investor protection it would be best to not only allow mitigation of certain conflicts of interests but rather, eliminate them entirely. It is equally important to remember compliance is only as strong as enforcement. Minor fines and suspensions have not deterred selfish acts of brokers; in order to protect investors, brokers and firms must face harsher sanctions such as permanent suspension.

### **The Proposed Standard Does Not Do Enough to Alleviate Investor Confusion**

Retail investors do not understand the difference between or the differing obligations owed by investment advisors and broker-dealers. Recognizing a growing disparity between the regulation of investment advisers and broker-dealers, Dodd-Frank required the SEC to conduct a study investigating the ever-increasing gap that exists between investment adviser and broker-dealer obligations.<sup>72</sup> The SEC's study demonstrated that an overwhelming number of investors do not understand the basic differences between investment advisers and broker-dealers.<sup>73</sup> The SEC further found that investors rely on both broker-dealers' and investment advisers' advice, genuinely believing the advice given is in their best interest.<sup>74</sup> The advice was accepted without the investor truly understanding the "legal implications" or "different standards of care that apply to investment advisers and broker-dealers."<sup>75</sup> In one survey, it was asked whether investment advisers and financial planners are held to a fiduciary standards, to which, respectively, 75% and 77% of investors believed in the affirmative.<sup>76</sup> Approximately 66% and 76% of investors also incorrectly believed that both stockbrokers and financial

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<sup>70</sup> *Id.*

<sup>71</sup> SEC, Study on Investment Advisers and Broker-Dealers at \*98 ("SEC Study") (Jan. 2011), available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf> (discussing, generally, customers' understand of the difference between broker-dealers and investment advisers, however surveying customers experiences with investing).

<sup>72</sup> James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 5 (2012).

<sup>73</sup> See SEC, *Study on Investment Advisers and Broker-Dealers*, at \*i ("SEC Study") (Jan. 2011), available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at \*94.

advisers were held to a fiduciary duty.<sup>77</sup> The Dodd-Frank Act study made clear that the current regulations are not enough to protect retail investors or help retail investors make informed decisions. However, despite apparent investor confusion and the long-noted blurred lines of investment advisers and broker-dealers, it has been insisted that a uniform standard is neither needed, nor permitted under the current statutory scheme.<sup>78</sup>

The investing public's mistaken belief that all financial professionals owe the same standard of care is largely due to firms' publicly advertising as such. Some of the larger firms, such as Wells Fargo, Merrill Lynch, Morgan Stanley, Fidelity Investments and Charles Schwab, all produced advertisements suggesting the firms "offer[] the services of a fiduciary."<sup>79</sup> One of Fidelity's ad stated the following:

[a]cting in good faith and taking pride in getting things just right. The personal commitment each of us makes to go the extra mile for our customers and put their interests before our own is a big part of what has always made Fidelity a special place to work and do business.<sup>80</sup>

This is more than just innocent advertising. The continued absence of a uniform fiduciary standard costs investors an estimated \$17 billion per year.<sup>81</sup> Currently, investment advisers are regulated by the Investment Advisers Act of 1940 which in sum requires investment advisers to disclose certain information to their customers before executing a transaction of any security.<sup>82</sup> Under the Act, investment advisers are under a "fiduciary duty to act in the best interest of their clients;" a duty that is not actually specified for in the Act or established by the SEC, but required by operation of law due to the relationship between the adviser and customer and only "made enforceable by . . . the Act."<sup>83</sup> As part of this fiduciary duty, advisers have an obligation to act in the "utmost good faith" and provide "full and fair disclosure of all" material facts relevant to the client, as to not mislead the customer, as well as being required to disclose all

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<sup>77</sup> *Id.* at \*93.

<sup>78</sup> See SEC, *Certain Broker-Dealers Deemed Not to be Investment Advisors*, at \*4 (Release No. 34-51523) (April 12, 2005), available at <https://www.sec.gov/rules/final/34-51523.pdf>; see also Wrona, *supra* note 1, at 6 (discussing the absence of a uniform fiduciary duty in section 913 of the Dodd-Frank Act).

<sup>79</sup> The PIABA Study.

<sup>80</sup> *Id.*

<sup>81</sup> PIABA, *Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty; Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard* (Mar. 25, 2015) (the "PIABA Study"), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3084113](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3084113) (suggesting investors have lost approximately \$80 billion since the enactment of the Dodd-Frank Act).

<sup>82</sup> *Id.* at \*iii.

<sup>83</sup> SEC, *Regulation of Investment Advisers*, at \*22–23 (March 2013), available at [https://www.sec.gov/about/offices/oia/oia\\_investman/rplaze-042012.pdf](https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf).

material facts related to any conflicts of interest.<sup>84</sup> Disclosure in this manner was meant to provide the customer with all pertinent facts necessary to make an informed decision to either "enter into or continue an advisory relationship . . . or take some action to protect himself or herself against the conflict,"<sup>85</sup> however the vagueness of the standard often leaves investors vulnerable.

The regulation of broker-dealers varies greatly, although they perform similar functions as investment advisers. Unlike investment advisors, broker-dealers are generally not subject to a fiduciary duty, though such a duty may arise under state law in some circumstances, only serving to further confuse investors.<sup>86</sup> Broker-dealers are excluded from the Advisers Act so long as the advice is "solely incidental to the conduct of its business as broker or dealer, and it does not receive any 'special compensation' for providing investment advice."<sup>87</sup> "Solely incidental" has been interpreted as advisory services "in connection with and reasonably related to the brokerage services provided,"<sup>88</sup> another vague standard providing no clear insight on the difference between the advice by a broker-dealer as opposed to an investment adviser. Broker-dealers are regulated by the Securities Exchange Act of 1934, under which the SEC has broad regulatory power, some of which the SEC delegates to self-regulatory organizations.<sup>89</sup>

Some brokers are dually registered as investment advisers, however, which regulation governs is dependent on the hat the individual is wearing when giving advice. Though it would seem a material fact to disclose when a dual registrant is acting as an adviser as opposed to a broker-dealer, customers are often left unaware in what capacity their financial professional is acting. While the proposed regulation may help retail investors understand the difference in compensation between the two, it may not clarify the particular role the individual has assumed. Under the proposed rule, dual registrants merely have to disclose that they wear both hats, however they are under no obligation to disclose when they are specifically acting as a broker-dealer or an investment adviser.

Moreover, customers are inclined to believe the same obligations are owed for all accounts opened with the financial professional. Customers may have both brokerage accounts and advisory accounts with a firm, and have the same individual managing both types of accounts. This problem is likely to become more pervasive as the number of dually registered firms rises. According to a Wall Street Journal article, from 2008 to

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<sup>84</sup> *Id.* at 23.

<sup>85</sup> *Id.* at 24.

<sup>86</sup> *Id.* at 51.

<sup>87</sup> *Id.* at \*5.

<sup>88</sup> *Id.*

<sup>89</sup> Gary A. Varnavides, *The Flawed State of Broker-Dealer Regulation and the Case for an Authenticated Federal Fiduciary Standard for Broker-Dealers*, 16 *FORDHAM JOURNAL OF CORP. & FIN. LAW* 203, 205 (2011).

2013 the number of dually registered advisers rose 50% to over 24,000.<sup>90</sup> More individuals are likely to be doing business with a dually registered adviser, and may have multiple account types.

In one case handled by the Clinic, a client had multiple accounts with a dually registered financial professional. Although the accounts were initially opened as brokerage accounts, two of the client's accounts were converted to discretionary advisory accounts. The client did not understand that the accounts would be handled differently because they were advisory accounts. Nor did the client understand that the financial professional was not a fiduciary with respect to the brokerage accounts. The client assumed the financial professional was handling all of the accounts in the same manner. To the client, the only difference between the accounts was how the fees were paid. The client did not understand that the financial professional was a fiduciary with a duty to monitor only the advisory accounts, but was subject to a lower, suitability standard with respect to the brokerage accounts.

Financial professionals who are dually registered should be held to the highest fiduciary standard with respect to all of the accounts they handle. It is not fair to shift the burden to the client to understand which duty applies and when, especially if the client has multiple accounts with the individual.

### **It Must Be Made Clear the Proposed Regulation Does Not Preempt Higher State Standards of Conduct**

The regulation should make it clear that state legislation and regulation that have expanded the definition of fiduciary duty to broker-dealers will not be preempted. As of September 2017, thirty-two states have imposed some limited form of a fiduciary duty on broker-dealers, while only fourteen states have imposed no such duty on broker-dealers.<sup>91</sup> For example, in October 2017, Connecticut adopted a law that required "administrators of state-run retirement plans [] disclose certain investment fees and fees paid to investment advisors."<sup>92</sup> Nevada imposed a clear-cut, blanket fiduciary duty on "broker-dealers, sales representatives, and investment advisers who give investment advice."<sup>93</sup> New York further proposed a "best interest standard on [all that] sell[] life insurance and annuity products."<sup>94</sup> State adopted fiduciary duties may be stronger than

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<sup>90</sup> Matthias Rieker, *Dually Registered Investment Advisers Blur the Broker-Fiduciary Line*, WSJ (Mar. 26, 2015 11:44 a.m.), available at <https://www.wsj.com/articles/dually-registered-investment-advisers-blur-the-broker-fiduciary-line-1427384699>.

<sup>91</sup> Maggie Juliano, Esq., *State Law Fiduciary Duties and SEC and Blue Sky Laws – How they Might Work Together* (BENEFIT CONSULTANTS GROUP) (Jan. 23, 2018), available at <https://www.bcgbenefits.com/blog/dol-and-sec-and-blue-sky-law>.

<sup>92</sup> Kristen Ricaurte Knebel, *States Look to Help Investors, With Fiduciary Rule in Flux* (BLOOMBERG) (Feb. 7, 2018), available at <https://www.bna.com/states-look-help-n57982088470/>.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

that proposed by the SEC. Unsophisticated investors that are otherwise protected by more favorable state standards may be left vulnerable if the rule does not clearly state that it is not intended to preempt state standards.

The roles of investment advisers and broker-dealers has vastly changed in the past 70 years since the initial enactment of the Securities Exchange Act and the Investment Advisers Act, however not much has been done to close the gap between the two's similar functions but differing legal obligations. Brokers remain subject to inappropriate financial incentives which bias the investment advice they provide to customers. The SEC should restrict those conflicts, ensuring that brokers do not continue to be tempted to put their own interests ahead of their clients'. Additionally, the proposed Regulation Best Interest would best serve retail investors by holding both investment advisers and broker-dealers to a fiduciary standard, especially when an individual is acting in a dually registered capacity. Finally, the SEC must ensure that investors continue to be protected by higher state standards where such standards have been adopted.

Very truly yours,

/s/\_\_\_\_\_

Kayla Martin

Legal Intern

/s/\_\_\_\_\_

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