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Elizabeth M. Murphy, Secretary

Securities and Exchange Commission

100 F Street, NE., Washington, DC 20549-1090

Subject: File Number S7-23-07

Dear Secretary Murphy:

This Comment discusses the fiduciary status of broker dealers, underwriters, and traders for their own account, sometimes originators of asset-backed securities, and sometimes underwriters (Brokers Etc.). This comment addresses the issue of Brokers Etc., who either purport to be advisers or are registered as advisers, yet wish to engage in proprietary dealings and other conflict of interest transactions with clients.

This Comment does not distinguish between service to retail investors and institutional investors for two reasons. One is that harm to institutional investors can cause losses to thousands of "retail investors." The second reason is the relationship by Brokers Etc. under regulation pursuant to the Employee Retirement Income Security Act of 1974. This regulation is closely linked to advisers and other financial management activities in which Brokers Etc. engage. Because Congress has demonstrated a desire for unification of the law, this Comment highlights the recent proposed regulation by the Labor Department under ERISA (ERISA Rule).[1] This regulation focuses on the same problems facing Brokers Etc. who engage in advisory services. The unified regulation of Brokers Etc. activities will be efficient for those who are subject to the ERISA Rule, to the regulators, to the self-regulators, and hopefully to the investors as well.

1. Who are fiduciaries?[2]

Fiduciaries are experts that are entrusted with power over other people, or property that belongs to other people, by virtue of the fiduciaries' expertise. In all cases the *sole purpose* of the entrustment is to enable these experts to serve their clients, and for no other purpose. It is with respect to this entrusted property and power that fiduciaries are

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[1] Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (Dep't of Labor proposed Oct. 22, 2010) (to be codified at 29 C.F.R. § 2510.3-21).

[2] For a discussion of fiduciary law see TAMAR FRANKEL, FIDUCIARY LAW (Oxford University Press) (2010).

subject to fiduciary law. Entrusted power and property never belong to the fiduciaries and were never given to them for any other purpose. If fiduciaries use entrusted power for any other reason, they are considered to have abused the power. If they misappropriate entrusted property, they are embezzlers. Therefore, fiduciaries that act in conflict of interest violate their fiduciary duties and are punished as embezzlers, or required to pay punitive damages even if the clients were not damaged by their wrongful actions. That is why fiduciary duties include accounting to clients for what was done with entrusted property or power.

The main purpose of fiduciary duties is to induce investors to rely on experts when duplication of expertise and functions is costly for society. The choice is not between paying and not paying for advice. The choice is between paying for advice, and substituting one's opinion for advice—that is rejecting the advice and distrusting the Brokers Etc.

Investors should seek fiduciary-advice and society will be better off for it. Just as patients should seek and pay for doctors' service and not choose their antibiotic medicines for themselves by being given a book on the subject.

With respect to entrusted power and property fiduciary relationships are not contractual. They are consensual relationships. That is why under the common law fiduciaries are not automatically entitled to compensation for their services. Their right to compensation for services rendered must be based on a specific contract, or on a provision of a statute (and perhaps on the principle of unjust enrichment).[3]

Indirect fiduciaries (affiliates of fiduciaries) should be subject to fiduciary duties. The concentration of functions by Brokers Etc. makes unrealistic the division between their functions (whether or not they build a "Chinese wall" among them), that is even if they do not share the investors' fees. Thus, fiduciary duties should apply with respect to any affiliates of those who serve as fiduciaries to investors. The definition of affiliates can be as detailed as it is in the Investment Company Act of 1940 or less extensive as in the ERISA Rule.

Finally, fiduciary relationships may be established by the reasonable expectations of the investors in light of how Brokers Etc. behave and position themselves and what they say about their status.

2. There is no fiduciary duty to disclose conflicts of interest

Fiduciary relationships with respect to entrusted power and property are not contractual. The securities acts have imposed the duty of disclosure on issuers of their own securities. This change was effected in contract law. Sellers of their own obligations could not rely

[3] *Cf.* Employee Retirement Income Security Act, § 404, 29 U.S.C. § 1104 (2006 & Supp. II 2008) for a similar description of these duties.

on caveat emptor and wait for the buyers to ask. The securities acts imposed on these sellers of their own obligations the duty to disclose all relevant information. Having received the information, the investors should decide whether to buy or not to buy the issuers' obligations. The issuer does not say: "Trust me and rely on me: This offering is the best for you." The issuer does not say: "Rely on my recommendation and do not bother to decide for yourself. I am the expert. Rely on me."

Therefore, fiduciary law is fundamentally different. Brokers Etc. do not sell their own securities but the securities that they *own*, not securities that they *owe*. These people give advice and ask the buyers for their trust.

There is a fiduciary law *prohibition on engaging in conflict of interest transactions*. Brokers Etc. either manage securities that are entrusted to them or give advice so that the client (being less expert) will not have to determine whether to buy or sell the offered securities. That is why entrusted money or power may be used and exercised *only, solely, and exclusively* for the benefit of the client not because of moral dictates or goodness of the fiduciary's heart but because any other use constitutes embezzlement and abuse of power. Entrusted money and power were given to fiduciaries for the sole purpose of performing their service. Information that a financial planner receives from clients was given for the sole purpose of preparing a plan for the client. Bernard Madoff was a fiduciary. He received money from clients and stole it by pretending to advise and manage the investors' money. Brokers Etc. who give advice and benefit from it abuse their entrusted power and violate their fiduciary duties in just the same way.

The one exception to this rule is the right of fiduciaries to be compensated for their services, as mentioned above. The other exception involves the possibility that some prohibited transactions involving conflicts of interest might be beneficial to the clients.

Being the experts, fiduciaries are also subject to a duty of care: a duty to do their job well, to do it in accordance with the expertise that the fiduciaries purported to possess. Duty of care does not include a duty to act exclusively for the benefit of the clients and avoid conflicting interests.

3. Under certain conditions clients may be asked to consent to conflict of interest transactions in violations of fiduciaries' duties

Fiduciaries may seek the clients' permission to engage in such transactions. In most cases of trustees, for example, only the courts are authorized to grant such permission (except when the trustees are banks). In the case of advisers, permission may be granted by their clients under certain conditions. Clients may refuse to consent arbitrarily.

When Brokers Etc. offer advice, investors may reasonably assume that the advice is given for the investors' benefit. The law supports this assumption. But Brokers Etc. question it, relying on the process of disclosure.

To be sure, Brokers Etc. may seek their clients' consent to a violation of their duties by engaging in conflict of interest transactions. The clients' consent will exonerate fiduciaries if the fiduciaries can prove that: (a) the clients had capacity to understand and agree to the transactions; (b) the clients received full information and explanation of the violating transactions; and (c) the clients were not under the influence of the fiduciaries and exercised free will. In sum, the clients must act as they would under a contract regime and understand that they should no longer rely on the fiduciary in relationship to the proposed transaction.

In the case of advisory services by Brokers Etc., it is very doubtful whether the clients' consent is meaningful. First, the Brokers Etc. present themselves as advisers devoted to the clients' interests. Second, when clients hand over money and securities to brokers, the clients must trust the brokers. How can the clients then mistrust the brokers when the brokers give the clients advice? Third, there is convincing experimental literature that demonstrates the fallacies of clients' consent to brokers' conflict of interest transactions. In fact, once clients consent, it seems that brokers might feel freer to engage in more serious conflicts.[4] Fourth, most of the consents are demanded and given in advance. Clients have no idea what the future transactions would be like and how much they would gain or lose as a result of the transactions. They cannot know because the information is in the future. These consents are hardly worth the paper they are written on.

Yet, the "business model" of many Brokers Etc. includes advisory services as well as selling to clients proprietary securities. Many of their activities involve conflicts, such as advisers who sell to clients the shares they own. If these advisers are also underwriters, they may dump on clients whatever they cannot sell elsewhere at the offering price. This temptation is not new and has been addressed in section 10(f) of the Investment Company Act of 1940 by a prohibition. Thus, while investors in mutual funds are protected from this conflict of interest possibility, the retail investors and the sophisticated investors are not. That is, unless they are asked shamefully to sign (usually in advance without any understanding of the possibilities and implications) a waiver that their Brokers Etc. may engage in conflict of interest transactions.

Furthermore, commission-based compensation for Brokers Etc. creates an insatiable drive to induce more transactions and higher securities market prices. This drive increases the Brokers Etc.'s benefits but also the investors' cost and might perhaps contribute to market bubbles. The fee structures drive to create new and exciting innovative trading products and processes (see, *e.g.,* ETFs), that increase trading.

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[4] *See* Daylian Cain, Why Disclosures Are Ineffective and authorities cited there (transcripts from The Fiduciary Forum 2010. Presented to the Securities and Exchange Commission).

Fee structures linked to assets reduce the pressures, but do not eliminate the pressure to sell, as the experience of mutual fund complexes has shown. That is because it is more difficult to perform than to sell. Hence in an ideal world brokers should wait for customers rather than press them to trade.

4. Suggestions to reduce the pressures of conflicts of interest and sales

Fees. I recognize that Brokers Etc. are not likely to offer fixed compensation to their sales persons. Neither do I suggest that the Commission should fix fees. However, if fee structure affects incentives and there is need to reduce pressures to trade, what can be done? How can Brokers Etc. be imposed with fiduciary duties, and yet engage in their profitable business model?

Part of the answer may lie in investor education and consequent market reaction. Rather than merely imposing on Brokers Etc. a duty to disclose their fee structure there should be an attempt to educate investors to focus on the incentives of who they talk to, rather than what is being sold. To be sure, such investor education will reduce the main purpose of fiduciary law--to induce investors to trust the securities markets intermediaries. Yet, trust is not gullibility, and reduced trust is necessary to protect investors against those who ask for trust and deny their duty to be trustworthy.

Investors should understand the conflicts their brokers or advisers might act upon: Therefore, Brokers Etc. may have to tell investors: "I am now a purchaser or seller and not your adviser." In addition, it would be helpful for investors to know "any fee or compensation" received by the purported adviser" (or by an affiliate) from any source and any fee or compensation incident to the transaction in which the investment advice has been rendered or will be rendered," including "brokerage, mutual fund sales, and insurance sales commissions and fees and commissions based on multiple transactions involving different parties." Perhaps an additional item should be: "How does the purported adviser cover the costs of their 'free' lunches, advice and financial planning?"

Similarly, Brokers Etc.'s "free" advice, "free" lunches and "free" financial planning may not be free at all. Apart from the fact that giving something free induces the recipient to reciprocate, the clients may pay higher costs or other services or higher risks. Clients may be given a choice by an "objective list" drawing attention to the costliest securities (because the Broker Etc. purporting to be an adviser has been paid for providing the list and the order of the offered securities).

One solution to this issue is to prohibit conflicts by a following rule: Broker Etc. is free to sell and buy from clients but is not free to pretend to be the client's adviser. He is not free to say to the client in writing: "Trust me. I am your adviser. I am an expert. I am offering you advice cheaply—free." Or he may say to the client in writing: "I am a seller and buyer for myself."

But he cannot say to the client both. And if he chooses to serve as an adviser, regardless of how he calls himself, his advice must be solely for the benefit of the client, and no conflicting interest should be involved.

Public disclosure. Another similar solution to the conflicts of interest is to disclose the "business model" of Brokers Etc. publicly. The disclosure must be clear and simple and filed with the Securities and Exchange Commission. The publication must be accurate and truthful and carry the punishment of a prohibition similar to section 11 of the Securities Act of 1933. Alternatively, inaccuracy in the disclosure might constitute a violation of a new rule under section 206 of the Advisers Act of 1940.

For any conflict of interest transaction, require an independent unaffiliated adviser that is not a Broker Etc. to review the "advice" of the Broker Etc. with a "business model." This solution can follow the process established in private placements. When unregistered securities are sold to unsophisticated investors (as defined) there must be an adviser that is independent of the issuer to verify the investments' terms and impact.

This adviser focuses on what is offered. Regulation D allows the limited offer and sale of securities without 1933 Act registration. Rule 506 allows an offering to up to 35 purchasers, without regard to dollar amount, but: ""Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description."

Educate investors to separate their investment services. Suggest to investors to separate the conflicted functions and seek two unaffiliated servicers. That means choosing an adviser that is not a broker and executing transactions with an unaffiliated discount broker that is not the adviser. Advice will cost investors more. Execution of the advice is likely to cost them far less. If the results are still more costly, they can view the cost as their insurance for following choices made for them, and them alone.

Although this proposal involves costs to investors the cost should be weighed against the losses that investors may incur not only from ABSs and other exotic creations but also from stocks and bonds that may present hybrids. The cost of understanding the product for investors is not only much higher than that for Broker Etc. (who has either created the product or evaluated it for its own purposes). It is socially desirable for investors to rely on trustworthy advisers rather than to be required to determine their future investments and savings. Notifying investors that their brokers have conflict of interest undermines the trust not only in the brokers but also in financial intermediaries generally. The system must protect investors from tainted advice which some Brokers Etc. might give.

Enact a rule that any client of Brokers Etc. may cancel his relationship within 3 days from the day of signup. To be sure, any ordered transaction cannot be cancelled. But the relationship as to future transactions should. If the client chooses the offered investment before that time, he must own it, but nothing else. Alternatively, during the 3 days no transaction should be made, notwithstanding the broker's promise of the "best deal ever."

5. Avoid specific rules and emphasize policy

Specific rules v. standards. Brokers Etc. as well as other regulated institutions have usually sought specific rules. After all, they have to know with what they should comply. However, because specific rules leave an area of freedom above, below and around, the regulated institutions assumed that anything which is not prohibited explicitly is permitted. That was the basis for the mutual funds' justification to engage in market timing. At the same time regulated institutions complain about the enormous number of specific rules to which they are subject and the cost involved in learning and complying with such rules.

In the case of Brokers Etc. who offer clients advice while engaging in conflict of interest transactions, the Commission may provide the actors with guidelines and leave to the actors to specify their rules or lack of the rules and explain them. The Commission has adopted this approach before.

To be sure, Brokers Etc. can gain more when they engage in conflict of interest. Investors may pay less initially for advice. However, these "savings" can cost investors and the system far more. That is why we pay to ensure against serious losses. The lament over the cost of brochure information has already been heard. The threat to cease giving advice by Brokers Etc. that purport to give it together with other service may be welcome. In addition, free advice is not necessarily cheaper for investors in the long run. Therefore, investors might benefit from a charge for a brochure. This payment may save investors their entire savings. Therefore, the Advisers Act should apply to Brokers Etc., regardless of their increased costs.

What should the law provide? Brokers Etc. are fiduciaries. The Advisers Act of 1940 should apply to those who call themselves advisers and financial planners. In addition, notwithstanding the unification purpose state laws should not be preempted. Let there be at least some uncertainty for Brokers Etc. It exists now, and yet they are not doing badly in spite of it.

The Advisers Act should apply to Brokers Etc. in their relationship to institutional investors whether or not they are sophisticated. Institutional investors that rely even once on unreliable Broker Etc. can cause losses to many small investors and might impact adversely the entire economy. This potential harm should match the regulation.

The Advisers Act is not very strict and there are no reasons to relax it or tighten it at this time. Congress has amended the Act to impose greater legal supervision on hedge funds and private equity funds, and if they are or were engaged in buying insider information these activities are sufficiently regulated by law and can be enforced. The results may point to a stricter or laxer regime, but should not be dealt with currently.

The distinction between institutional and individual investors should be limited. The ERISA Rule which applied first only to institutional investors (pension plans) has been proposed as an extension to individual plan participants. The reverse should now apply to investors outside the pension participation. Pools of investors are just as vulnerable as individual investors.

Rulemaking should remain with the SEC. The SEC has sufficient resources to promulgate rules and a process to receive and evaluate the public's comments. I would also retain the "no-action letters" and the exemptive process. These are great mechanisms for adjusting the law as the environment changes without having to change the entire system and seek congressional action. In some cases the SEC seeks congressional approval of its rules about every 10 years and that works better.

I believe that the Commission should not allow this topic to be subject to self-regulation by anyone. One reason is that there is most experts in this area are involved in conflict of interest. In addition the Commission's cost of regulation is not overwhelming and it has the talent and ability to continue to establish the rules. Enforcement of the laws and rules, however, may be subject to a different process.

6. Who should enforce the Commission's regulation?

Qualifying examinations and certifications. Various functions and expertise may require different examinations and certifications. Today brokers must qualify by passing examinations conducted by FINRA. Advisers have established mechanisms for certifying advisers and financial planners. These certifications have acquired a reputation and recognition. These certifications should be imposed on anyone who desires to represent himself as adviser and/or financial planner.

Other professions follow a similar path. While all medical doctors must qualify as doctors their specializations require additional education and examinations. This should be the model for intermediaries that purport to offer various specialized services in the financial area. Thus, while FINRA should continue to administer its examinations, other expert advisers and financial planners should devise and administer their examinations. It may well be necessary for the Commission to review the examinations that FINRA is currently administering and determine whether additional or different materials especially with respect to fiduciary duties should be added to the exam.

Advisers have developed examinations and certification that have acquired reputation and respect. Therefore their examinations and certifications will be counted as required (by Brokers Etc. as well).

Inspections and examinations. Keeping in mind that Congress required uniformity, inspection and enforcement pose a problem. It is unclear that the Commission possesses the resources necessary to examine Brokers Etc. which now include numerous small advisers. If the advisers that are currently examined by the States should be examined in a uniform way, then one possibility is to inquire whether the state securities regulators' organization would not be ready to create a uniform examination system for all advisers, both the managers of large amounts and smaller amounts.

Self Regulatory Organization (SRO) of Adv isers. Advisers were invited to create SROs a number of times throughout the years and did not accept the responsibility. Therefore, examinations of Brokers Etc. etc. should remain in the hands of FINRA until it is determined whether the examinations are sufficiently rigorous. If more situations like Madoff's appear, then the law might have to be changed, and some other organization must take over.

Self regulation has advantages of expertise in the area as well as reputational interest. Nonetheless, if FINRA serves as the examiner of all market intermediaries included in Brokers Etc. then its examinations should be reported to the Commission, the Commission should have supervision over the examiners and FINRA's power to examine should be limited in time and revisited and evaluated periodically, for example, every two years. That is because FINRA has already accumulated significant power and because it is, by definition, influenced by Brokers Etc. whom it examines.

Regulation of disputes. Disputes between the advisers, Brokers Etc. and clients should not swamp the courts. So arbitrations should remain in place. However, whether FINRA should be the supervisor of such arbitrations is a serious issue. FINRA's arbitrators are experts in the financial area. However, their sympathy lies with the intermediaries. They may have less understanding towards the client, and especially the stupid, gullible, trusting, client. They are less inclined to worry about the current culture in which they live or have lived. If FINRA is to continue to manage these arbitrations and help select the arbitrators then there must be a measure of accountability for the selection process.

Accountability might take the form of publishing the results of the arbitrations. I was told that this suggestion raised howls of protests from the arbitrators and the lawyers. There was too much work, they argued. And it would cost investors more. However, there must be some compromising solution. Cases that involve a minimal amount may be left unreported. Arbitrators may hire young lawyers who would outline the facts and the results without the arguments and the evidence. After all, arbitrators do listen to the facts and determine which facts should be important. The information about these facts and decisions is helpful to those who consider seeking arbitration and the arbitrators. Experience in this area may be helpful to determine whether FINRA should continue to manage the arbitration. And perhaps investors should pay some of the cost of such arbitrations (apart from the cost of their representation).

Sincerely,

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