NAPFA
The National Association of Personal Financial Advisors

November 2, 2007

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Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re: File Number S7-22-07**
**"Interpretive Rule Under the**
**Advisers Act Affecting Broker-Dealers"**

Dear Ms. Morris:

The National Association of Personal Financial Advisors (NAPFA) appreciates the opportunity to provide comments regarding the Proposed Rule, "Interpretative Rule Under the Advisers Act Affecting Broker Dealers." NAPFA is the nation's leading organization dedicated to the advancement of Fee-Only®[i] comprehensive financial planning, and is comprised of over 1,000 financial planners who have agreed to adhere to NAPFA's strict fiduciary guidelines.[ii] NAPFA believes that certain aspects of the Proposed Rule relating to the termination of fiduciary status, and permitting dual fiduciary/non-fiduciary status at the same time, will blur the distinctions between fiduciary and non-fiduciary advisors and increase the confusion of consumers of investment advisory services. NAPFA urges the Commission to withdraw the Proposed Rule in its present form and consider adopting a new rule, consistent with long-standing principles of fiduciary law and the Advisers Act.

NAPFA believes that the Commission's proposed interpretation of the Investment Advisers Act of 1940 (hereafter "Advisers Act" or "IAA"), which would only apply the Advisers Act to *accounts* as opposed to *persons* and *relationships*, and would permit a dual registrant, with respect to a particular client, to wear "two hats" (fiduciary, non-fiduciary), to "switch hats," and to "remove the fiduciary hat," outcomes are contrary to the Advisors Act. The following points summarize our position.

- The Advisers Act definition of "Investment Advisor" imposes fiduciary status upon a "person," not an account through the plain language of the Act. The Commission is seeking to have the Act apply to particular transactions or accounts instead of to persons and relationships as was originally intended.

- Congressional intent supports the broadened application of the Advisers Act and not the narrow interpretation by the Commission.

- The language of the Broker-Dealer Exemption is limited to certain brokers and does not provide a basis for exempting only brokerage accounts based upon the language of the "incidental advice" limitation.

- The plain language of the Broker-Dealer Exemption does not apply when "special compensation" is, or has been, received by the broker-dealer firm.

- Applying Congressional intent, when "special compensation" is received for the provision of investment advice, the Broker Dealer Exception is not applicable.

- Prior interpretations of the Advisors Act clearly show that fiduciary status attaches to the advisor as a result of the relationship with the client.

- The Proposed Rule is contrary to state common law, which is not preempted by the Advisors Act. This means there would be different federal and state standards, which is contrary to the interests of the public and the securities industry for uniform application of securities laws.

- In practice there is no real end to financial planning or investment advisory relationships. The Proposed Rule therefore contributes to increasing confusion for the consumer.

- The Proposed Rule would permit dual registrants to seek a client's waiver of fiduciary duties, which is prohibited by Section 215 of the Advisors Act;

- Even if waiver were permitted, the Proposed Rule does not require full disclosure and informed consent to a change in fiduciary status;

- The economic effects of the Proposed Rule have not been adequately considered. The Proposed Rule:
  - will adversely impact consumers of financial planning and investment advisory services; and
  - will negatively impact the economic interests of investment advisors and financial planners.

- Another aspect of the Proposed Rule, relating to differential commissions, would permit broker dealers to receive "special compensation" for the receipt of advisory services.

**THE PROPOSED RULE WOULD HAVE THE ADVISERS ACT APPLICABLE ONLY TO "ACCOUNTS", THEREBY PERMITTING "TWO HATS" AND "REMOVAL OF FIDUCIARY HAT" AND "SWITCHING OF HATS."** That portion of the Proposed Rule which is most contrary to law and public policy is the section which provides that: "A broker or dealer registered with the Commission under Section 15 of the Exchange Act is an investment adviser solely with respect to those accounts[iii] for which it provides services or receives compensation that subject the broker-dealer to the Advisers Act."[iv] [Emphasis added.] By the plain language of the Proposed Rule, dual registrants would be able to:

1. ***"wear two hats" at the same time*** – i.e., stand in a fiduciary relationship with respect to part of an investor's portfolio, but not stand in a fiduciary relationship with respect to other parts of an investor's portfolio – a result which is contrary not only to current law but also to the basic understanding of the nature of fiduciary relationships which has been developed over millennia;
2. ***"remove" the fiduciary hat*** and assume the broker-dealer hat (which has no broad fiduciary duty requirement, only the much lesser requirement that investment recommendations be "suitable" to the investor)[v] for the same client or customer; and
3. ***continue to "switch hats" back and forth,*** as the dual registrant desires, with respect to a customer, achieving a result – the ability to take advantage of a customer when not governed by the fiduciary hat - that is foreign both to the various laws governing fiduciary relationships and general common sense.

NAPFA believes the "dual hats" aspect of the Proposed Rule is contrary to the plain language of the Advisers Act, clearly expressed Congressional intent, public policy, and long-standing principles underlying the fiduciary concept in law. Given the importance of this issue to individual consumers, and to the preservation of the integrity of the investment advisory and financial planning professions, NAPFA discusses the specific legal and public policy issues presented by the Proposed Rule in detail in the paragraphs which follow. See also Exhibit A, which notes that the re-proposal of the Proposed Rule is controversial.

**THE ADVISERS ACT DEFINITION OF "INVESTMENT ADVISER" IMPOSES FIDUCIARY STATUS UPON A "PERSON," NOT AN "ACCOUNT."** The Commission appears to misapply the Advisers Act, seeking to have the Advisers Act only apply to particular *transactions* or *accounts*, instead of to *persons* and *relationships* as was originally intended. In so doing, the Commission has mixed the regulatory scheme arising under the 1934 Act with the different regulatory scheme arising under the 1940 Act. It should be noted that Section 206 of the Advisers Act, under which fiduciary duties arise for investment advisers, has even broader application than the antifraud provisions in the other federal securities laws. For example, unlike Rule 10b-5 under the 1934 Act, Section 206 is not limited to situations involving the purchase of sale of a security, but can be applied in other circumstances. Moreover, "the SEC has also applied [Section 206] where fraud arose from an investment advisory *relationship*, even though the wrongdoing did not specifically involve securities. In other words, the SEC and its staff determined that once an investment adviser is subject to the antifraud provisions of the Advisers Act, *the provisions may apply to all the adviser's activities with respect to its advisory clients.*"[vi] [*Emphasis added*.] It is important to recognize this important distinction between the federal securities laws – that unlike the Securities and Exchange Act of 1934 (the primary federal act covering broker-dealer firms and their registered representatives), the Advisers Act does not apply to just a "transaction" nor just to an "account" – but applies much more broadly the fiduciary duties of an investment adviser to the whole of his or her relationship with the client.

**THE PROPOSED RULE IS CONTRARY TO THE PLAIN LANGUAGE OF "INVESTMENT ADVISER" DEFINITION CONTAINED IN THE ADVISERS ACT.** Analysis of a statute must begin with a careful examination of its text. The Investment Advisers Act of 1940 ("Advisers Act" or "Act") regulates the activities of certain "investment advisers," who are defined in section 202(a)(11) of the Act as follows:

> "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. [Emphasis added.]

The plain language of the Advisers Act denotes that the definition of investment adviser relates to advice provided to "others." The term "others" in the sentence is used as a pronoun, referring back to the noun "person." Furthermore, under accepted dictionary definitions the term "others" "refers to *people* in general, not the person you are talking to or about."[vii] (*Emphasis added*.) Hence, under its plain language the Advisers Act is applicable to the advice provided to "persons" – not just to specific "accounts" of those persons.

Furthermore, the Commission's proposed interpretation found in the Proposed Rule would limit the applicability of the important consumer protections of the Advisers Act only to "accounts" that are denoted as investment advisory accounts, and not to persons who provide investment advisory services. This is contrary to the express language of the Act which applies the important anti-fraud consumer protections of the Act, and fiduciary status, upon "persons" who "engage in the business of advising others."

As stated by the U.S. Supreme Court, "[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters ….'"[viii]

**CONGRESSIONAL INTENT SUPPORTS THE BROADENED APPLICATION OF THE ADVISORS ACT AND NOT THE NARROW INTERPRETATION BY THE COMMISSION.** Although the plain meaning of the statute is sufficient to reach the conclusion that the Proposed Rule is contrary to the Advisers Act, it is also clear that Congress in enacting the Advisers Act intended that the definition of "investment adviser" be construed broadly. As stated recently in *Financial Planning Association vs. SEC*:

> Just as the text and structure of paragraph of 202(a)(11) make it evident that Congress intended to define 'investment adviser' broadly and create only a precise exemption for broker-dealers, so does a consideration of the problems Congress sought to address in enacting the IAA. A comprehensive study conducted by the SEC pursuant to the Public Utility Holding Company Act of 1935 indicated that 'many investment counsel have `strayed a great distance from that professed function' of furnishing disinterested, personalized, continuous supervision of investments.' Securities and Exchange Commission, Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, at 25 (1939) (quoting testimony of brokerage executive James N. White, of Scudder, Stevens & Clark). Floor debate on the IAA called attention to the fact that while this study was being conducted investment trusts and investment companies had perpetrated "some of the most flagrant abuses and grossest violations of fiduciary duty to investors." 86 Cong. Rec. 2844 (daily ed. Mar. 14, 1940) (statement of Sen. Wagner). Congress reiterated throughout its proceedings an intention to protect investors and bona fide investment advisers.
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> The overall statutory scheme of the IAA addresses the problems identified to Congress in two principal ways: First, by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined, *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979), and second, by requiring full disclosure of all conflicts of interest. As the Supreme Court noted, Congress's 'broad proscription against `any … practice … which operates … as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end.' *Capital Gains*, 375 U.S. at 191, 84 S.Ct. 275.
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> [T]he Committee Reports indicate a desire to … eliminate conflicts of interest between the investment adviser and the clients as safeguards both to `unsophisticated investors' and to `bona fide investment counsel.' The [IAA] thus reflects a … congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously – to render advice which was not disinterested. *Id.* at 191-92, 84 S.Ct. 275.[ix]

The Proposed Rule would make ineffective the very strong fiduciary protections which Congress intended to afford to consumers, and would impermissibly permit investment advisers to engage in practices involving often-undisclosed conflicts of interest. The federal fiduciary standard established by the Advisers Act was designed to protect not only investors, but also bona fide investment advisers who adhere to the fiduciary standard of conduct in their relationships with their clients at all times (such as NAPFA members).

Several times in the *Financial Planning Association vs. SEC* decision the U.S. Court of Appeals alluded to the broad construction which Congress intended as to the definition of "investment adviser." Hence, the Commission's attempt in this Proposed Rule to exempt certain *accounts* from the application of the broadly construed "investment adviser" term is contrary to Congressional intent, in addition (as set forth above) being against the plain meaning of the Advisers Act definition of "investment adviser."

**THE PLAIN LANGUAGE OF THE BROKER-DEALER EXEMPTION IS LIMITED TO CERTAIN *BROKERS*, AND DOES NOT PROVIDE A BASIS FOR EXEMPTING ONLY *BROKERAGE ACCOUNTS.*** The Advisers Act provides a series of exemptions from the definition of "investment adviser."[x] Given the plain meaning of the language in the definition of the term "investment adviser," and clear Congressional intent as to the intended broad construction of that term, as noted above, it must then be inquired as to whether any statutory exemption from the definition exists upon which the Commission might rely in enacting the Proposed Rule. The only possible exemptions upon which the Commission could rely, if this Proposed Rule were to be enacted, are those found in: (1) Section 202(a)(11)(C), which explicitly provides the only exemption for broker-dealers, and (2) Section 202(a)(11)(F), which provides the exemption for "such other persons not within the intent of this paragraph." The Proposed Rule does not fit within the broker-dealer exemption.

The Plain Language of the "solely incidental" limitation provides an exception to the application of the Advisors Act only if the advisory services are solely incidental. Exempted from the definition of "investment adviser" under Section 202(a)(11)(C) is "any broker or dealer whose performance of such [investment advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." Hence, the plain language of the broker-dealer exception to the Advisers Act provides an exception to the application of the Advisers Act to brokerage activities only if the advisory services are *solely incidental* to the conduct of the dual registrant's business as a broker. The SEC has provided only limited guidance over the years as to what may constitute "solely incidental" investment advice, thereby permitting the applicability of the Advisers Act to be continually called into question.

The Proposed Rule contemplates that an investment advisory relationship already exists between the client and the dual registrant (i.e., registered representative / investment adviser representative), or that it has previously existed, as the Proposed Rule contemplates that, with respect to the same client or customer, the Advisers Act would only apply to with respect to "those accounts for which it provides services or receives compensation that subject the broker-dealer to the Advisers Act." Hence, the Proposed Rule thereby attempts to restrict the term "solely incidental" only to "accounts." But, under the plain language of the Advisers Act the "solely incidental" advice requirement flows back not to accounts, but is in direct reference to the performance of services by persons – i.e., "any broker or dealer." Stated differently, *one cannot act as an investment adviser, providing investment advisory services (which could often be comprehensive or ongoing in nature), and then provide other advisory services and claim that the other advice is only "solely incidental."* There is simply no logical basis for such a construction of the Advisers Act's limited exemption for broker-dealers. *See* Appendix D for an additional discussion of the "solely incidental" language.

**THE PLAIN LANGUAGE OF THE BROKER-DEALER EXEMPTION DOES NOT APPLY WHEN "SPECIAL COMPENSATION" IS, OR HAS BEEN, RECEIVED BY THE BROKER-DEALER FIRM, AS WOULD OCCUR IF A SEPARATE ADVISORY ACCOUNT EXISTED.** By its terms, the broker-dealer exemption to the application of the Advisers Act applies only when "no special compensation" is received for the advisory services. As stated in the recent *Financial Planning Association vs. SEC* decision of March 30, 2007:

> [T]he plain text of subsection (C) exempts only broker-dealers who do not receive special compensation for investment advice. The word "any" is usually understood to be all inclusive. *See New York v. EPA*, 443 F.3d 880, 885 (D.C.Cir.2006). As '[t]he plain meaning of legislation should be conclusive, except in the `rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters' [citations omitted] the terms of the IAA establish the precise conditions under which broker-dealers are exempt from the IAA. 'To read out of a statutory provision a clause setting forth a specific condition or trigger to the provision's applicability is … an entirely unacceptable method of construing statutes.' *Natural Res. Def. Council v. EPA*, 822 F.2d 104, 113 (D.C.Cir.1987) … By seeking to exempt broker-dealers beyond those who receive only brokerage commissions for investment advice, the SEC has promulgated a final rule that is in direct conflict with both the statutory text and the Committee Reports.[xi] [Emphasis added.]

Hence, should *any* special compensation – i.e., anything other than a commission – be received from the client by the broker-dealer, the broker-dealer exception cannot apply, by its plain language. For example, the receipt of a flat fee, or percentage of assets under management fee, in connection with an advisory account by a dual registrant, would clearly constitute "special compensation," thereby rendering the broker-dealer exemption inapplicable to all accounts of the dual registrant with respect to that client.

By seeking to exempt only brokerage accounts, not brokers, that the Commission will exceed its authority in promulgating the rule under §202(a) of the Advisers Act. This is because Congress has addressed the precise issue at hand. Congress exempted brokers *only when* the broker provides to the customer a very limited amount of advice which is *solely incidental* to the sale of a security and for which *no special compensation* has been received. There is no authority the Commission possesses to except *brokerage accounts* of a customer from the application of the Advisers Act, where that customer is, or has previously, received investment advisory services from the dual registrant and/or his or her firm.

NAPFA notes that it does *not* take the position that a brokerage firm that also is registered as an investment adviser cannot act as an investment adviser only with regard to some clients, and then act only as a broker or dealer with regard to *other customers* of the firm.[xii] However, if an investment advisory relationship is, or has ever been, established with a particular client, neither the firm nor its registered representative is then permitted to maintain a separate brokerage-only relationship with that client. To promote otherwise would permit dual registrants to engage in "bait-and-switch" activities, which have long been criticized by consumer advocates in a broad variety of commercial contexts, and in this context the higher standards of fiduciary conduct apply. By the plain language of the Advisers Act the fiduciary and other protections of the Advisers Act apply to all of the dual registrant's activities with respect to an investment advisory client. "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[xiii]

**APPLYING CONGRESSIONAL INTENT, WHEN "SPECIAL COMPENSATION" IS RECEIVED FOR THE PROVISION OF INVESTMENT ADVICE. THE BROKER DEALER EXCEPTION IS NOT APPLICABLE.** While interpretation of the broker-dealer exemption under its plain language is sufficient, Congressional intent also provides an alternative analysis of the scope of the broker-dealer exemption as it applies to the Proposed Rule. It is clear that Congress intended that when "special compensation" is received from a customer of a broker-dealer firm, the broker dealer exemption to the definition of "investment adviser" under the Advisers Act is not available. As stated in *Financial Planning Association vs. SEC*:

> Very shortly after enactment of the IAA, the SEC advised that any charges directly related to the giving of investment advice would be special compensation. On October 28, 1940, the SEC General Counsel issued an opinion stating … that portion of clause (C) which refers to "special compensation" amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities. 11 Fed. Reg. 10,996 (Sept. 27, 1946) (reprinting SEC General Counsel opinion letter of October 28, 1940). [Emphasis added.][xiv]

As seen, the Commission's general counsel in this very early interpretation of the Advisers Act set forth clearly and succinctly that a broker cannot be excluded from the application of the Advisers Act *merely because* the broker is *also engaged* in effecting market transactions in securities. But this is precisely what the Commission seeks now to do in its Proposed Rule! This aspect of the Proposed Rule is therefore contrary to long-established interpretations by the Commission of the Advisers Act and contrary to the "special compensation" test of the broker-dealer exclusion.

Congress intended that brokers would be subject to the restrictions imposed by the Advisers Act except in very narrowly defined circumstances. The Proposed Rule would eliminate the very safeguards which Congress intended to afford to clients of investment advisers. The Proposed Rule would enable a broker to engage in conduct which is not required to be in the best interests of an investment advisory client. The Proposed Rule would seek to negate the application of the highest standards imposed by law which are required of investment advisers, including the fiduciary duties of due care, loyalty, and utmost good faith, as Congress intended. Moreover, as seen in the *Financial Planning Association vs. SEC* decision, the definition of "investment adviser" is to be broadly applied and the broker dealer exemption is to be narrowly construed, applying the intent of Congress. There is no indication in Congressional intent that certain *accounts* of a client receive the fiduciary protections of the Advisers Act while other *accounts or activities* of the broker do not receive such fiduciary protections.

The Commission attempts to carve out a new exemption from the Advisors Act. Given the broad construction of the definition of "investment adviser" and given the inapplicability of the broker-dealer exemption, as explained above, the Proposed Rule is also inconsistent with a proper construction of the SEC's limited authority to provide further exemptions from the application of the Advisers Act using Section 211(a) of the Advisers Act. The Commission is proposing to amend Rule 202(a)(11)-1 to provide the ability to "remove the fiduciary hat" and to "switch hats" pursuant its general rulemaking authority under Section 211(a)[xv] of the Advisers Act. As seen above, the broker-dealer exemption is inapplicable under its plain language. Hence, the Commission's Proposed Rule attempts to create an impermissible additional exemption for broker-dealers, an action which clearly exceeds the Commission's authority. This is especially clear in light of this clear recent judicial pronouncement delineating the limited authority of the Commission to create exemptions for broker-dealers from the Advisers Act:

> The SEC's invocation of its general rulemaking authority under IAA section 211(a), is likewise to no avail because it suggests no intention by Congress that the SEC could ignore either of the two requirements in subsection (C) for broker-dealers to be exempt from the IAA[citation omitted] … Paraphrasing an apt observation, while, in the SEC's view, '[t]he statute may be imperfect, ... the [SEC] has no power to correct flaws that it perceives in the statute it is empowered to administer. Its [subsection (F) authority and its] rulemaking power[s][are] limited to adopting regulations to carry into effect the will of Congress as expressed in the statute.'[xvi]

The Commission's prior attempt to carve out an additional exemption for broker-dealers was struck down earlier this year by the D.C. Court of Appeals. If, in enacting this Proposed Rule (to exempt certain brokerage accounts from the applicability of the Advisers Act), the Commission were to intend to rely upon Section 202(a)(11)(F), which provides the exemption for "such other persons not within the intent of this paragraph," the Commission would be acting contrary to the express language of a controlling judicial decision which has directly addressed the limits of the authority of the Commission with respect to carving out new exemptions for broker-dealers from the application of the Advisers Act.

**PRIOR INTERPRETATIONS OF THE ADVISERS ACT CLEARLY DENOTE THAT FIDUCIARY STATUS ATTACHES TO THE ADVISER AS A RESULT OF THE *RELATIONSHIP* WITH THE CLIENT.** Prior decisions of the U.S. Supreme Court and the Commission itself reflect the fact that fiduciary duties arise from the existence of a *relationship* between the investment adviser and his or her client, not an account.

1. *Arleen Hughes*: Commission Recognition of the Advisor-Client Relationship of Trust and Confidence.
2. *SEC vs. Capital Gains Research Bureau*: The Delicate Fiduciary Nature of an Investment Advisory Relationship.
3. SEC Release No. 626 (1978), cited in the release, does not support the Commission's position.

Each of these cases is discussed in more detail in Appendix B.

Again, this and many other precedents establish that fiduciary status attaches to the whole of the relationship between the investment adviser and his or her clients. There is no basis in the law to permit a dual registrant to avoid fiduciary status when investment advisory services have been or are being provided simply by denoting the account paperwork as a "brokerage account."

**THE PROPOSED RULE IS CONTRARY TO STATE COMMON LAW, WHICH IS NOT PREEMPTED BY THE ADVISERS ACT. THIS MEANS THERE WOULD BE DIFFERENT FEDERAL AND STATE STANDARDS WHICH IS CONTRARY TO A DESIRE FOR UNIFORMITY IN THE APPLICATION OF SECURITIES LAW.** The Proposed Rule is not in accord with state common law, which imposes fiduciary status where the relationship between the advisor and client is based upon trust and confidence. The common law imposes fiduciary duties and applies them to relationships. There are many recent cases illustrating the application of broad fiduciary duties upon investment advisers, applying not the Investment Advisers Act of 1940, but state common law. State common law, which is not preempted by the Advisers Act,[xvii] continues to apply fiduciary duties to the activities of those who provide investment advice. A few of the more recent cases applying state common law fiduciary duties are discussed in Appendix C hereto.

**IN PRACTICE THERE IS NO REAL END TO A FINANCIAL PLANNING OR INVESTMENT ADVISORY RELATIONSHIP ONCE IT IS BEGUN. THE PROPOSED RULE CONTRIBUTES TO INCREASING CONFUSION FOR THE CONSUMER.** There exist very large and important distinctions between the functions of broker-dealer firms and investment advisory firms. A broker-dealer and its registered representative are engaged in the business of product sales, and the fiduciary duties of the registered representative flow back to its firm. In contrast, an investment adviser functions not as a representative or sales agent of the product manufacturer, but instead acts as a "purchaser's representative" whose primary fiduciary duties are to his or her client. Unfortunately, due to the Commission's past inaction in failing to apply the Adviser's Act to activities that are clearly not "merely incidental" to a sales transaction, and by the Commission's refusal to prohibit the use of descriptive titles of registered representatives which clearly imply a relationship based upon trust and confidence,[xviii] consumer confusion has resulted and continues to this day as to the functions of these wholly different types of financial intermediaries. Appendix E sets forth an illustration of the unintended consequences of the Proposed Rule.

**THE PROPOSED RULE WOULD PERMIT DUAL REGISTRANT FIRMS TO SEEK A CLIENT'S WAIVER OF FIDUCIARY DUTIES, WHICH IS PROHIBITED BY SECTION 215 OF THE ADVISERS ACT.** Section 215(a) of the Advisers Act provides: "**(a) Waiver of compliance as void.** *Any* condition, stipulation, or *provision* binding any *person* to *waive compliance* with any *provision of this subchapter* or with any rule, regulation, or order thereunder shall be void." [*Emphasis added.*]

1. **The Advisers Act Voids Waiver of Fiduciary Duties, Under Its Plain Language.** As emphasized above, Section 215(a) voids *"any … provision …* (which seeks to) … *waive compliance with any provision … of this subchapter*." In essence, the Proposed Rule would seek to permit a dual

registrant to advise or request a client of an investment adviser to waive rights which attach to the relationship between the fiduciary and his or her client, in order to be governed by far lesser standards, in direct contravention of the plain language of 215(a).

2. **<u>The Proposed Rule Would Permit Dual Registrants To Ask Clients To Negotiate Away Their Rights, In Contravention of Recent Statements by the Commission Staff.</u>** In essence the Proposed Rule would permit dual registrants to seek to have clients waive their important rights granted under Section 206 and other provisions of the Advisers Act, which is expressly not permitted under Section 215(a). As recently explained by Robert E. Plaze, Associate Director, Division of Investment Management: "The [fiduciary] duty [of an investment adviser] is not specifically set forth in the [Advisers] Act, established by SEC rules, or a result of a contract between the adviser and the client (*and thus it cannot be negotiated away*). "[xix] [*Emphasis added.*] Mr. Plaze also noted that "[t]he [Advisers] Act voids any provision of a contract that purports to waive compliance with any provision of the Act. The SEC staff takes the position that an adviser that includes any such provision in a contract misleads its clients in violation of the Act's anti-fraud provisions by creating in the mind of the client the belief that a legal right or remedy under the Act is not available."[xx] Yet, by this Proposed Rule, the Commission would seek to negate the important protections provided to consumers under Section 215(a).

3. **<u>Rights Conferred by the Advisers Act But Which Affect The Public Interest Cannot Be Waived.</u>** The U.S. Supreme Court has held that rights conferred upon a private party but affecting the public interest cannot be waived, as such waiver "would thwart the legislative policy which it was designed to effectuate."[xxi] The fact that the public interest is advanced through the imposition of fiduciary standards of conduct upon relationships between investment advisers and their clients is clear. Indeed, the "Findings" set forth by Congress at the beginning of the Advisers Act state that "it is found that investment advisers are of national concern, in that … the foregoing transactions occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system and the national economy."[xxii]

   The clear public purpose of the Advisers Act, to promote participation in the capital markets and to thereby empower the national economy, was alluded to by Professor Tamar Frankel, for many years a leading authority on fiduciary law: "Americans are trusting and, some would say, gullible people. State securities laws are called 'Blue Sky laws' for a reason: the legal system presumes that Americans would buy anything, including the Blue Sky. In some countries those who save their money do not trust the securities markets or even the banks. They invest their savings in non-productive assets, like gold, to the detriment of the countries' economies."[xxiii] Professor Frankel added that "it seems that the policies underlying the Securities Acts are based on a number of assumptions: First, the viability of the securities markets depends on the participation of small investors. Second, small investors will withdraw from the markets not only, or necessarily, when they sustain serious losses, but also, or even mainly, if they perceive these losses to be the result of an unfair market system. Even people who are willing to gamble will not play with the other players' loaded dice and when the rules of the game are rigged in favor of others. Thus, among other things, investor protection is designed to assure the existence of a fair securities market - a system that would give small investors a fair chance against large investors, corporate insiders, and market intermediaries. Third, the integrity and fairness of the securities markets as institutions cannot be left to individual investors. It is too precious, and too vulnerable. Therefore, *the protection of the Securities Acts must be made mandatory, and their waiver should be prohibited*."[xxiv] [*Emphasis added.*]

In enacting Section 215(a), Congress did not wish to allow an investment adviser to be able to induce his or her client to opt out of the securities law protections that the Advisers Act provides. In discussing the anti-waiver provisions of the federal securities laws, Professor Welle noted: "By prohibiting fraud and mandating disclosure, the securities laws protect investors and promote honesty, trust, and ethical behavior in commercial transactions. The securities laws set standards that serve to socialize, to educate, and to direct individuals toward more morally appropriate forms of behavior. The anti-waiver provisions and the mandatory nature of the securities laws send a strong signal that certain behavior will not be tolerated in any transaction involving a security."[xxv]

Clearly, then, the private rights of clients which are provided by the fiduciary duties imposed upon investment advisers by the Advisers Act affect the public interest, and hence are incapable of waiver, whether by contract or even by any attempted rule adopted by the Commission (which would be subordinate in its legal effect, of course, to the Advisers Act).

4. **<u>Under General Principles of Fiduciary Law, Mandatory Fiduciary Duties Are Not Waivable.</u>** Other general principles of law which prohibit the waiver of protections afforded to clients of fiduciaries, under state common law, can be discerned by a review of the writings of legal scholars in this area of the law.

    a. <u>Professor Frankel: Fiduciary Duties Are Not Waivable For Various Reasons.</u> Professor Tamar Frankel, for long the leading American scholar on fiduciary law, has written: "[C]ircumstances exist where fiduciary duties are not waivable for reasons such as doubts about the quality of the entrustors' consent (especially when given by public entrustors such as shareholders), and the need to preserve institutions in society that are based on trust. Further, non-waivable duties can be viewed as arising from the parties' agreement ex ante to limit their ability to contract around the fiduciaries' duties.

Under these circumstances fiduciary rules should generally be mandatory and non-waivable."[xxvi]

b. Professor Berg: Questions of Automony Exist When Waiver Is Sought, and In Such Instances Waiver May Not Be Permitted. "To the extent that fiduciary obligations are imposed to ensure efficiency in specialized exchanges, conflicts of interest may not be waivable."[xxvii] Professor Berg also notes: "Waivers of safeguards that have been put in place to promote descriptive autonomy, such as those designed to remedy disparities in bargaining power between the parties [are] [o]ften created as statutory requirements … they are designed to grant rights to the weaker party in the transaction, and therefore genuine questions of autonomy are raised when that party seeks to waive the protection."[xxviii]

c. Professor Frankel: Waivers Not Permitted When Our Financial System Is Put At Risk. "[T]he legal system should be concerned with maintaining investor trust both in corporate management and other financial intermediaries who are the investors' fiduciaries. Allowing the tinkering with the model of fiduciaries may erode trust. Therefore, waivers of fiduciaries' duties should not be allowed where our financial system can be at risk."[xxix]

d. Professor Frankel: Parties Should Not Be Able To Reclassify Their Relationship. "Allowing the parties to determine the categories of laws that apply to their relationship would undermine the enforceability of mandatory rules. If we wish to maintain mandatory rules, then the parties should not be allowed to reclassify them as default rules."[xxx]

5. **Voluntary Waivers of Rights Are Highly Suspect When Applying Mandatory Rules.** As noted in the academic literature discussing the nature of fiduciary duties, waivers of rights granted to clients of fiduciaries are highly suspect, despite assertions by some in the securities industry to the contrary.[xxxi]

> *Waive* (vb.): [T]o abandon, renounce, or surrender (a claim, privilege, right, etc.); to give up (a right or claim) voluntarily.[xxxii]

"[I]n fiduciary relationships fraud cannot easily be proved. In such situations, it may be more efficient to make the terms of the arrangement, such as the duty of loyalty, mandatory. Arguably, it is reasonable to assume that by their very entry into fiduciary relationships the parties have agreed in advance to limit their power to waive fiduciary duties. To the extent that we believe rational entrustors would not otherwise enter the relationship, it is important to make mandatory the fiduciary duties protecting them."[xxxiii]

It should also be noted that the harm which will result from the Proposed Rule will likely affect most those who need the very protections which fiduciary standards of conduct promote. "The most fraudulent actors are the most likely to include such disclaimers and integration clauses in their contracts and the most inexperienced investors are the most likely to sign them without protest. Congress clearly intended to protect those innocent investors."[xxxiv]

**AN ADVERSE ECONOMIC IMPACT UPON INVESTMENT ADVISERS EXISTS, DUE TO DIFFERENCES IN FEDERAL AND STATE LAW.** Given that state common law clearly finds broad fiduciary duties to exist for investment advisers on the basis of their relationship with the client, while the Commission's Proposed Rule would focus on the type of account, a substantial disparity in the law, and the standards of conduct imposed upon dual registrants, will often exist. Registered representatives who might attempt to rely upon the Proposed Rule and not adhere to fiduciary duties, but rather only adhere to the lower suitability standard, may well find that their actions (from the standpoint of both state regulation and enforcement and civil liability to their customers) will fall far short of the level of conduct required to adhere to the fiduciary standards of due care, loyalty and utmost good faith.

**Note: There Is No Preemption of State Regulators' Authority To Enforce Anti-Fraud Rules (and Hence Fiduciary Duties) Against Investment Advisers and Their Representatives.** Despite preemption of state authority on securities regulation in some areas by NSMIA, state regulatory authority with respect to regulation against fraudulent sales or advisory activities was retained. This was made clear by the recent decision of *Capital Research and Management Company v. Brown*.[xxxv] Hence, even if the Commission continues down its path to refuse to apply the Advisers Act broadly, as Congress intended, to investment advisory activities not solely incidental to brokerage transactions, the various state securities administrators may seek to enforce their own state statutes and state common law imposing fiduciary status to prohibit dual registrants from engaging in the practices of "removing the fiduciary hat" and "switching hats" with respect to any specific client of that dual registrant.

**EVEN IF WAIVER OF FIDUCIARY STATUS WAS PERMITTED BY THE ADVISORS ACT, THE PROPOSED RULE FAILS IN THAT IT DOES NOT REQUIRE FULL DISCLOSURE AND INFORMED CONSENT TO A CHANGE OF FIDUCIARY STATUS.** While there is much legal authority, as noted above, for the conclusion that fiduciary status cannot be removed in the context of the relationship of trust and confidence between an investment adviser and his or her client, outside of the securities law context there are situations in which waiver of fiduciary duties may occur. However, even in such situations fiduciary law still requires, at a minimum, clear and complete disclosure of all material facts and informed consent prior to any change from fiduciary to non-fiduciary status.

Fiduciaries in many professions are required to provide meaningful disclosure to their clients and to obtain the informed consent of their clients for the waiver of a conflict; this is a logical restriction upon fiduciaries which arises as a result of their honored position and status as fiduciaries. As explained in the recent U.S. Court of Appeals case of *Huber vs. Taylor*, U.S.Ct.App., 3rd Circuit (Oct. 31, 2006): "This is the cost of doing business as an attorney at law, and we will not countenance shortcuts. Disclosures to clients must be meaningful, by which we mean something beyond form disclosures, as clients must understand a conflict to give their informed consent to an intelligible waiver."[xxxvi]

Accordingly, even if waiver of fiduciary status were permitted under the Advisers Act (which it is not), the Proposed Rule also fails to meet the fiduciary duty requirements of the Advisers Act and state common law as it fails to require complete disclosure of all material facts relating to the switch of status (from fiduciary to non-fiduciary), followed by informed consent. Furthermore, and inexplicably, there is no requirement in the Proposed Rule for a mandatory form of disclosure.

Moreover, even if the Proposed Rule adequately set forth appropriate language to effect a meaningful disclosure, it is unlikely that informed consent would be provided by the vast majority of individual investor. The reasons for this are explored in Appendix F.

**THE PROPOSED RULE ADVERSELY IMPACTS CONSUMERS OF FINANCIAL PLANNING AND INVESTMENT ADVISORY SERVICES, WHICH IS NOT CONSIDERED IN THE PROPOSED RULE'S COST-BENEFIT ANALYSIS.**

Contrary to the assertions by some broker-dealer firms, it is the experience of NAPFA members that consumers receiving investment advice under a fiduciary relationship possess, on average, far fewer "total fees and costs" relating to their investment products (including the often-hidden transaction and opportunity costs found within many pooled investment vehicles) and the receipt of advisory services than those who receive advice from registered representatives. This is because fiduciary advisers act not as product salespeople but rather as "purchaser's representatives." Free of the inherent conflicts of interest in selling commission-based products (i.e., the higher the commission, nearly always the more expensive the product and the higher the compensation to the broker-dealer and/or his firm, to the detriment of the customer), fiduciary advisers are free to search out much lower-cost investments for their clients.

The common result of the receipt of investment advice from a fiduciary is disintermediation – a substantial reduction in the diversion of the returns the capital markets have to offer to financial intermediaries – in favor of a higher delivery of returns to individual investors. The Commission, through this Proposed Rule, if it should be adopted, would provide a substantial hurdle to these forces of disintermediation. The Proposed Rule fails to consider this adverse economic effect.

Moreover, the continued abuse of consumers by product salespeople who push equity-indexed annuities, costly variable annuities, and other highly expensive and often inappropriate products, especially with respect to our senior citizens, will continue should this Proposed Rule be adopted. As such abuses are uncovered and revealed to individual consumers, some consumers will flee altogether participation in many of the capital markets. This departure of capital from a market decreases the supply of capital, thereby jeopardizing economic growth, which then leads to a poorer economic future for Americans. This is not just a theoretical event – NAPFA members have observed the departure of individuals (who were sold highly expensive investment products by product salespeople) from the capital markets because they believe that the "system" is designed to benefit not the consumer, but instead only protects the interests of the many layers of financial intermediaries. Again, the Proposed Rule fails to consider this adverse and substantial economic effect.

**THE PROPOSED RULE ADVERSELY AFFECTS THE ECONOMIC INTERESTS OF INVESTMENT ADVISORS AND FINANCIAL PLANNERS, WHICH IS NOT CONSIDERED IN THE PROPOSED RULE'S COST-BENEFIT ANALYSIS.** Despite the Commission's statement that this section of the Proposed Rule would likely possess no economic impact upon investment advisers,[xxxvii] it is clear that a substantial adverse economic impact exists upon the profession of investment advisers and the emerging profession of financial planning, as explained by the following observations:

> "Since fiduciary relations are important in our society, the law should provide incentives to encourage potential fiduciaries and entrustors to enter into the relation. Prospective entrustors might refrain from these relations if the risks of abuse of power outweigh the expected benefits."[xxxviii]

Furthermore, should others be permitted to hold themselves out as trusted advisors to their clients, but then engage the consumer as a financial intermediary not governed by the professional standard of conduct to put the client's best interests first, the increased marketability of the investment adviser or financial planner would be thwarted. As the 2002 FPA White Paper by Professor Macey observed:

> Each financial planner has incentive to develop and maintain a reputation for honesty and competence in order to increase the demand for his services. All financial planners suffer when the reputation of the profession suffers because consumers are unable to distinguish between high-quality services of ethical or competent financial planners and low-quality services of unethical or incompetent financial planners. This, in turn, reduces the market's demand and willingness to pay for financial planners. The practical implications of this basic problem, described by economists as "information asymmetry" because of the fact that consumers have less information than producers (and therefore the distribution of information between the sellers of services and the buyers of services is asymmetric) are important for the future of any industry or profession … The general problem was first described in a famous article by George Akerloff,[xxxix] in which he showed what would happen to an industry if consumers were unable to distinguish between high quality producers and low quality producers. The consequences of this problem are far more severe than may appear at first blush. The structure of the problem can be

> described with reference to the financial planning profession as follows: suppose, for the sake of clarity and simplicity, there are only three types of financial planners, excellent quality planners, whose work is worth $900 per hour, medium quality financial planners, whose work is worth $300 per hour, and low quality financial planners, whose work is worth minus $300 per hour because of the costs that such planners impose on their clients through incompetence and fraud. Imagine further that consumers are unable to differentiate among these various types of financial planners until after they have received their services. They don't know whether the advice they are getting is of high, medium or low quality until they have purchased the advice. Where this is true, economists have shown that the products all will sell for the same price, because consumers who pay more than the standard market price still will be unable to increase the probability that they are receiving high quality advice.

The Proposed Rule fails to consider these substantial and detrimental long-term effects on the investment advisory and financial planning professions, even though Congressional intent clearly demonstrates that one of the two main purposes of the Advisers Act was to create and maintain a true profession of investment advisers.

**<u>THE PROPOSED RULE IS POOR PUBLIC POLICY IN THAT IT ADVERSELY IMPACTS THE ECONOMIC INTERESTS OF THE UNITED STATES.</u>**

1. **<u>The fiduciary principles which form the foundation of the Investment Advisers Act of 1940 are more relevant in today's modern financial world, not less so</u>**. The world is far more complex for individual investors today than it was in 1940. There exists a broader variety of investment products, including many types pooled and/or hybrid products, and such products employ a broader range of investment strategies. The explosion of investment products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor's portfolios. Furthermore, as investment vehicles have proliferated, individual investors are challenged to discern an investment product's true "total" fees, costs, investment characteristics, tax consequences, and risks. Also, U.S. tax laws have increasingly become more complex, presenting both opportunities for the wise through proper planning, but also traps for the unwary.

   As the sophistication of our capital markets, as well as portfolio construction and management methodologies, have increased, so has the knowledge gap between individual consumers and knowledgeable financial advisors. Investment theory continues to evolve, with new insights gained from academic research each year. In constructing an investment portfolio today a financial advisor must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

The fact that this evolution has occurred, and its potential for greater (not lesser) application of fiduciary standards of conduct, has not gone unnoticed:

> "Early in [the 20th Century, a person giving advice with respect to investing in securities would have been subject to little, if any, systematic regulation. However, in the 1930's … Congress determined that the investment advisory industry … warranted additional scrutiny and oversight. The result was the Investment Advisers Act of 1940 … During this period, and in the years since, states also determined to bring investment advisers under increasing regulation … The numbers and types of investment advisers have increased dramatically since the Advisers Act was initially adopted. This fact, along the phenomenal success of mutual funds, the rapid development of the financial planning industry, the increasing popularity of hedge funds, and the enormous growth in pension plan assets (particularly in defined contribution plans where participants have a great degree of responsibility for choosing investments), *ensures an increasingly influential role for investment advisers in the financial markets*. As a result, regulation of investment advisers at both the federal and state level assumes a correspondingly greater importance."[xl] [*Emphasis added.*]

The Proposed Rule would cast aside fiduciary principles in favor of a far lesser regime. Facing a more complex world, investment consumers would be faced with less protection from those with far superior knowledge of the inner workings of the securities industry, instead of the much-needed greater protection investors deserve in navigating the modern financial world.

2. **<u>Contrary to the assertions of the broker-dealer industry, consumer choice Is not affected.</u>** There is an argument made by some in the securities industry that "consumer choice" should be preserved. NAPFA agrees - investors should have a choice. They should be able to deal directly with a product manufacturer's representative, such as a broker-dealer, and they should also be able to deal with someone who provides financial planning and investment advisory services to them – a trusted fiduciary. But to permit broker-dealers to provide financial planning advice and investment advisory services (other than product-specific recommendations which are incidental to a sales transaction, not involving the provision of investment advisory services), without fiduciary duties being applied, results not in a lack of consumer choice but rather results in consumer confusion. Simply put, the argument to preserve "consumer choice" is a red herring. That choice exists. It merely requires a uniform fiduciary standard of conduct for all those who desire to enter into relationships of trust and confidence with investment consumers. What the "consumer choice" argument is really about is preserving not choice, but preserving, and furthering, consumer confusion and the profits of the broker-dealer industry

3. **<u>The economic future of The United States and its citizens would be adversely affected.</u>** Proper financial planning is essential to encourage both an increase in household savings and in order to invest those funds more effectively. If people do not make careful, rational decisions about

how to provide for their financial security over the course of their lifetimes, then the government will have to step in to save people from the consequences of their poor planning.

The non-application of fiduciary duties will serve to minimize the availability of objective, trusted advice, and hence endanger the quality of investment advice provided to Americans. Conflicted advice in turn leads to poor financial planning decision-making, endangering the financial futures of more and more of our fellow U.S. citizens. Hence, the Proposed Rule, if enacted, will therefore endanger the economic future of our fellow citizens and the economic future of America itself. [xli]

4. **The fiduciary standard will be eroded, to the detriment of all fiduciaries.** If the Commission were to enact the Proposed Rule, the Commission would continue down a course of action which permits the fiduciary standard of conduct – the highest standard under the law - to be eroded by more particular exceptions. The adverse effects of such a errant course were forecast by Chief Justice Benjamin Cardoza, when he warned against such actions nearly 80 years ago in his famous passage in *Meinhard vs. Saloman*.[xlii] In essence the Proposed Rule would take fiduciaries – who should always be those governed by the highest standards under the law – and create something lesser and different. The erosion of the high standards of fiduciary conduct possesses adverse implications for fiduciary law which reach far beyond the halls of federal securities regulation. Moreover, a different "class" of fiduciary would be created. What do we call them? "Part-time fiduciaries?" "Lesser fiduciaries?" Or, as would be proper – should we not call them fiduciaries at all, but a wholly different name – for no customer of a dual registrant who could "switch hats" upon a whim could in fact rely upon the dual registrant to remain a trusted, objective investment adviser.

**THE SEPARATE ISSUE OF DIFFERENTIAL RATES OF BROKERAGE COMMISSIONS WHEN ADVISORY SERVICES ARE PROVIDED: THE ADVISORS ACT APPLIES.** NAPFA is also concerned about the section of the Proposed Rule which sets forth that "special compensation" would not be received by a broker-dealer firm by charging a higher commission for "full service brokerage" services while charging lower commissions for discount brokerage services. This aspect of the Proposed Rule reverses the Commission's long-standing position to the contrary, and will also lead to situations wherein the Advisers Act is not applied as it should be to the activities of broker dealer firms. While the Commission and its staff have historically drawn the line between broker-dealer and investment adviser activity primarily by focusing on the form of compensation rather than the substance of a broker-dealer's activity, NAPFA is concerned about the Commission's continued reluctance to define "incidental advice" in the context of the broker-dealer exemption. Historically, investment advice by registered representatives at the time of the enactment of the Advisers Act was limited to product-specific recommendations. Changes which began occurring in the late 1960's were accelerated in 1975 with demise of fixed commission rates for sales of securities. Before broker-dealer firms had emphasized, as their "incidental advice," their research recommendations and reports about general economic conditions.

This narrow focus of broker-dealer activities in the early decades following the enactment of the federal securities laws was explained in 1963 in a report issued by the Commission:

> The predominant concern of the securities industry is the sale of securities, and in pursuit of this activity members of the industry make use of many of the standard techniques of merchandising … Public investors are attracted to securities markets through the extensive use of sales promotion activities, which include advertising in almost all media of communication as well as market letters, research reports, lectures, and even investor contests. In style and emphasis these range from the 'institutional' approach to the highly flamboyant, and the former is not necessarily the exclusive domain of the more conservative firms. Whatever style is used, one of two themes predominates: the trust and confidence which the customer should place in the firm because of its superior research facilities and experience, or the potential profits to be reaped by investors from the purchase of its merchandise[xliii] … Most of the published material distributed by broker-dealers is in one of two general categories: brief 'market letters' and longer 'research reports.'[xliv]

As further evidence of the limited activities of broker-dealer firms in the early decades following the enactment of the Advisers Act, in 1982 former SEC Commissioner John R. Evans stated: "Until recently, securities firms were not active in creating new investment vehicles that were similar to traditional banking or insurance services. However, faced with increasing competition in securities activities from other financial institutions, and the cyclical volatility of securities markets, major securities firms have diversified into other related financial services such as insurance, real estate, and financial planning …."[xlv]

Moreover, in the very recent decision of *Financial Planning Association vs. SEC*, the U.S District Court of Appeals noted the long-standing interpretation of "special compensation" by the SEC when it stated:

> Very shortly after enactment of the IAA, the SEC advised that <u>any charges directly related to the giving of investment advice would be special compensation</u>. On October 28, 1940, the SEC General Counsel issued an opinion stating:
>
>> Clause (C) of section 202 (a) (11) amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause (C) which refers to "special compensation" amounts to an equally clear recognition that a broker or dealer who is <u>specially compensated for the rendition of advice</u> should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities.

> 11 Fed. Reg. 10,996 (Sept. 27, 1946) (reprinting SEC General Counsel opinion letter of October 28, 1940). Thus, any charges "directly related to the giving of advice" would be special compensation. *Id.*
>
> This contemporary interpretation was reflected as well when the SEC addressed two-tiered pricing arrangements (including a discounted fee arrangement) in 1978:
>
>> [I]f a broker-dealer has in effect, either formally or informally, two general schedules of fees available to a customer, <u>the lower without investment advice and the higher with investment advice</u>[,] and the difference is primarily attributable to this factor . . . the [SEC] would regard the extra charge as "special compensation" for investment advice.
>
> 43 Fed. Reg. 19,224, 19,226 (May 4, 1978). The SEC made clear at the time that "[t]his would be the case even in a situation, currently nonexistent, in which a current 'full service' firm implements a 'discount' or 'execution-only' service." *Id.*; *see also Townsend & Assocs., Inc.*, SEC No-Action Letter, 1994 SEC No-Act. LEXIS 739 (Sept. 21, 1994); *Am. Capital Fin. Servs., Inc.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2209 (Apr. 29, 1985).[xlvi] <u>[Emphasis added.]</u>

Given this recent pronouncement by the D.C. Court, it is again curious why the Commission acts in contravention of these observations of the Court, in addition to contravening decades of its own pronouncements, by hastily re-proposing this aspect of the Proposed Rule and providing only a limited time for comments thereon.

Additionally, NAPFA notes that the "differential brokerage commissions" aspect of the Proposed Rule also impacts financial planning as an investment advisory service, since higher brokerage commissions would provide the additional special compensation for firms to provide "free" financial planning services (thereby, under their arguments, avoiding the "special compensation" restriction of the broker-dealer exemption). NAPFA further notes that the Commission declined in Release No. IA-2652 to opine further about whether and when financial planning activities are subject to the Advisers Act, given the pending receipt of the RAND Corporation study. It is only logical that all of these issues, which are inter-related, be considered carefully and at the same time, and following a liberal period of time for review of the RAND Corporation's study, analyses and submission of comments.

Again, given the limited amount of time provided by the Commission between the publication of the Proposed Rule and the deadline for comments, and the importance to consumers of both the "two hats" and "differential brokerage compensation" issues presented by the Proposed Rule, NAPFA suggests that more time could be given by the Commission for interested parties to consider the Proposed Rule and its potential adverse impacts upon investment consumers.

## IN CONCLUSION

Federal and state securities laws with regard to the fiduciary duties of investment advisers, and those engaged in activities which are investment advisory in nature, continue to diverge in two major ways. First, the Commission continues, to the detriment of individual investors, to seek to restrict the reach and application of the Advisers Act, despite governing legal precedent stating that the term "investment adviser" is to be broadly construed and despite Congressional intent to this effect. In contrast, state common law, in recognition of the high degree of knowledge and expertise required to successfully navigate the increasingly complex financial markets, continues to apply broad fiduciary duties of due care, loyalty, and utmost good faith upon investment advisers, financial planners, and those who hold themselves out as performing such functions, in recognition that relationships based upon trust and confidence are formed. Second, the Commission continues to advance rules or positions which would either permit a waiver of fiduciary duties or particular exceptions to them. Hence, federal securities law, as applied by the Commission, proceeds down a path of evolution toward the creation of a federal fiduciary standard of conduct which falls far below state common law fiduciary principles – in essence creating a class of "sub-fiduciaries."

Recent comments[xlvii] by certain Commissioners themselves, to the effect that securities regulation should be conformed to current industry practices, seem altogether at odds with the concept that the industry should conform to the law which governs it, not the other way around. It also denotes a focus not on protecting the interests of the individual investor through the application of the highest standards of conduct provided by law, as was intended by the Advisers Act, but rather a focus on doing what many large broker-dealer firms desire in their quest to preserve their profits (in a changing financial services industry and more complex financial world in which consumers increasingly desire not to deal with product salespeople but with trusted investment advisory services). NAPFA is reminded of this excerpt from a 2004 speech given by Lori Richards, Director, Office of Compliance Inspections and Examinations: "[M]y colleague Steve Cutler, the Director of the SEC's Enforcement program, spoke about the 'conflicts crisis' on Wall Street. He said that one of the lessons of the research analyst matter – and I will add to that, a lesson too from the current mutual fund scandal - is that it illustrates that just because a certain way of doing things seems to be industry practice, it doesn't mean that this is the correct way to do things."[xlviii] The world has changed, and the result of these changes is a greater need to protect individual investors. Despite this, the Proposed Rule pursues and opposite course, and substantially lessens consumer protections.

Disintermediation, a powerful force which has transformed many industries, will be thwarted by an application of an ill-advised federal regulation which serves not to advance a better future but rather to preserve a conflict-ridden product sales industry. As a result consumers will continue to see far too large a portion of the returns of the capital markets diverted and consumed by financial intermediaries.

At the same time the profession of investment advisers is undermined, and the emerging profession of financial planning suffers serious setbacks.

Now is not the time for the Commission to abandon the fiduciary protections which are so important in our modern society. NAPFA urges the Commission to rescind the Proposed Rule and adopt, in its place, a rule which will make clear to all securities industry participants and consumers that those who seek by representations or actual action to place themselves in relationships based upon trust and confidence, and provide investment advice, are at all times governed by the fiduciary duties of due care, loyalty, and utmost good faith in their relationship with the client.

The National Association of Personal Financial Advisors thanks the Commission for the opportunity to submit these comments. As the nation's leading organization of fiduciary financial advisors, we are available to respond to questions or submit further comments as the Commission may desire.

Respectfully,

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**Appendix A: The Proposed Rule Is, In Fact, Controversial**

While the Proposed Rule is advanced as a "re-proposal" of certain non-controversial portions of the "Merrill Lynch Rule"[xlix] which were not overturned by the holding in the recent *Financial Planning vs. SEC* decision, the "dual hats" aspect of the Proposed Rule is far from being non-controversial. While many comments were filed with regard to the specific issue of fee-based accounts raised by the Merrill Lynch Rule, former Rule 202(a)(11)-1(c) may have been overlooked by many commentators at that time, and to some extent in the litigation that ensued, due to the magnitude of the specific issues relating to fee-based accounts. Additionally, lack of understanding of the impact of part 1(c) by readers of the former release may be due to the following statement found in the 2005 issuing release which appears to negate the effect of part 1(c): "Our rule [Section 202(a)(11)-1(b)(1)] contains a provision that *a broker-dealer that separately contracts with a customer for investment advisory services (including financial planning services) cannot be considered to be providing advice that is solely incidental to its brokerage. A separate contract specifically providing for the provision of investment advisory services reflects recognition that the advisory services are provided independent of brokerage services and, therefore, cannot be considered solely incidental to the brokerage services*."[l] This statement appears to contradict, and even negate, the provisions of former Rule 202(a)(11)-1(c), consequently unintentionally misleading many observers and causing them to overlook the dilatory effects of part 1(c) at the time the Merrill Lynch Rule was enacted.

Also, the ability to maintain "separate" brokerage accounts (not governed by the Advisers Act) and investment advisory accounts (governed by the Advisers Act and its imposition of fiduciary duties), at the same time and for the same client or customer, was obscured in responses to the issuing release as a result of the extremely controversial[li] interpretation by the Commission of the "solely incidental" requirement in adopting the Merrill Lynch Rule. This second key aspect of the Merrill Lynch Rule (the main point of contention being the existence of fee-based accounts) continues to generate substantial controversy.

It should be noted that, while not directly addressing the former Rule 202(a)(11)-1(c), the U.S. Court of Appeals nevertheless made clear earlier this year that "the text and structure of paragraph of 202(a)(11) make it evident that Congress intended to define "investment adviser" *broadly* and create *only a **precise** exemption* for broker dealers."[lii] [***Emphasis added***.] It is curious that the Commission now acts to create another exemption for broker-dealers (for, as explained herein, the "dual hats" aspect of the Proposed Rule cannot be justified under any reasonable reading of the broker-dealer exemption to the application of the Advisers Act nor by Congressional history), in contravention of the recent pronouncement of the U.S. Court of Appeals.

**Appendix B: Discussion Of Case Law: Prior Interpretations Of The Advisers Act Clearly Denote That Fiduciary Status Attaches To The Adviser As A Result Of The *Relationship* With The Client.**

1. ***Arleen Hughes*: Recognition of the Relationship of Trust and Confidence.** In a very early case applying the Advisers Act, the Commission itself stated:

   > The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice "in almost every instance." This reliance and repose of trust and confidence, of course, stem from the *relationship* created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis -- learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities -- *cultivates a confidential and intimate relationship* and imposes a duty upon the registrant to act in the best interests of her clients and to make only such recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. [*Emphasis added*.][liii]

   Note that very shortly after this case was decided, the Commission's legal counsel stated, in determining which doctrine or standard of conduct to apply, "it is necessary to decide whether a firm is acting in a particular transaction as a dealer pure and simple or as a fiduciary. In some cases, as in the Arleen Hughes case itself, the answer is easy: *A firm which is registered as an investment adviser, and which admittedly renders investment advice with respect to the same transactions in which it purports to act as principal, can hardly deny its fiduciary status*."[liv] [*Emphasis added.*] Similarly, once investment advice is rendered to a client, such as the formulation of an asset allocation plan, all recommendations which follow from the investment advice are provided by a dual registrant under its status as a fiduciary.

   Investment advisory services today cover the entire gamut of a client's portfolio, and investment advisers must consider all of the assets of a client (in order to adhere to the duty of due care in undertaking the analyses required to provide investment advice). Following the provision of investment advice of a nature which is not solely incidential to the sale of an investment product, a dual registrant should not then be able to sell specific investment assets, which relate directly or even indirectly to the advisory services provided, under a standard of conduct which is not that of a fiduciary.

2. ***SEC vs. Capital Gains Research Bureau*: "The Delicate Fiduciary Nature of An Investment Advisory Relationship."** In this landmark U.S. Supreme Court decision the Court stated:

   > Although certain changes were made in the bill following the hearings, there is nothing to indicate an intent to alter the fundamental purposes of the legislation. The broad

> proscription against 'any … practice … which operates … as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end. And the Committee Reports indicate a desire to preserve "*the personalized character* of the services of investment advisers," and to eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors" and to "bona fide investment counsel.' The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the *delicate fiduciary nature of an investment advisory relationship*,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested. [*Emphasis added*.][lv]

Again, this and many other precedents establish that fiduciary status attaches to the whole of the relationship between the investment adviser and his or her clients. There is no basis in the law to permit a dual registrant to avoid fiduciary status when investment advisory services have been or are being provided simply by denoting the account paperwork as a "brokerage account."

3. **SEC Release No. 626 (1978) Does Not Support the Commission's Position.** The Commission has traditionally viewed the Advisers Act as applying only to those clients to whom a registered broker-dealer provides investment advice that is not incidental to brokerage services or for which the firm receives special compensation. While the Proposed Rule cites, at fn. 27, Advisers Act Release 626 as a "long-standing interpretation" in support of the Commission's position that "accounts" is where the distinction lies, that release notes only that the SEC has recognized that "[t]he *relationship* of a broker or dealer to his brokerage customers does not become an investment advisory *relationship* merely because the broker or dealer is a registered investment adviser …."[lvi] [*emphasis added*]. By the Proposed Rule the SEC has attempted an incorrect construction of not only the law and Congressional intent, but also of its own prior interpretations of the Advisers Act.

4. **<u>Appendix C: Discussion Of Case Law: The Proposed Rule Is Contrary To State Common Law, Which Is Not Preempted By The Advisers Act. This Means There Would Be Different Federal And State Standards Which Is Contrary To A Desire For Uniformity In The Application Of Securities Law.</u>** There are many recent cases illustrating the application of broad fiduciary duties upon investment advisers, applying not the Investment Advisers Act of 1940, but state common law. A few of the more recent cases applying state common law fiduciary duties include:

*Graben* (2007). A dual registrant crossed the line in "holding out" as a financial advisor, and in stating that ongoing advice would be provided, and other representations, and in so doing the dual registrant, who sold a variable annuity, and was found to have formed a relationship of trust and confidence with the customers to which fiduciary status attached. "Obviously, when a person such as Hutton is acting as a financial advisor, that *role* extends well beyond a simple arms'-length business transaction. An unsophisticated investor is necessarily entrusting his funds to one who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his investor/entrustor. The *relationship* goes well beyond a traditional arms'-length business transaction that provides 'mutual benefit' for both parties." *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007). [*Emphasis added.*]

*Sergeants Benevolent Assn. vs. Renck* (2005). The provision of advice regarding asset allocation, portfolio manager selection, investment objectives, and investment guidelines, and holding out as experienced in the field of investment consulting and management, was held by a New York state court to be sufficient to raise a factual issue regarding the existence of fiduciary *relationship* based upon trust and confidence. *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 4430 (NY 6/2/2005) (NY, 2005).

*Fraternity Fund* (2005). A federal court, applying New York state law, found that the customer "relied upon superior knowledge. Asset Alliance allegedly was plaintiff's investment advisor and committed to 'monitor the status and performance of [Beacon Hill and Bristol] at least once a month and [to] promptly inform Sanpaolo if, for any reason, it believes that [Beacon Hill or Bristol] should be de-selected.' These allegations are sufficient to plead a *fiduciary relationship*." Fraternity Fund v. Beacon Hill Asset, 376 F.Supp.2d 385, 414 (S.D.N.Y., 2005). [*Emphasis added.*]

*Mathias* (2002). "In the fall of 1985, plaintiff, having recently divorced and relocated to Columbus, Ohio, sought investment advice from Thomas J. Rosser. At the time, Rosser was a licensed salesman for Great Lakes Securities Company and held himself out as a financial advisor … [T]he evidence established that Rosser was a licensed stockbroker and held himself out as a financial advisor, and that plaintiff was an unsophisticated investor who sought investment advice from Rosser precisely because of his alleged expertise as a broker and investment advisor. Further, Rosser testified that plaintiff had relied upon his experience, knowledge, and expertise in seeking his advice. Therefore, we conclude that plaintiff presented sufficient evidence to establish that she and Rosser were in a *fiduciary relationship*." *Mathias v. Rosser*, 2002 OH 2531 (OHCA, 2002). The court further noted, that under Ohio law, a *fiduciary relationship* is "*a relationship in which one party to the relationship places a special confidence and trust in the integrity and fidelity of the other party to the relationship, and there is a resulting position of superiority or influence, acquired by virtue of the special trust*." [*Emphasis added.*]

**Appendix D: The "Solely Incidental" Test Which Is Proposed By The SEC Would Gut The Protections Of The Advisers Act**

SEC Release No. IA-2652 states: "In the 2005 Proposing Release, we explained our understanding that investment advice is "solely incidental to" the conduct of a broker-dealer's business within the meaning of section 202(a)(11)(C) when the advisory services rendered to an account are in connection with and reasonably related to the brokerage services provided to that account. We further explained that our understanding is consistent with the legislative history of the Advisers Act, which indicates Congress' intent to exclude broker-dealers providing advice as part of traditional brokerage services. We also explained that it is consistent with the Commission's contemporaneous construction of the Advisers Act as excepting broker-dealers whose investment advice is given "solely as an incident of their regular business."

The SEC's suggested interpretation of the "solely incidental" test is fundamentally flawed, for the reasons which follow.

First, the Commission's interpretation of the "solely incidental" test by using the phrase "in connection with and reasonably related to," would, in essence, gut this requirement for the broker-dealer exemption altogether. *See* Comment letter of Barbara Roper, Director of Investor Protection, Consumer Federation of America, dated Feb. 7, 2005, which sets forth in detail the flaws in the Commission's interpretation.[lvii] In essence, by attempting to rewrite the phrase "incidental advice," the SEC is attempting to exercise its authority, erroneously, to establish new, broader exemptions for broker-dealers than the "precise exemption"[lviii] permitted by law.

Second, the Commission sets forth that its understanding of the "incidental advice" requirement is consistent with the legislative history of the Advisers Act, "which indicates Congress' intent to exclude broker-dealers providing advice as part of traditional brokerage services." Such an expansive reading of the broker-dealer exemption, and the Commission's interpretation of Congressional history, was flatly rejected by the D.C. Circuit in *Financial Planning Association vs. SEC*, wherein the U.S. Court of Appeals recently stated:

> In an attempt to overcome the plain language of the statute, the SEC asserts that Congress was also concerned about the regulation of broker-dealers under both the IAA and Exchange Act, and that such concern was reflected in the "intent" of the paragraph. *See* 70 Fed. Reg. 20,430; *see also* 64 Fed. Reg. 61,228. **The SEC points to no convincing evidence that supports these assertions.** At the time Congress enacted the IAA in 1940, broker-dealers were already regulated under the Exchange Act. In the IAA, **Congress expressly acknowledged that the broker dealers it covered could also be subject to other regulation. IAA § 208(b), 15 U.S.C. § 80b-8(b).** The IAA's essential purpose was to "protect the public from the frauds and misrepresentations of

> unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful." H.R. Rep. No. 76-2639 at 28; *see also id.* at 21. [**Emphasis added.**][lix]

As alluded to by the D.C. Circuit, by seeking to exempt broker-dealers beyond those who receive only brokerage commissions for incidental advice, the SEC has promulgated a Proposed Rule that is in direct conflict with both the statutory text and the Committee Reports.

Third, the Commission continues to seek to advance the proposition that its interpretation of the "solely incidental" language "is consistent with the Commission's contemporaneous construction of the Advisers Act as excepting broker-dealers whose investment advice is given 'solely as an incident of their regular business.' " However, the Commission's "contemporaneous construction" (much of which occurred following the promulgation of the ill-fated Merrill Lynch Rule in 1999) flies in the face of both the plain language of the Advisers Act and Congressional intent, and does not form any basis upon which to expand the broker-dealer exemption nor to create another exemption from the definition of "investment adviser" (which definition of "investment adviser" the D.C. Circuit repeatedly said should be broadly construed).[lx] Furthermore, and as stated by the Court, the "SEC's suggestion that 'new' broker-dealer marketing developments fall within the scope of its authority under subsection (F) ignores its own contemporaneous understanding of Congressional intent to capture such developments."[lxi]

By its continued insistence on seeking to expand the broker-dealer exemption, through a renewed but nevertheless still inappropriate attempted redefinition of the phrase "solely incidental," the Commission sets the stage for another judicial review, given that the Commission's interpretation is contrary to both the plain text of the Advisers Act and Congressional intent.

NAPFA is not alone it its view of the impropriety of the SEC's attempted redefinition of the "solely incidental" test. Following are excerpts from prior comments submitted on this issue:

Comments submitted by AARP, March 9, 2005:

> [T]he Commission's characterization of "solely incidental" advisory services in the re-proposal with terms such as "in connection with" and "reasonably related to" the brokerage business expands the scope and level of advisory services that would be considered incidental. For example, it is hard to imagine how financial planning --that by definition is selling advice that may relate to investments, but also may encompass other financial issues --could not be considered to be "in connection with" or "reasonably related to" a broker's business.

Comments of Mercer Bullard, Fund Democracy, and Barbara Roper, Consumer Federation of America, April 4, 2005:

> We believe that there should be a level regulatory playing field that is functionally related to the financial services provided. When brokers provide execution services, they should be subject to broker regulation; when they provide non-incidental investment advice, they should be regulated, as Congress decided 65 years ago, as investment advisers. The SEC's broker exemption would undermine this functional regulatory scheme by allowing virtually any broker to offer investment advice without being subject to the regulations that apply to financial planners and other professionals providing the same advisory services.

Comments of Fund Democracy, Consumers Union, and Consumer Act, and the Consumer Federation of America, Feb. 7, 2005:

> The aspect of the SEC's proposal that we find most disturbing is its discussion of the meaning of "solely incidental." Reasonable people can disagree about how significant advisory services must be before they no longer qualify as solely incidental to the brokerage services provided. No reasonable interpretation could lead, however, to the conclusion that advisory services are solely incidental when they are rendered "in connection with and reasonably related to the brokerage services provided to the account," as stated by the Commission …
>
> [T]he terms "in connection with" and "reasonably related to" do not limit the scope of the advisory services provided to those that arise only as a consequence of the brokerage business. Indeed, the meaning of these terms is essentially in opposition to the meaning of "solely incidental" in the context of the broker exclusion. Advisory services that are offered "in connection with" or are "reasonably related to" a brokerage business would include a substantially broader category of services than are included in the category of advisory services than are provided solely as a consequence of the brokerage business …
>
> In presenting its interpretation, the Commission has ignored not just the plain meaning of the statutory language, but also the vast majority of the legislative record. Contrary to the SEC's assertions, the legislative history and early Commission interpretations of the legislation both clearly demonstrate Congress's expectation that the solely incidental test would result in brokers' sometimes being subject to adviser regulation, even when they did not offer that advice through a separate advisory department or charge a special fee for it. Further, the legislative history demonstrates that a significant concern was to ensure that the provision of advisory services would be subject to the higher fiduciary standard to which professionals were held. Congress addressed this concern by establishing the solely incidental test. This requirement of the exception recognized that traditional brokerage necessarily included some degree of incidental advisory services, such as recommending securities for purchase or sale and expressing a view on the value of particular investment opportunities. At the same time, Congress sought to ensure that, if the advisory services

offered went beyond these sorts of traditional brokerage activities, the broker's customers would be protected by the higher legal standards of the Advisers Act …

The Commission also relies for its interpretation on more recent history that has been created by its own lax enforcement of the law. For decades, the Commission has turned a blind eye to advisory services provided by brokers under commission-based programs that were not solely incidental to their brokerage services under any reasonable interpretation of that standard. In permitting these commission-based programs to provided unlimited advisory services, the Commission substantially exacerbated the breakdown of the functional distinction between brokers and advisers that Congress intended the solely incidental test to maintain. The SEC's proposal would codify its longstanding disregard for the statute by … extend[ing] its position by eviscerating the solely incidental test as well …

We also are concerned that the Commission, in a number of respects, has shown a striking insensitivity to the interests of the investing public and the public policy underlying the Investment Advisers Act.

Comments of Duane Thompson, Financial Planning Association, Feb. 7, 2005:

The reproposing release provides a highly selective interpretation of what "solely incidental" means as it relates to the broker exemption. This strained analysis reaches for obscure, secondary meanings in various dictionaries and latches onto the noun "incident" -- as it was used in an early Commission release -- instead of "incidental," an adjective used in the Advisers Act to describe a limitation. According to the Commission's interpretation in the reproposed release, however, "incident" means to be dependent upon, or pertinent to, something else, even if it is not essentially a part of that something else. The reproposing release then goes on to suggest that since the advice given in connection with traditional brokerage was often "substantial in amount and importance to the customer," incidental advice is appropriate with the meaning of the brokers' exemption from the Advisers Act. In other words, virtually whatever a broker-dealer does is going to be solely incidental to being a broker-dealer simply because a broker-dealer does it. The Commission's analysis cites no direct evidence from the legislative history of the Advisers Act; only that its reading is "based on the view" of, or an "understanding" about Congress' intent in 1940.

We would point to the more common and frequent usage of the term "solely incidental" in the Advisers Act, its legislative history, in industry, and staff commentary over the ensuing decades. The SEC should not grasp at straws in honing in on an isolated use of the term "incident." "Incidental" is defined in modern dictionaries as "occurring or likely to occur as an unpredictable or minor accompaniment" and "occurring by chance or in isolation." "Solely" is defined as "alone" or "singly." The legislative history of the Advisers Act also contains references to "merely incidental" advice by brokers. "Merely" appears to have

> been used interchangeably with "solely," and suggests a very similar result: "nothing else or more; only." In combination, the plain-English meaning of the term "solely or merely incidental" strongly suggests that investment advice was to be dispensed only in isolated or limited circumstances – not as a regular part of brokerage where the customer paid for advice in connection with a stock purchase or sale.

Comments submitted by Certified Financial Planner Board of Standards, Inc., Feb. 6, 2005:

> In a variety of cases in previous years the Commission interpreted "solely incidental" to mean limited in amount. For example, a professional who primarily engaged in other work—such as a lawyer doing legal work—could provide investment advice and not be subject to the '40 Act if the work amounted to less than ten or fifteen percent of the professional's business. In addition to being constrained by amount, the earlier ruling constrained the meaning of "solely incidental" by description. In other words a professional could not give investment advice and escape the '40 Act even if the advice was limited in amount if the professional held him- or herself out as primarily providing investment advice. These were two significant constraints; they are also constraints that are consistent with what average people understand words like "solely incidental" to mean.
>
> The Commission's new release, however, departs dramatically from both its own precedent and the commonly understood meaning of the word "incidental." In the new release "solely incidental" is defined to have no limitation in amount whatsoever. Under this new rule a broker can spend 99% of his or her time engaging in the services otherwise covered by the '40 Act and escape coverage as long as he or she engages in any brokerage service. This odd result is possible because the Commission has redefined "solely incidental" to mean "in connection with or reasonably related to the brokerage services provided in the account." There is, in other words, nothing in this definition limiting the amount of investment advice that can escape '40 Act regulation as long as brokers engage in some brokerage activity on the side …
>
> The public would be better served if the Commission defined "solely incidental" to be both consistent with what the words mean to most people and consistent with the Commission's own past interpretations of this very language.

Lastly, the outstanding comment letter of Barbara Roper, Director of Investor Protection, Consumer Protection of America, dated February 7, 2005, which provides an extensive discussion of the "solely incidental" issue, is worthy of re-review in its entirety, and is incorporated into this comment letter by reference.

**Appendix E: Illustration Of The Difficulties Of Consumers In Distinguishing "Two Hats"**

The following skit illustrates the impracticality of consumers being able to adequately distinguish between services which are "investment advisory" in nature (and governed by fiduciary standards of conduct) and those which are "solely incidental" to the sale of an investment product (which recommendations are held to a far lesser standard of conduct, in essence an arms-length transaction with a customer modified slightly by the requirement of product suitability):

> *(Financial consultant places on fiduciary hat (FH)]*
> Ma'am, come right in. Yes, ma'am, I'm a certified financial planner and a registered investment adviser. And here's the plan I've devised for you, with a strategic asset allocation, plans for monitoring your portfolio and rebalancing it periodically, and the use of tax efficient investments in some accounts. What's that, you've already studied it, and you're ready to implement. That's great.
>
> [*Financial consultant replaces fiduciary hat (FH) with broker-dealer hat (BDH)]*
> Now this part of the plan we are going to implement in a <u>brokerage account</u>. This variable annuity product is outstanding – with lots of guarantees as to its death benefit, and, when you want, an income for life that you'll never outlive. What's that, how does this fit into the plan?
>
> *[BDH removed, FH put on.]*
> We're going to use this product as part of your allocation to fixed income, and part as allocation to U.S. large company stocks.
>
> *[FH removed, BDH put on.]*
> Now, back to this variable annuity … the returns of the funds in this annuity have just been spectacular over the past five years … what's that … what about the rest of your investment portfolio?
>
> *[BDH removed, FH put on.]*
> The rest of your money we are going to put into an <u>advisory account</u>, <u>NOT</u> a brokerage account. What's that … no, no, no – not an ADVISOR'S ACCOUNT … an <u>advisory</u> account.
>
> *[FH removed, BDH put on.]*
> Let me explain. An advisory account is just like a brokerage account. You'll get all the same monthly statements. What's that? How does all of this relate to your asset allocation and the risks of your <u>overall</u> portfolio?
>
> *[BOTH FH and BDH placed on head of Financial Consultant.]*

You know, I'm going to treat you as if you were my own mother. Trust me. I'm a fiduciary to you on your ADVISOR'S ACCOUNT – I mean ADVISORY account. I'm required, of course, to make sure the products are SUITABLE for you in your broker accounts … uh … in fact, I'm required to make certain products are SUITABLE for you at all times … What's that, there's something you forgot to tell me about, or your situation has changed, and we need to amend the plan.

*[BDH removed, FH remains]*
OK, let's amend the plan …

*[BDH and FH placed on head]*
You know, just don't worry … I'LL TAKE CARE OF YOU.

This skit illustrates the important fact that financial planning and investment advisory services are not discrete events but rather dynamic processes. Moreover, under Modern Portfolio Theory and many other academic concepts applied in the design, construction and management of investment portfolios, the entirety of an investment portfolio and all of the circumstances of the client (including various risks – both those directly related to investment holdings and other risks in life) are considered when undertaking recommendations of securities. Additionally, once a financial plan or investment plan is undertaken, ongoing advice (which is much more than "merely incidental") is provided to the client with respect to the plan, and the plan is likely to be changed from time to time.

The above skit also illustrates the lack of adequate disclosure of the "switching of hats" which often occurs in practice, and the lack of discussion which occurs as to the precise role of the dual registrant at each point in time. It is simply wholly impractical for a consumer to discern and understand the role of the dual registrant at any point in time, as the switching of hats frequently and rapidly occurs. The lack of ability to determine the precise role of the dual registrant at any point in time is made more profound, since there is no actual switching of hats, or switching of nameplates on the desk, or switching of business cards, by the dual registrant, as each change from fiduciary to non-fiduciary status (and back and forth) occurs. The consumer or client simply has no realistic way of knowing when he or she can trust the advice which is given (under a fiduciary standard), or when he or she should fully evaluate and analyze the options presented and read prospectuses and/or other materials provided (as would be prudent to do in an arms-length relationship, such as that which exists between a registered representative and his or her customer).

**Appendix F: Exploring Clients' Inability To Provide Informed Consent To A Switch From Fiduciary To Non-Fiduciary Status**

1. **Generally, Clients Have No Adequate Means To Monitor The Conduct of Their Fiduciaries.** "[E]ntrustors become dependent on their fiduciaries and may not be able to monitor the quality of their services because: (1) the skills involved are not easily acquired or understood; (2) the cost to entrustors of monitoring and evaluating such services would undermine the utility of the arrangement; and (3) there exists no other effective alternative monitoring mechanism. In sum, fiduciary rules reflect a consensual arrangement covering special situations in which fiduciaries promise to perform services for entrustors and receive substantial power to effectuate the performance of the services, while entrustors cannot efficiently monitor the fiduciaries' performance."[lxii]

2. **When Bargaining On Issues Related To Waiver, Consumers Must Fend For Themselves; Specific Procedures Must Be Followed.** "While bargaining with their fiduciaries on the issue of waiver, entrustors must fend for themselves as independent parties. Their right to rely on their fiduciaries must be eliminated. In fact, during the bargaining, the entire relationship must be terminated. Fiduciary law allows such termination of the relationship with respect to specified transactions only if the parties follow a specific procedure. This procedure is designed to ensure an effective transition from the fiduciary mode in which entrustors rely on their fiduciary, to a contract mode in which parties rely on themselves. That is why fiduciaries must put entrustors on notice that, in connection with the specified transaction, entrustors cannot rely on their fiduciaries. That is why entrustors must be capable of bargaining independently with their fiduciaries and have the capacity to enter into bargains. That is also why, to allow entrustors to make informed decisions, fiduciaries must provide them with information regarding the transaction, especially when the fiduciaries acquired this information in connection with the performance of their services to the entrustors. This procedure is, and should remain, mandatory."[lxiii]

   "In order to transform the fiduciary mode into a contract mode, four conditions must be met: (1) entrustors must receive notice of the proposed change in the mode of the relationship; (2) entrustors must receive full information about the proposed bargain; (3) the entrustors' consent should be clear and the bargain specific; (4) the proposed bargain must be fair and reasonable. Thereafter, two other general bargaining conditions apply. One relates to consenting parties: entrustors must be capable of independent will. The other relates to the subject matter of the bargain: the proposed bargain must not cover non-waivable duties."[lxiv]

3. **Disclosure of Material Information Would Be Required.** "Fiduciaries must provide entrustors material information necessary for the entrustors to make an informed decision regarding the waiver. This is necessary because, in contrast to contract law, there is no assumption in fiduciary law

that the parties' information about the proposed waiver or bargain is symmetrical. Asymmetrical information among the parties to a fiduciary relationship results both from the nature and from the purpose of the relationship. Fiduciaries possess far more information about their own activities. Entrustors and fiduciaries are not equally equipped to make a cost-benefit analysis of the contemplated change in their relationship. In reality, entrustors can seldom perform such an analysis because they lack accurate information to make it. Therefore, when the fiduciaries possess information in connection with the bargain, and especially if the information has come to them by virtue of their position as fiduciaries, the change of the relationship mode must be accompanied by the fiduciaries' disclosure of this information to the entrustors."[lxv]

4. **<u>Lacking Adequate Consideration, The Validity of Informed Consent Is Highly Suspect, Especially With Respect to Broad Waivers of Rights.</u>** "The entrustors must clearly consent to waive or bargain around the fiduciaries' duties towards them, and their awareness must be sharper than contract parties' awareness when they waive contract obligations owed to them. That is because, by waiving fiduciary duties, entrustors always give fiduciaries something of value. For example, consent to breach the fiduciary duty of loyalty (misappropriation) can provide a defense for fiduciaries - negating a necessary element of a wrong, and the existence of a wrong. Whether entrustors receive something in return is less clear and depends on their ability to sever the umbilical cord with their fiduciaries, as well as on their bargaining capabilities. The requirement of clarity relates to the condition that the bargain be fair and reasonable. This condition, in turn, is grounded in a rationale, derived from contract law, suggesting that if the bargain is highly unfair and unreasonable, the consent of the disadvantaged party is highly suspect. Experience demonstrates that people rarely agree to terms that are unfair and unreasonable with respect to their interests. Because the bargain or waiver is more likely to be in the fiduciaries' interests, but less likely to be in the entrustors' interests, the consent, by entrustor's action or inaction, must be clear. To ensure clarity, default rules should be as specific and precise as possible. Fiduciary duties of loyalty and care, however, are broad standard rules. Therefore, the bargain around these duties must carve out explicit and specific situations. A number of reasons can be offered for requiring specificity. First, specific rules are efficient for the parties' planning and for bargaining around the rules. Second, specificity is necessary to avoid misunderstandings among the parties. Third, in many cases, a broad waiver of duties is bound to be uninformed and speculative. Waivers of specific claims or level of losses will be more readily upheld. For example, if the fiduciary relationship is an escrow, waiver of particular conditions in advance would likely be upheld because the conditions of the initial relationship are fairly specific, and the waiver will be specific. Fiduciaries may also have better luck enforcing waivers of specific fiduciary duties after violations have occurred. Their chances are improved because the nature and extent of the violation are easily ascertainable, and because the entrustors' bargaining position is stronger. Similarly, waivers of bonding requirements by executors, especially family members or friends of the testator, are likely to be upheld because the testators presumably knew the executors well, and because the waivers are specific and limited to a particular function. A broad

waiver of the underlying duties of the executors, however, might not be enforced. Similar reasons apply to waivers of the duty of loyalty in other contexts. Overall, the courts are not likely to uphold bargaining around the broad duties of fiduciaries far in advance when the fiduciaries have substantial discretion over the entrustors' power or property."[lxvi]

"Even if above requirements are met, courts will generally not enforce an unfair or unreasonable bargain, but will require a showing that the transaction is fair and reasonable … A second reason for doubting the voluntariness of an apparent consent to an unfair transaction could be a lingering suspicion that generally, when entrustors consent to waive fiduciary duties (especially if they do not receive value in return) the transformation to a contract mode from a fiduciary mode was not fully achieved. Entrustors, like all people, are not always quick to recognize role changes, and they may continue to rely on their fiduciaries, even if warned not to do so. Lack of fairness may also signal the absence of more or less equal bargaining power by the entrustor …."[lxvii]

5. **Informed Consent to a Switch From Fiduciary to Non-Fiduciary Status is Highly Unlikely, Due to Behavioral Biases.** There now exists substantial academic evidence of the difficulties of securing informed consent from individual investors, the vast majority of whom do not possess the training and education sufficient to provide "informed consent" to a switch from fiduciary status to non-fiduciary status. In part this is because individual investors possess substantial behavioral biases which negate the likelihood of informed consent occurring. [For a fuller discussion of this issue, *see* Appendix F of the FPA® Fiduciary Task Force Final Report (at pp. 104-119), "Lessons From Behavioral Science: The Effectiveness of Disclosures Provided to Clients of Financial Intermediaries."]

6. **Complete Termination of the Fiduciary Relationship Must Occur, *Prior* To Any Engagement as a Non-Fiduciary.** For an investment adviser to recommend dropping the fiduciary status, termination of the relationship must first occur, and completely, at a minimum, or a breach of fiduciary duty results. Additionally, the duty of a fiduciary to provide objective advice negates any possibility of a suggestion by a fiduciary adviser to his or her client to a switch to non-fiduciary status. Furthermore, it must be asked whether any person, acting as a surrogate decision-maker or advisor to a client as to whether to waive the fiduciary duties of one who desired to provide investment advice, could ever advise a client to forego the fiduciary duty. There is no advantage in the waiver of the legal requirement to act in the client's best interests and as a fiduciary. This is because the same services could be obtained, for the same fees,[lxviii] from another advisor who chooses to be bound by the fiduciary duty. If a choice were to exist, there simply is no situation in which an investment adviser would advise a client to forego the fiduciary protections which could otherwise be afforded to the client.

**END NOTES:**

[i] NAPFA defines a Fee-Only financial advisor as a financial advisor who is compensated solely by the client with neither the advisor nor any related party receiving compensation that is contingent on the purchase or sale of a financial product. Neither Members of NAPFA nor affiliates of Members of NAPFA may receive commissions, rebates, awards, finder's fees, 12b-1 fees, bonuses or other forms of compensation from others as a result of a client's implementation of the individual's planning recommendations.

[ii] All of NAPFA-Registered Financial Advisors adhere to the following Fiduciary Oath, which oath they are pleased to provide at any time to their clients and in writing: "The advisor shall exercise his/her best efforts to act in good faith and in the best interests of the client. The advisor shall provide written disclosure to the client prior to the engagement of the advisor, and thereafter throughout the term of the engagement, of any conflicts of interest which will or reasonably may compromise the impartiality or independence of the advisor. The advisor, or any party in which the advisor has a financial interest, does not receive any compensation or other remuneration that is contingent on any client's purchase or sale of a financial product. The advisor does not receive a fee or other compensation from another party based on the referral of a client or the client's business."

[iii] SEC Release No. IA-2652, at pp.13-14, describes this aspect of the Proposed Rule as follows: "The provision would codify a long-standing interpretation of the Act that permits a broker-dealer also registered under the Act to distinguish its brokerage customers from its advisory clients." [Emphasis added.] Given that the Proposed Rule itself later sets forth that the distinction is not as to individual customers or clients of a dual registrant, but as to accounts, this language of the Release may have unintentionally misled readers of the Release to infer that a different type of Proposed Rule was being adopted, and may have unintentionally diminished the outcry which would have naturally resulted from the Proposed Rule's attempt to apply or not apply fiduciary duties to different *accounts* of the *same client or customer*.

[iv] *Id.*, revising § 275.202(a)(11)-1(c).

[v] The fiduciary standard of conduct has historically been the highest standard under the law. Assertions to the contrary are inherently misleading, such as the NASD's (now FINRA's) longstanding argument that investment adviser standards are not as protective for consumers in comparison to broker-dealer requirements. *See Letter from Elisse B. Walter (NASD) to Jonathan G. Katz* (Apr. 4, 2005), wherein NASD described an investment adviser's fiduciary duty as "imprecise and indeterminate" and "more implied than expressed", concluding that such an "implied duty *simply cannot* afford retail investors with the same level of protection as the explicit regulatory standards governing the conduct of business as a broker-dealer…" (*Emphasis added.*) SIFMA, the industry association representing, among other entities, major broker-dealer firms, also advocates the same incredulous position, as it recently stated: "The Exchange Act includes antifraud provisions that are substantially similar in content and scope to the antifraud provisions of the Advisers Act (i.e., Sections 206(1) and 206(2))." [SIFMA letter to Robert Plaze and Catherine McGuire, seeking relief.] This is despite the fact that the Advisers Act has been construed to impose *broad* fiduciary duties of due care, loyalty, and utmost good faith – the highest standards under the law – to the entirety of the relationship between the investment adviser and his or her client, and under 206(1) scienter is not required, while the Exchange Act's requirements do not impose broad fiduciary standards of conduct. It must be asked, as well … if, as FINRA and SIFMA appear to advocate, the fiduciary standard of conduct does not impose upon fiduciaries an obligation to act under a higher standard of conduct, then why do they resist it so greatly, and why has SIFMA petitioned for this relief from the Advisers Act? [*See* SIFMA's June 27, 2007 "request for rulemaking" letter, which inexplicably was not made public on the SEC's web site.] FINRA and SIFMA apparently advocate a much lower standard of protection for consumers, that of investment product "suitability," which would leave investors, the vast majority of whom do not possess (and will not possess) adequate knowledge to make informed and good financial planning decisions, without trusted advisors. Congress' desire to create a

profession of trusted investment advisers, avoiding conflicts of interest where possible or, at the minimum, disclosing such conflicts and properly managing them, was one of the central purposes of the Advisers Act.

[vi] Lemke, Lins, *Regulation of Investment Advisers* (2007 edition) at §2.30.

[vii] Cambridge Dictionary of American English, online edition.

[viii] *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989) (quoting *Griffin v. Oceanic Contractors, Inc*., 458 U.S. 564, 571 (1982)). *See also Financial Planning Association vs. SEC*, 482 F.3d 481, 488 (D.C. Cir., 2007).

[ix] *Financial Planning Association vs. SEC*, (U.S.Ct.App., D.C.Cir., March 30, 2007), 482 F.3rd 489-90, slip opinion at pp. 15-16.

[x] Carving out six exemptions from the broad definition of "investment adviser," Congress determined that an "investment adviser" did not include:

(A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser;

(B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession;

(C) any broker or dealer [1] whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and [2] who receives no special compensation therefor;

(D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation;

(E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934, as exempted securities for the purposes of that Act; or

(F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

15 U.S.C. § 80b-2(a)(11).

[xi] *Financial Planning Association vs. SEC*, 482 F.3d at 488.

[xii] NAPFA suggests that dual registrants, when acting in a registered representative capacity only, should use caution to avoid the application of fiduciary duties under several sources of the law. When a dual registrant (broker-dealer firm or registered representative) provides only brokerage services only to a customer it is crucial that the firm's representations, advertising, and disclosures result in a clear understanding by the customer that only brokerage services are to be received, and that a relationship based upon trust and confidence does not exist. Far too many registered representatives assume that their activities are not governed by fiduciary standards of conduct, when, in fact, due to the representations of the firm, a relationship of trust and confidence has been formed with the registered representative's customer and a broad fiduciary duty to act in the best interests of that customer are then found to exist, whether under the Advisers Act, similar state legislation, or state common law (which will be explored later in this comment letter).

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[xiii] *Financial Planning Association vs. SEC*, slip opinion at p.11, *citing Chevron, USA, Inc. v. Natural Res. Def. Counsel, Inc.*, 467 U.S. 837, 842-43 (1984).

[xiv] *Financial Planning Association vs. SEC*, 482 F.3d at 493, fn.7.

[xv] Section 211(a) of the Advisers Act provides: "The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title. For the purposes of its rules or regulations the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters."

[xvi] *Financial Planning Association vs. SEC*, 482 F.3d at 493.

[xvii] "This Court has found nothing indicating that Congress intended to preempt state-law duties by establishing a federal registry. Second, where Congress or an agency has enacted a comprehensive scheme that leaves no room for state regulation, the federal action is deemed to have preempted the field. Id. The scheme in question here simply spells out the federal requirements for disclosure, and there is no implied preemption of any state law duties. See 15 U.S.C. § 78bb(a) (In promulgating the SEC act, Congress expressly indicated that it did not intend to preempt state laws or regulations unless there was a direct conflict). Third, a federal law or regulation may preempt a state law where there is a direct conflict between the two. Id. Again, there is no direct conflict in this situation. State and common-law duties and requirements do not directly conflict with the scheme implementing the CRD. Thus, this Court finds that although Congress created the SEC, which in turn gave birth to the NASD, which set up the CRD, states continue to have control over brokers and securities agents. State-law and common-law duties and requirements continue to govern the behavior of brokers and securities agents and their firms. Therefore, the existence of the CRD does not imply that state law and common law requirements and rights have withered away. Rather, the CRD represents the minimum duties that the federal government requires — a floor, rather than a ceiling. Contrary to the Defendant's claims, the duties that Plaintiffs seek to impose upon brokerage firms are not newly-discovered. In fact, these duties have always loosely bound the behavior of broker-agents, predating the advent of the CRD by many years." *French v. First Union Securities, Inc.,* 209 F.Supp.2d 818, 829 (M.D. Tenn., 2002).

[xviii] The Commission's has refused to restrict the use of the terms "financial consultant," "financial adviser," "wealth manager," and other terms to investment advisers. This is despite a growing body of case law which, determining when fiduciary duties apply under state common law, notes that the use of such terms plays an important role in determining whether fiduciary status exists. In addition, the Commission has failed to put an end to advertisements which continue to imply that the broker-dealer firm is in a relationship of trust and confidence with the client, such as advertising "objective advice" by brokerage firms (and dual registrant firms who are not always held to the fiduciary standard, without denoting that objective advice is only provided when investment advisory services subject to the Advisers Act are provided).

[xix] Plaze outline, "The Regulation of Investment Advisers By The Securities and Exchange Commission" (as updated to November 22, 2006). *See also* Tamar Frankel, "Fiduciary Law," 71 Calif. L. Rev. 795 (1983), stating: "Once a relation is established, however, its classification as fiduciary and its legal consequences are primarily determined by the law rather than the parties. Thus, unlike a party to a contract, a person may find himself in a fiduciary relation without ever having intended to assume fiduciary obligations. The courts will look to whether the arrangement formed by the parties meets the criteria for classification as fiduciary, not whether the parties

intended the legal consequences of such a relation. If the criteria are satisfied, the fiduciary will be subject to duties flowing from that relation, and the entrustor will be entitled to the resulting legal protection." *Id.* at p. __.

[xx] Plaze outline, *supra* note 34 at p.27, citing Opinion of the General Counsel, Investment Advisers Act Release No. 58 (Apr. 10, 1951), which stated in pertinent part: "("[I]n the opinion of [SEC General Counsel Roger S. Foster], the antifraud provisions of the SEC statutes are violated by the employment of any legend, hedge clause or other provision which is likely to lead an investor to believe that he has in any way waived any right of action he may have ….").

[xxi] *Brooklyn Sav. Bank v. O'Neil*, 324 U.S. 697, 704 (1945).

[xxii] 15 U.S.C. § 80b–1.

[xxiii] Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, at fn. 154 (1995).

[xxiv] *Id.* at p. *See also* FPA® Fiduciary Task Force Final Report (June 1, 2007), which stated in an Appendix thereto, as to a consideration of the inability of the vast majority of individual investors to provide consent to a switch from fiduciary to non-fiduciary status, "a legislature (or regulatory organization), recognizing the inadequacy of informed consent [and for the other reasons stated above], [may] undertake a judgment that the lack of informed consent is so harmful, either to individual investors (as to inability of individuals to secure the returns of the capital markets within a reasonable spectrum of risks due to poor or conflicted advice, or unwillingness to seek advice given concerns regarding ability to obtain trusted advice, or to the national interests - i.e., placing additional burdens upon government due to inadequate retirement savings and/or improper investments of retirement "nest eggs") as to merit further regulatory restrictions upon financial planners. Under this scenario the regulatory body prohibits the fiduciary advisor from seeking informed consent to the casting off of fiduciary status." *Id.* at p.118.

[xxv] Welle, "Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement," 56 WASH. & LEE L. REV. 519, 541 (1999).

[xxvi] Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, 1212 (1995).

[xxvii] Berg, "Understanding Waiver", 40 Houston L. Rev. 281, 313 (fn.157) (2003).

[xxviii] *Id.* at p.341.

[xxix] Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209 (1995), at fn.154.

[xxx] *Id.* at p. 1221.

[xxxi] NAPFA is aware of the arguments of some dual registrant firms in support of the proposition that a dual registrant should be permitted to "switch hats" with consent of the client. However, such arguments fail to adequately consider the interplay of federal securities law, its public purposes, and fiduciary principles. One recent presentation to a broker-dealer organization conference noted: "[B]roker-dealers have argued that, regardless of the capacity in which they may be acting when providing financial planning services, in the implementation phase of a financial plan, they execute specific investment ideas stemming from the financial plan in the customer's brokerage account and are acting as broker-dealers (not investment advisers or fiduciaries), unless the customer expressly elects to execute the plan through a discretionary or other type of advisory account." Outline prepared by Steven W. Stone, Esq. of Morgan, Lewis & Bockius LLP, "Investment Adviser Issues

for Broker-Dealers," presented at SIFMA Compliance & Legal Division Annual Seminar 2007, Phoenix, AZ, March 25-28, 2007, at p.17. Mr. Stone's outline cites two highly suspect decisions, *Safer v. Nelson Financial Group, Inc*., No. 04-31092 (5th Cir. Oct. 14, 2005), *and In the Matter of IFG Network Securities, Inc.*, Initial Decision Release No. 273 (Feb. 10, 2005) (stating that "[t]here is no case precedent that holds that an associated person of an investment adviser cannot change hats, to use [defendant's] metaphor, and act in the capacity of an associated person of a broker-dealer without the higher obligations of an adviser," and rejecting contentions by the SEC's Division of Enforcement that the IAA antifraud provision applied to the defendant's execution of transactions to implement customer financial plans where the agreements with customers stated that the defendant would be acting as broker when doing so). However, as observed in the Financial Planning Association's (FPA's) Fiduciary Task Force Final Report, dated June 1, 2007, at pp.39-40, the *IFG Network Securities* "decision was overturned on appeal by the SEC's Division of Enforcement to the Commission, and a Commission opinion was rendered on July 11, 2006. *See In The Matter Of IFG Network Securities, Inc*., 1934 Rel. No. 54127, IA Rel. No. 2533, Admin. Proc. File No. 3-11179. The Commission opinion does not address, however, the issue of conversion from an advisory relationship to a non-advisory relationship. Given the fact that the administrative law judge's decision was subsequently overturned, and the lack of discussion of the adequacy of informed consent both in the initial decision and in the Commission's opinion, the FPA® Fiduciary Task Force does not believe that this decision establishes any precedent in this area." The FPA® Fiduciary Task Force Final Report also suggested that the *Safer* decision was not dispositive of the issues, noting that "there is no significant discussion in the case as to the fiduciary duties which arise under the Investment Advisers Act of 1940 or the common law, the adequacy of disclosure and informed consent, and when and whether such fiduciary duties can be terminated. Given such, and the unique facts of the case (as to the facts which were pled by the plaintiff), this decision should not be relied upon as authoritatively addressing the issue of adequacy of informed consent." Final Report at p. 40. Hence, reliance cannot be placed upon these decisions, in which many of the positions advanced in this comment letter were not examined, in which there did not appear to be any significant discussion of fiduciary principles, and in which either the decision cited was subsequently overturned or, as noted by the court, the decision was confined to the unique facts pled by the plaintiff in the case.

[xxxii] BLACK'S LAW DICTIONARY 1580 (7th ed. 1999).

[xxxiii] Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209 (1995).

[xxxiv] Prentice, "Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis," 2003 Univ.Ill.L.Rev. 337, 357.

[xxxv] Decision No. B189249 (Cal. App. 1/26/2007) (Cal. App., 2007), wherein the Court stated: "NSMIA's savings clause is sufficiently broad to permit the Attorney General of California to pursue injunctive relief and penalties against a covered security's investment advisor and wholesale broker-dealer who allegedly made inaccurate or inadequate representations to purchasers … The plain language of the savings clause and its legislative history persuade us that Congress intended to preserve the states' anti-fraud authority to control the conduct of brokers and dealers."

[xxxvi] *Huber vs. Taylor*, U.S.Ct.App., 3rd Cir. (Oct. 31, 2006), slip opinion at p.34.

[xxxvii] "[T]he rule would clarify that a registered broker-dealer is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject it to the Advisers Act. Proposed rule 202(a)(11)-1 would re-codify substantially identical interpretations of section 202(a)(11)(C) of the Advisers Act that we adopted in 2005. Therefore, we do not believe that the proposed rule would have an economic impact on broker-dealers or investment advisers, regardless of whether these broker-dealers or investment advisers are

small entities, because these entities would likely have conformed to the interpretive positions previously adopted." Release No. IA-2652 at pp.19-20.

[xxxviii] Frankel, "Fiduciary Law," 71 Calif.L.Rev. 795, 811.

[xxxix] George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," 84 Q. J. Econ. 488 (1970).

[xl] Lemke, Lins, *Regulation of Investment Advisers* (2007 edition) at §1:1.

[xli] Representatives of the broker-dealer industry often seek to cast the dialogue of the past several years over the proper application of the Advisers Act as a desire for "fee-only" financial planners and/or investment advisers to seek a competitive advantage. This is definitely not the case, as NAPFA members already possessed a competitive advantage, in that they can hold themselves out to potential clients as fiduciaries under the law and hence governed by a higher legal standard than the standards governing the conduct of registered representatives. Indeed, one of the fall-outs from the *Financial Planning Association vs. SEC* decision has been a recent rush by registered representatives to also become registered as investment adviser representatives, and the competitive advantage of NAPFA members and other investment adviser-only professionals has therefore been somewhat diminished. Hence, the interests advanced by NAPFA in this comment letter do not relate to the preservation of any competitive advantage for its members, but rather the interests advanced are those of consumers. As professionals, NAPFA members not only embrace their fiduciary oath, but they live within its spirit and with a "fiduciary attitude." As professionals NAPFA members also possess altruistic views – the desire to help consumers and to protect them from harm. NAPFA members all too often are angered when they see new clients to their firms who, before they became clients of the NAPFA member, were sold terribly expensive and tax-inefficient products by non-fiduciary "financial consultants." Hence, NAPFA seeks to advocate on behalf of consumers, in order to eliminate, or at least reduce, the substantial harm caused to investors each and every day by actors who purport to provide objective investment advice but who are not governed by a fiduciary standard of conduct. By this comment letter, NAPFA seeks inform the Commission of the substantial legal and public policy arguments in favor of a broader application of the Advisers Act. It is NAPFA's hope that the Commission will pursue a different course than that advanced by the Proposed Rule. It is NAPFA's wish that the Commission act to protect individual consumers through the eradication of the opportunities to do harm by those who purport to be in a relationship of trust and confidence, but who instead seek to continue to avoid the high fiduciary duties of due care, loyalty, and utmost good faith to the customer, through a grant of particular exceptions to the fiduciary standard. Should NAPFA's positions be adopted by the Commission, there would occur a further rush by registered representatives as they register as investment adviser representatives, and act under fiduciary standards of conduct, a result which would to a degree sacrifice the competitive interests of NAPFA members. However, appropriate Commission action to reverse course and more broadly apply the Advisers Act, as the plain language of the text of the statute mandates and as Congress intended, serves the best interests of investment consumers and the economic future of all Americans, thereby indirectly benefiting NAPFA members – for the financial security of the United States of America, and of many of its citizens, would be enhanced.

[xlii] *Meinhard v Salmon*, 249 NY 458 (1928). Chief Justice Benjamin Cardoza opined: "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions … Only thus has the

level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court." *Id.* at 463.

[xliii] *Report of Special Study of Securities Markets of the Securities and Exchange Commission* (1963), at p. 323.

[xliv] *Id.* at p. 345.

[xlv] John R. Evans, Speech before the Second Annual Southern Securities Institute, Feb. 5, 1982.

[xlvi] *Financial Planning Association vs. SEC*, slip opinion at pp.18-19.

[xlvii] At the Sept. 19, 2007 open meeting of the SEC, Commissioner Nazareth stated, in connection with the Proposed Rule, that "more needs to be done for our rules to better reflect current market practice." Commissioner Casey stated: "In certain respects, the statutory framework in which we operate is losing its relevance in today's competitive environment." With respect, the principles embodied in the Advisers Act – that those who are in positions of trust and confidence in providing advice upon other people's money – are more important today than they ever have been. Current market practices which negate the distinctions between fiduciaries and non-fiduciaries have only resulted as a result of improper action, or lack of action, by the Commission over the past few decades to enforce the Advisers Act broadly, as Congress intended, for the protection of consumers.

[xlviii] "The Need for More Proactive Risk Assessment," by Lori A. Richards, Director, Office of Compliance Inspections and Examinations, Securities and Exchange Commission, Remarks at NRS Annual Spring Compliance Conference, April 14, 2004.

[xlix] SEC Release IA-2376 (2005), in adopting the "Final Rule" (*a/k/a* "Merrill Lynch Rule") stated: "Rule 202(a)(11)-1(c) provides that a broker-dealer that is registered under the Exchange Act and registered under the Advisers Act would be an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject the broker or dealer to the Advisers Act." *Id.* at pp.46-7. As the Commission is aware, this portion of the Merrill Lynch Rule was also overturned in connection with the *Financial Planning Association vs. SEC* decision due to the lack of a severability clause in the Final Rule.

[l] *Id.* at p.52.

[li] *See* Comment letter of Barbara Roper, Director of Investor Protection, Consumer Federation of America, dated Feb. 7, 2005, stating in part: "Rather than clarifying the ["solely incidental"] standard, the Commission has in essence interpreted it out of existence. In its place, it has proposed an 'in connection with and reasonably related to' standard that would allow brokers virtually unlimited freedom to offer advisory services outside the protection of the Advisers Act. In proposing this anti-investor standard, the Commission has misrepresented much of the legislative record it cites as supporting its position and ignored the vast majority of the legislative record, which directly contradicts its interpretation." *See also Brief Of Amici Curiae Of Fund Democracy, Inc. And Consumer Federation Of America In Support Of Petitioner* dated April 10, 2005 in *Financial Planning Association vs. SEC*.

[lii] *Financial Planning Association vs. SEC*, slip opinion at p.15.

[liii] *In The Matter Of: Arleen W. Hughes*, Securities Exchange Act Of 1934 Release No. 4048 (February 18, 1948).

[liv] "The SEC And The Broker-Dealer", An Address By Louis Loss, Chief Counsel, Trading And Exchange Division, Securities And Exchange Commission, Before The Stockbrokers' Associates Of Chicago (March16,1948).

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[lv] *SEC vs. Capital Gains Research Bureau*, [CITE NEEDED]

[lvi] Release No. IA-626 (1978).

[lvii] *Supra* n. 9.

[lviii] *Financial Planning vs. SEC*, slip opinon at p.15.

[lix] *Financial Planning Association vs. SEC,* slip opinion at p.17.

[lx] *Financial Planning Association vs. SEC*, slip opinion at pp.5 (twice), 12, 16, and 22.

[lxi] *Financial Planning Association vs. SEC*, slip opinion at p.22.

[lxii] Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, (1995).

[lxiii] *Id.* at pp. 1210-1.

[lxiv] *Id.* at p.1218.

[lxv] *Id.*

[lxvi] *Id.*

[lxvii] *Id.*

[lxviii] The argument that investment advisory accounts are more expensive for investors than brokerage accounts is spurious. Burdened with the duty of due care, an investment adviser must take great care in discerning the total fees and costs the client bears in connection with any investment product recommended and the investment advisory services provided. Many NAPFA members report that customers of "full-service" brokerage firms often pay "total fees and costs" which are higher by 50% or more than the total fees and costs incurred in connection with receipt of fee-only investment advisory services and the products recommended by fiduciary advisors.