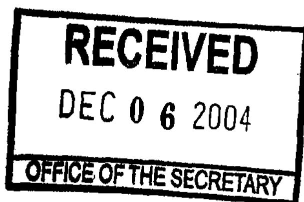

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November 30, 2004

4-495

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: **Request for Rulemaking Pursuant to Rule 192(a), SEC Rules of Practice: Application of the Investment Advisers Act of 1940 To Investment Advisory Activities As Was Originally Intended By the U.S. Congress**

Re: Release No. IA-2278; File No.: S7-25-99

Re: Release No. 34-49639; File No. S7-20-04

Mr. Secretary:

This is a request for rulemaking pursuant to Rule 192(a), SEC Rules of Practice.[1] ***The undersigned ("Petitioner") requests the the creation of a rule designed to enforce the clear language, plain meaning, and intent of Congress as expressed in the Investment Advisers Act of 1940, as amended, in order that the will of Congress is no longer thwarted by the SEC's actions.*** Furthermore, Petitioner proposes the repeal of Rule 206(3)-1,[2] and Proposed Rule 202(a)(11)-1 [17 CFR

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[1] Rule 192. Rulemaking: Issuance, Amendment and Repeal of Rules of General Application. (a) By Petition. Any person desiring the issuance, amendment or repeal of a rule of general application may file a petition therefor with the Secretary. Such petition shall include a statement setting forth the text or the substance of any proposed rule or amendment desired or specifying the rule the repeal of which is desired, and stating the nature of his or her interest and his or her reasons for seeking the issuance, amendment or repeal of the rule. The Secretary shall acknowledge, in writing, receipt of the petition and refer it to the appropriate division or office for consideration and recommendation. Such recommendations shall be transmitted with the petition to the Commission for such action as the Commission deems appropriate. The Secretary shall notify the petitioner of the action taken by the Commission.

[2] Rule 206(3)-1 -- Exemption of Investment Advisers Registered as Broker-Dealers in Connection with the Provision of Certain Investment Advisory Services. An investment adviser which is a broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934 shall be exempt from section 206(3) in connection with any transaction in relation to which such broker or dealer is acting as an investment adviser solely (1) by means of publicly distributed written materials or publicly made oral statements; (2) by means of written materials or oral

275.202(a)(11)-1], as well as the proposed amendment to the instructions for Schedule I of Form ADV [17 CFR 279.1], all of such proposed rules promulgated under the Investment Advisers Act of 1940.[3] The latter Proposed Rule, while not finalized, has effectively governed the actions of certain broker-dealers pursuant to the no-action position undertaken therein.

I. Executive Summary.

The U.S. Securities and Exchange Commission ("Commission") has long sought to require disclosure of pertinent facts as a means of enabling individual investors to make proper decisions. Given the current crisis in the securities markets, it is important for the Commission to finally adopt rules that give full effect to one of its most important tools - the Investment Advisers Act of 1940. The Congressional intent behind this

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statements which do not purport to meet the objectives or needs of specific individuals or accounts; (3) through the issuance of statistical information containing no expressions of opinion as to the investment merits of a particular security; or (4) any combination of the foregoing services: Provided, however, That such materials and oral statements include a statement that if the purchaser of the advisory communication uses the services of the adviser in connection with a sale or purchase of a security which is a subject of such communication, the adviser may act as principal for its own account or as agent for another person. For the purpose of this Rule, publicly distributed written materials are those which are distributed to 35 or more persons who pay for such materials, and publicly made oral statements are those made simultaneously to 35 or more persons who pay for access to such statements.
[Regulatory History:
40 FR 38159, Aug. 27, 1975.]

[3] CFR §275.202(a)(11)-1 Certain broker-dealers deemed not to be investment advisers. A broker or dealer registered with the Commission under Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o) (the "Exchange Act"):

(a) Will not be deemed to be an investment adviser based solely on its receipt of special compensation, provided that:

(1) The broker or dealer does not exercise investment discretion, as that term is defined in Section 3(a)(35) of the Exchange Act (15 U.S.C. 78c(a)(35)), over the accounts from which it receives special compensation;

(2) Any investment advice provided by the broker or dealer with respect to accounts from which it receives special compensation is solely incidental to the brokerage services provided to those accounts; and

(3) Advertisements for, and contracts or agreements governing, accounts for which the broker or dealer receives special compensation include a prominent statement that the accounts are brokerage accounts;

(b) Will not be deemed to have received special compensation solely because the broker or dealer charges a commission, mark-up, mark-down or similar fee for brokerage services that is greater than or less than one it charges another customer; and

(c) Is 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 Act.

PART 279 -- FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940
By amending Instruction 7 in Form ADV Schedule I Instructions (referenced in § 279.1) by adding paragraph (c)(5) to read as follows:
Instruction 7. Determining Assets Under Management

(c) Continuous and Regular Supervisory or Management Services. Accounts that do not receive continuous and regular supervisory or management services:

(5) Brokerage accounts, unless the applicant has discretionary authority.

important legislation, and its potential impact, can be observed in the landmark U.S. Supreme Court case of *S.E.C. vs. Capital Gains.*

Rather than seek to narrow the scope of this important piece of consumer legislation, both as to its applicability to various functional activities and as to the types of requirements imposed upon investment advisers, it is time for the Commission to seek to fully embrace the important concept of the investment adviser as a "fiduciary." It is time for Commission can take a long overdue step down the right path and toward the restoration of investor confidence in our capital markets. Without such a step, all of the reforms initiated by the Commission during the past few years will mean very little to the individual investor. Without a new rule affirmatively applying a fiduciary duty to the actions of investment advisers, and the repeal of two existing Proposed Rules which seek to limit the application of the Investment Advisers Act, the Commission's past reforms will not prevent the continued deceit of individual investors by product salespersons who tout their "objective advice" but who, in reality, possess numerous conflicts of interest, undisclosed allegiances, and hidden compensation - all of which serve to operate against the best interests of the individual investor.

This correspondence seeks to propose a new rule, for the benefit of the investment public. This correspondence seeks to advance a rule which, if enacted, would greatly protect the individual investor. This correspondence also suggests additional actions the Commission might undertake to protect the best interests of the investment consumer.

II. Background.

A. The Important Role of the Commission. The U.S. Securities and Exchange Commission ("Commission") oversees key participants in the securities world, including stock exchanges, self-regulatory organizations, broker-dealers, investment advisors, investment companies (mutual funds), and public utility holding companies. The primary mission of the Commission is to protect investors and maintain the integrity of the securities markets. To this end, the Commission is concerned primarily with promoting disclosure of important information, enforcing the securities laws, and protecting investors who interact with these various organizations and individuals.

B. The Current Crisis In Regulation of the Financial Markets. In 2003, as in years past, the Commission received substantially more complaints about broker-dealers than any other type of entity (including issuers, mutual fund companies, and transfer agents). The ten most common types of complaint, in descending order, are: (1) misrepresentations; (2) fees, commissions, and administrative costs, (3) unsuitable recommendations; (4) transfer of account problems; (5) unauthorized transactions; (6) failure to follow customer's instructions; (7) failures to process/delays in executing orders; (8) bankruptcy; (9) errors/omissions in account records; and (10) cold calling.

Beyond the "usual" problems, however, have existed a bevy of scandals which have rocked the securities industry. Not too long ago, and even continuing this year, corporate scandals had come to dominate the daily business news. Wall Street was tarnished by the $1.4 billion penalty which challenged the very core of the conflict-ridden relationship between investment banking and investment research. A new law, the Sarbanes-Oxley Act, has been approved, in part to cure the disease of corporate fraud, manifested by a focus on "making the numbers" and managing earnings in a way that satisfied the Wall Street beast. Stock options were awarded with no recognized accounting costs, thereby distorting true earnings figures of many corporations to such a degree that the key earnings information gathered by individual investors was often meaningless. Self-regulatory organizations have been criticized for failing to adequately enforce their own regulations. Late trading and other scandals have even rocked the mutual fund industry, once seen as pristine relative to the actions of broker-dealers. The cumulative effect of these and other breakdowns has been a crisis of investor confidence in our capital markets.

C. The Major Concept Underlying All Securities Laws: Adequate Disclosure of Information. All of the laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it. Only through the steady flow of timely, comprehensive and accurate information can people make sound investment decisions.

D. But Wait!!! - The Higher Standard of The Investment Advisers Act: A Broad Fiduciary Duty. Notwithstanding the foregoing general concept underlying securities laws, the Investment Advisers Act of 1940 ("Advisers Act") adopts a far higher standard of conduct for those who are "investment advisers." The

Advisers Act regulates the activities of certain "investment advisers," which are broadly defined in Section 202(a)(11) as "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."[4] Limited exceptions are prescribed under the Advisers Act for certain narrowly proscribed activities.[5]

Investment advisers must register with the Commission and conform to regulations designed to protect investors. Since the Act was amended in 1996, generally only advisers who have at least $30 million of assets under management or advise a registered investment company must register with the Commission. A specific set of standards governs investment advisers. For example, all advisory clients must be delivered an informational brochure.[6] Advisory clients must also receive, among other things, certain disclosures about their investment adviser, including disclosure about the firm's conflicts of interest, other business activities and affiliations, disciplinary history and, in some cases, financial condition.[7] Advisory clients' accounts also have restrictions on effecting principal trades. 15 U.S.C. 80b-6(3).

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[4] Section 202(a)(11) of the Advisers Act provides: "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; but does not include

(A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 [12 U.S.C. 1841 et seq.] 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 whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and 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 ... as exempted securities ...

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

[5] *Id.*

[6] Rule 204-3 [17 CFR 275.204-3].

[7] Rule 206(4)-4 [17 CFR 275.206(4)-4].

Beyond these requirements, however, rests a fundamental rule within the Investment Advisers Act of 1940 which Congress intended to be broadly applied. This all-important concept, too frequently overlooked by the Commission, is that an investment adviser is a "fiduciary." In understanding the imposition of this fiduciary standard, the U.S. Supreme Court's landmark decision, *SEC vs. Capital Gains Research Bureau*,[8] is the beginning point for any examination of the monumental scope of the Investment Advisers Act of 1940. Furthermore, this leading decision, which is the law of the land, evidences Congressional intent that this statutory tool be applied by the Commission to protect individual investors to a very high degree. Given the importance of this decision, following are extensive excerpts from it:

> "The Public Utility Holding Company Act of 1935 'authorized and directed' the [SEC] 'to make a study of the functions and activities of investment trusts and investment companies ... The report reflects the attitude - shared by investment advisers and the Commission - that investment advisers could not 'completely perform their basic function - furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments - *unless all conflicts of interest between the investment counsel and the client were removed*.' The report stressed that affiliations by investment advisers with investment bankers, or corporations might be 'an impediment to a disinterested, objective, or critical attitude toward an investment by clients. . . .'
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> "This concern was not limited to deliberate or conscious impediments to objectivity. Both the advisers and the Commission were well aware that *whenever advice to a client might result in financial benefit to the adviser - other than the fee for his advice - 'that advice to a client might in some way be tinged with that pecuniary interest [whether consciously or] subconsciously motivated . . . .' The report quoted one leading investment adviser who said that he 'would put the emphasis . . . on subconscious' motivation in such situations.* It quoted a member of the Commission staff who suggested that a significant part of the problem was not the existence of a 'deliberate intent' to obtain a financial advantage, but rather the existence 'subconsciously [of] a prejudice' in favor of one's own financial interests. The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations, which contained the following canon: '*[An investment adviser] should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect.*'
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> "Other canons appended to the report announced the following guiding *principles: that compensation for investment advice 'should consist exclusively of direct charges to clients for services rendered'; that the adviser should devote his time 'exclusively to the performance' of his advisory function; that he should not 'share in profits' of his clients; and that he should not*

[8] 375 U.S. 180 (1963).

'directly or indirectly engage in any activity which may jeopardize [his] ability to render unbiased investment advice.' These canons were adopted 'to the end that the quality of services to be rendered by investment counselors may measure up to the high standards which the public has a right to expect and to demand' ....

"This study and report ... culminated in the preparation and introduction ... of the bill which, with some changes, became the Investment Advisers Act of 1940. In its 'declaration of policy' the original bill stated that: 'Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission . . . it is hereby declared that the national public interest and the interest of investors are adversely affected ... when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients ... It is hereby declared that the policy and purposes of this title, in accordance with which *the provisions of this title shall be interpreted, are to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section ...*

"Hearings were then held before Committees of both Houses of Congress. In describing their profession, *leading investment advisers emphasized their relationship of 'trust and confidence' with their clients* and the importance of 'strict limitation of [their right] to buy and sell securities in the normal way if there is any chance at all that to do so might seem to operate against the interests of clients and the public.' The president of the Investment Counsel Association of America, the leading investment counsel association, testified that the *'two fundamental principles upon which the pioneers in this new profession undertook to meet the growing need for unbiased investment information and guidance were, first, that they would limit their efforts and activities to the study of investment problems from the investor's standpoint, not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their investment judgment; and, second, that their remuneration for this work would consist solely of definite, professional fees fully disclosed in advance.'*

"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.* It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any

practice which operates 'as a fraud or deceit,' intended to require proof of intent to injure and actual injury to clients ...

"An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is *serving 'two masters' or only one*, 'especially . . . if one of the masters happens to be economic self-interest.' *United States v. Mississippi Valley Co.*, 364 U.S. 520, 549 ...

"The statute, in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested ...

"Experience has shown that disclosure in such situations, while not onerous to the adviser, is needed to preserve the climate of fair dealing which is so essential to maintain public confidence in the securities industry and to preserve the economic health of the country ...."[9]

As seen in the discussion above, the Advisers Act clearly imposes a broad fiduciary duty upon those who seek to provide investment advice. Moreover, the Advisers Act expresses the will of Congress to not only *disclose* conflicts of interest, but also that investment advisers *proactively eliminate* conflicts of interest wherever reasonable to do so.

E. What Is A "Fiduciary"? A fiduciary has rights and powers which must be exercised for the benefit of another (i.e., a trust beneficiary, or an investment client). A fiduciary has rights and powers which would normally belong to another person. The fiduciary holds those rights which he or she must exercise to the benefit of the beneficiary. A fiduciary is a person in a confidential relationship who owes a duty of trust, utmost loyalty and good faith to another. A fiduciary must not allow any conflict of interest to infect their duties towards the beneficiary and must exercise a high standard of care in protecting or promoting the interests of the beneficiary.

Accordingly, a registered investment advisor, as a fiduciary, possesses a legal duty arises to put the client's interests above his or her own. The investment advisory firm and its representatives must act with a high degree of care, skill, diligence and prudence, and must act objectively on behalf of the investor client.

The fiduciary investment adviser must seek to avoid, not merely disclose, material conflicts of interest. A conflict of interest generally arises when a person's or entity's duty of loyalty to another clashes

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[9] *Id., at* 187-201. *(Emphasis added).*

with other interests of that person or entity. A material conflict of interest exists when there is any circumstance which might incline an investment adviser to not be completely objective in the rendering of advice.

F. The Fiduciary Duty To Avoid (Not Merely Disclose) Conflicts of Interest. As set forth in the *Capital Gains* decision, the investment adviser "should devote his time 'exclusively to the performance' of his advisory function; that he should not 'share in profits' of his clients; and that he should not 'directly or indirectly engage in any activity which may jeopardize [his] ability to render unbiased investment advice."

Why is mere disclosure not enough? Because at the core of the fiduciary duty are the twin duties of due care and loyalty, each equally important and each very broad in their scope and potential application. Chief Judge Cardozo of the Court of Appeals of the State of New York, in an often quoted passage from his opinion in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928), described a fiduciary's duty of loyalty as follows: "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."

Registered investment advisors are simply held to a higher standard, and adherence to this higher standard must dictate the manner in which their business is organized and client relationships are developed and maintained. For the registered investment advisory profession to advance to serve the best interests of the investment public, fiduciaries should eliminate (and not just disclose) conflicts of interest wherever possible. Only in those instances where removal of a material conflict of interest would not be possible should the investment adviser seek to fully disclose the conflict of interest. Even then, proper management of the conflict of interest should be required in order to keep the best interests of the client paramount. Seventy years ago Supreme Court Justice Harlan Stone observed:

> I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.' More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle ... Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent ... suggest how far we have ignored the necessary implications of that principle.

The loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity are incalculable.[10]

Reflecting on the comments of the late Justice Stone, made in the year (1934) in which the Commission began its operations, one can only wonder if the 1999 Proposed Rule is not just another "clever legal device" to avoid application of the all-important fiduciary duty, and how much harm it has already caused and will continue to cause should the Proposed Rule not be repealed. Moreover, one can only wonder why the Commission has, over the past six decades and more, yet to strictly enforce the fiduciary principles and guidelines laid out by the Investment Advisers Act of 1940, and how much harm has been caused as a result thereof.

The Commission should not substitute its judgment on policy issues that were already the subject of extensive Congressional deliberations and final action. In effect, over several decades the Commission has dealt inappropriately with issues that already had been settled by Congress, even though these issues and Congressional intent was given further weight by the U.S. Supreme Court in its interpretative decision. Over the past 64 years, the Commission has proceeded down a different road than that prescribed by the U.S. Congress. This different road is indeed a slippery slope, at the bottom of which is the complete erosion of the protections afforded by imposition of the fiduciary duty standard. Given the conflict-ridden, scandalous activities of many Wall Street participants, the time has come for the Commission to back up that slope and proceed instead down a road that protects individual investors, rather than eviscerates the protections intended by Congress. It is time for the SEC to proceed down a straight and narrow road in favor of, and not opposed to, protection of investment consumers, lest the Commission's actions become meaningless as to them.

G. Pending Exceptions From the Advisers Act. Section 202(a)(11)(C) of the Advisers Act excepts from the definition a broker or dealer "whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." A 1999 Proposed Rule (known as the "Merrill Lynch Rule")[11] seeks to extend this exception to nearly all broker-dealer fee-based accounts (except those which are discretionary). This Proposed Rule is still being reviewed, as of the date of this Petition, as is another proposed new rule that would exempt certain thrift institutions from the Investment Advisers Act of 1940.[12]

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[10] 48 Harv. L. Rev. 1, 8 (1934).

[11] *Certain Broker-Dealers Deemed Not To Be Investment Advisers* [Release No. IA-2278; File No.: S7-25-99].

[12] *Certain Thrift Institutions Deemed Not To Be Investment Advisers* [Release No. 34-49639; File No. S7-20-04].

The Petitioner has previously submitted extensive comments[13] regarding the Merrill Lynch Rule. These comments set forth a compelling legal/public policy rational for the repeal of the Merrill Lynch Rule, and the Petitioner does not desire to repeat those arguments in this Petition. Rather, the Petitioner seeks to propose, for the Commission's consideration, a new Proposed Rule which would, for the first time, adequately guide investment advisers as to the true scope of their duties under the Investment Advisers Act of 1940.

However, I would be remiss if I did not provide some additional factual context for the Commissioners to consider. Perhaps this tale will convey the plight of individual investors today.

I was sitting one evening with a group of CPAs, attorneys, and registered investment advisors, all of whom were attending a conference. As we sat around the hotel lounge that evening, the discussion of the typical activities of stockbrokers comes up. High-cost variable annuities being sold aggressively to retirees. Everyone in the group emitted a low laugh - a "chuckle." Tax-inefficient mutual funds, causing significant tax consequences to the individual investor. Another chuckle. Sales of proprietary, high-cost mutual funds to investors. Chuckle. A constant chasing of investment returns, buying and selling mutual funds or other products in response to past performance, and inevitably leading to portfolio underperformance by the investor customer. Chuckle. Individual investors who think that their stockbroker has never charged them anything, and are totally unaware of deferred contingent sales charges, hidden costs from bid and asked spreads and principal markets, and the substantial payments often made by mutual funds to brokerage firms (and, indirectly, to stockbrokers) for selling their funds. Chuckle. Stock brokerage firms who constantly disclaim that they do not give tax advice, even though advising on investments in any reasonable fashion must, necessarily, involve tax planning and tax advice. Another chuckle.

The next evening I flew home. I happened to sit by a nice elderly widow, Mrs. Anderson, on the flight back. We had a nice conversation, and as she inquired of what I do she tried to understand what I, as an investment adviser, do for my clients. Like nearly all of the investors I meet, she simply had no idea that there was a difference between a stockbroker and an investment advisor. To help her understand, I related to her the conversation of the prior evening. As I finished that story, Mrs. Anderson turned to me and told me that I had it wrong. She said that my tale was not some Shakespearean comedy. Rather, it was a Shakespearean tragedy. A tragedy that people like her know so little about investments. A tragedy that so many investors walk into brokerage firms and are never told of the many undisclosed conflicts of interest, while thinking they were receiving objective advice.

This is why this new Proposed Rule is so necessary - to protect the Mrs. Andersons of the world. It is why the Investment Advisers Act of 1940 was enacted by Congress. It is why the Commission should

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[13] *See* Comments of Ron A. Rhoades, August 30, 2004, and supplemental comments dated November 7, 2004, with regard to the Proposed Rule, *Certain Broker-Dealers Not To Be Investment Advisers*.

seek to fully apply this powerful legislation which was meant to protect consumers - all of those who seek out investment advice, not the mere purchase of a security. In part due to inaction by the Commission to enforce the Investment Advisers Act of 1940, the vast majority of individual investors today fail to understand that a brokerage account means that the registered representative - unlike a registered investment adviser - has no blanket fiduciary duty to place the client's interests first nor any affirmative obligation to disclose all material conflicts of interest.

III. **New Proposed Rule On Fiduciary Duty.** The protections of the Advisers Act and the rules promulgated thereunder must be afforded to those persons ("advisory clients") the Advisers Act was intended to protect. Furthermore, the fiduciary duty of an investment adviser should extend to the avoidance of material conflicts of interest, not their mere disclosure. Moreover, investors should be informed, clearly and prominently, as to whether they are dealing with a broker or an investment adviser, and what consequences may follow as a result.

Accordingly, Petitioner proposes a new Proposed Rule under the Investment Advisers Act of 1940, to supplement the anti-fraud provisions currently found in Section 204(2), as follows:

Rule ### under the Investment Advisers Act of 1940:

(1) An investment adviser possesses twin broad fiduciary duties of due care and loyalty to the advisory client. No investment adviser may, by contract or disclaimer, negate the application of such duties to the investment advisory relationship with an advisory client.

(2) An investment adviser shall seek to avoid any material conflicts of interest which might impair the objectivity of the investment adviser.

(3) For material conflicts of interest which cannot reasonably be avoided by the investment adviser, the investment adviser shall prominently disclose the conflict of interest to the advisory client at the time the investment advisory services are rendered.

(4) For any customer account of a broker-dealer, the agreement with the customer shall clearly state at the top of the form, in bold and in a font size greater than that used at any other place in the form, either (as applicable) the following disclosures:

(A) **THIS BROKERAGE ACCOUNT IS SUBJECT TO THE PROTECTIONS AFFORDED BY THE INVESTMENT ADVISERS ACT OF 1940. ACCORDINGLY, AS THE CUSTOMER YOU ARE ENTITLED TO FULL AND COMPLETE DISCLOSURE OF ANY MATERIAL CONFLICTS OF INTEREST WHICH THE ADVISORY FIRM AND ITS REPRESENTATIVE MAY POSSESS. YOU ARE ENTITLED TO THE TWIN FIDUCIARY DUTIES OF DUE CARE AND LOYALTY FROM YOUR INVESTMENT ADVISER. SHOULD YOU POSSESS ANY QUESTIONS REGARDING THE SCOPE OF THESE BROAD FIDUCIARY DUTIES, PLEASE REFER TO THE U.S. SECURITIES AND EXCHANGE COMMISSION'S WEB SITE AT <u>www.sec.gov</u> OR CALL THE U.S. SECURITIES AND EXCHANGE COMMISSION AT (#).**

(B) **THIS BROKERAGE ACCOUNT IS <u>NOT</u> AN INVESTMENT ADVISORY ACCOUNT, BUT RATHER THIS ACCOUNT IS MERELY A BROKERAGE ACCOUNT. AS SUCH, THE REGISTERED REPRESENTATIVE IS AN ORDER-TAKER. ANY ADVICE GIVEN TO YOU BY THE REGISTERED REPRESENTATIVE IS SOLELY INCIDENTAL TO THE SALE OF A SECURITY AND SHOULD NOT BE CONSIDERED OBJECTIVE OR COMPREHENSIVE. THE REGISTERED REPRESENTATIVE AND THE BROKERAGE FIRM DO <u>NOT</u> POSSESS A FIDUCIARY DUTY TO ACT IN YOUR BEST INTERESTS. SHOULD YOU DESIRE TO BE AFFORDED THE PROTECTIONS OF THE INVESTMENT ADVISERS ACT OF 1940, PLEASE INQUIRE WITH THE REGISTERED REPRESENTATIVE, OR ANOTHER ADVISOR, ABOUT A BROKERAGE ACCOUNT WHICH IS ALSO AN INVESTMENT ADVISORY ACT. MORE INFORMATION CONCERNING THE DISTINCTION BETWEEN INVESTMENT ADVISORY ACCOUNTS AND BROKERAGE ACCOUNTS (WHICH ARE NOT INVESTMENT ADVISORY ACCOUNTS) CAN BE FOUND AT THE U.S. SECURITIES AND EXCHANGE COMMISSION'S WEB SITE AT <u>www.sec.gov</u> OR CALL THE U.S. SECURITIES AND EXCHANGE COMMISSION AT (#).**

IV. Additional Efforts For The Commission To Consider.

Beyond the enactment of a clear rule which imposes broad fiduciary duties on all of those who seek to provide investment advisory services, and the repeal of two pending Proposed Rules which provide exceptions from the application of the Investment Advisers Act of 1940, the Commission should undertake several additional efforts to correct the inappropriate past treatment afforded to investment advisory accounts.

The Commission should prohibit the misleading advertisements by broker-dealer firms which tout investment advisory services, but which then steer clients to non-investment advisory accounts. The Commission should recognize that "financial planning" necessarily involves some form of investment advisory services. Accordingly, the Commission should prohibit brokers who claim the solely incidental exemption from marketing their services as advisory services by prohibiting use of the terms 'financial,' 'retirement,' 'wealth,' or similar terms in combination with 'advice,' 'consult,' 'counsel,' 'plan,' or any similar combination of words suggesting comprehensive financial planning services; or permitting individuals from using a title similar to 'financial planner.' "

In any action undertaken, the Commission should ensure that the fiduciary role of an investment adviser is not compromised by shared allegiances. In other words, an investment adviser, to be truly objective, cannot serve two masters. Given the very complicated world out there – with a myriad of tax rules, financial planning decisions, the need to integrate investment decisions with asset protection and estate planning, and the myriad of investment products available, investors need truly objective advice. Most investors desire some form of coaching, to make certain they do not make mistakes (such as the common mistake of chasing returns). Investors deserve to receive advice which is truly in their best interests. Conflicts of interest, so prevalent in Wall Street, should be avoided if at all possible. Only when conflicts of interest cannot be avoided should they be permitted, and then only with full disclosure. "The best interests of the client" is not a standard which should be subjected to compromise. The Commission should not act to proceed down a "slippery slope," at the bottom of which is a complete erosion of the protections afforded investors who desire and seek objective, unbiased investment advisory services.

In addition, the Commission should seek to assist investment advisers by defining for them the many specific duties encompassed within the broad fiduciary duty. Suggestions in this regard could include the issuance of a Commission staff report, a commission of those in the investment advisory profession which would seek to define both the scope of fiduciary duty and "best practices" for investment advisers who advise individual investors, or the use of educational funds (such as those set aside from the research analyst conflicts of interest settlement) to fund projects relating to investment adviser and broker-dealer education as to the nature and extent of fiduciary duties.

Clients of investment advisers who pay an hourly or flat or fixed fee, or a percentage of assets under management, are often placed at a substantial disadvantage, from a perspective of federal income tax law,

compared to those who compensate their "financial counselor" through commissions, 12b-1 fees, and other arrangements. Investment advisory fees are deductible, but only if the taxpayer elects to itemize deductions, and even then only to the extent that "miscellaneous itemized deductions" are greater than 2% of your adjusted gross income. Additionally, rules relating to alternative minimum tax and the phase-out of itemized deductions also can come into play. As a result, many taxpayers, especially retirees, receive no benefit from the possible tax deductibility of investment advisory fees. By contrast, since commissions and 12b-1 fees are deducted at the investment product level, but often utilized to pay broker-dealer firms and their registered representatives, and these fees offset the level of gross returns of the investment, thereby effectively resulting in a complete income tax deduction. Furthermore, investment advisory fees should be able to be deducted directly from tax-deferred accounts (such as IRAs), without such deduction being treated as a withdrawal by the account holder (and subjected to income tax). The Commission should seek to have the disparate treatment afforded to investment advisory accounts addressed by Congress through future tax legislation.

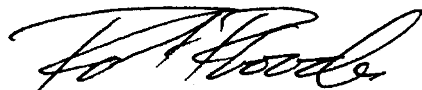
The Commission should have its staff act promptly to revise its own literature which exacerbates consumer confusion by not clearly delineating between broker accounts and investment advisory accounts. The Commission should inform those seeking investment advice that investment advisers are held to a very high fiduciary duty.

The old brokerage firm model is being replaced by fee-only advice. Investors want to seek advice from those who they pay – not from someone who is paid by others. The Commission should seek to encourage all broker-dealer firms to establish and promote separate investment advisory divisions. Those investment advisory divisions should be structured to operate completely independently from the many other business activities of a large wirehouse, in order that fiduciary duties can be strictly adhered to by the investment adviser representative. For example, the Commission should prohibit the promotion or placement of "proprietary products" into investment advisory accounts.

In Conclusion. I am hopeful that the Commissioners, and SEC staff, will take advantage of this opportunity to more fully apply the Investment Advisers Act of 1940. Such application should be broad in terms of the types of functional activities covered. Such application should also be broad as to the scope of the important duties levied upon investment advisers. Such application is key to restoration of investor confidence in our securities markets and adequately protecting the consumer in this complicated financial world. To prevent the continuation of the tragedies experienced so often by the Mrs. Andersons of this country, I urge the Commission to undertake prompt and decisive action.

I would be most willing to participate in further discussions with the Commission or its staff, and to respond to any questions which may be posed. Please contact me if I can be of assistance.

Respectfully submitted.



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