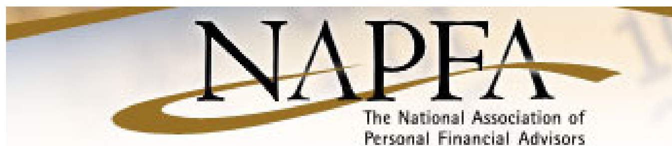

VIA ELECTRONIC MAIL

Revised - June 4, 2008

FOCUSonFiduciary™

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Subject: Amendments to Form ADV, Part II
File Number S7-10-00

Dear Ms. Morris:

The National Association of Personal Financial Advisors ("NAPFA")[i] appreciates the opportunity to submit these revised comments regarding the Commission's Proposed Rule regarding enhancements to Form ADV.

NAPFA is generally supportive of the Commission's efforts to revise the format and filing requirements for Form ADV, Part II ("Part 2"). An enhanced narrative disclosure can result in better understanding by consumers of an investment adviser's investment philosophies, fees, and policies to avoid or mitigate conflicts of interest. NAPFA also applauds the Commission's recent initiatives to make Part 2 available to consumers via the IARD web site. However, we request that some of the proposed revisions be reconsidered, in light of the burdens placed upon investment advisers by some aspects of the proposal. Moreover, while NAPFA generally supports the Commission's efforts to enhance Part 2 and provide further guidance for investment advisers, we are very concerned over some of the content of SEC Release IA-2711; we suggest changes which we hope the Commission will incorporate into future releases.

1. **Non-Uniform Format Preferred.** In IA-2711, the Commission stated: "We are of the initial view that the wide variety of business activities of the large number of advisers registered with us makes it impractical to develop a uniform format. We request comment on whether our view is correct." NAPFA concurs with the Commission's assessment. While a uniform table of contents for Part 2 might permit easier comparisons of one firm's services to another, the adoption of a uniform table could also confuse investors. For example, some of NAPFA's investment advisers emphasize as the core component of their practices the provision of personal financial advisory services and do not engage in investment management. Others stress wealth management services. Still others incorporate financial planning into their investment management services. Each investment adviser should be free to set forth, in order of the investment adviser's choosing, those services which it desires to emphasize. If a mandated order of describing services were imposed, this could actually create consumer confusion by misleading the consumer, on occasion, as to the primary service offering of the investment adviser; many consumers believe that just because a service is described first, in a pre-determined order, it is the emphasized service of the investment adviser.

2. **Brevity.** While NAPFA supports the concept that narrative disclosures, to be most effective, should be brief, we are concerned that certain aspects of the proposal will deter investment advisers from brevity and lead to lengthy disclosures in Part 2.

   For example, the Commission has focused a great deal of its examination and enforcement efforts in recent years on the adequacy of disclosures of conflicts of interest. Indeed, NAPFA has recently recommended to its members that they make enhanced disclosure of conflicts of interest relating to fee-only compensation, and this disclosure is anything but brief.[ii]

   While it is possible that brevity can be achieved, this brevity is not likely to result until such time as guidance from the Commission, perhaps through "safe harbor" disclosure formats, is provided. In the meantime, investment advisers are likely to go overboard on disclosures in their Part 2, in order to avoid any perception by the Commission's Division of Enforcement that the disclosures are inadequate in any way. We suggest that the Commission monitor, through the upcoming requirement that Part 2 be made available through the IARD system, the types and length of disclosures, in order to ascertain whether model disclosures or "safe harbor" disclosures could be useful to both investment advisers and their clients in the future.

   We also suggest that the Commission consider not requiring disclosure of proxy voting services and trade aggregation procedures in its Part 2. Proxy voting services employed by an investment adviser may change from time to time, and this may trigger an update to Part 2. Trade aggregation procedures are more appropriate addressed in other communications to client, such as in the client services agreement. If one goal of the proposal to amend Part 2 is

brevity, then investment advisers should possess a choice as to what document in which to include disclosures of these matters (i.e., Part 2, or the client services agreement, or some other document). NAPFA believes that disclosures of proxy voting services and trade aggregation, while important, do not arise to the level of concern for a client that their disclosure should be mandated in Part 2.

3. **"Specialization."** The Proposed Rule states that disclosure in Part 2 would be required if the investment adviser "holds itself out as specializing in a particular type of advisory service." We believe that the use of the word "specializing" could create problems relating to the standard of care and creates problems in its interpretation.

   As to the standard of care, we note that the duty of care is relational in nature; if the advisor holds out as a "specialist" in a specific field, then the duty of care to be provided is not that of a generalist investment adviser but rather the higher duty of care of a specialist. The Commission's rationale for this proposal states that it "simply acknowledges that a client likely would want to know whether an adviser provides specialized advisory services before engaging that adviser." It is unclear whether, if an investment adviser confines his or her work to a specific area, or works mainly with or emphasizes a particular type of clients (such as "retirees" or "business executives"), disclosure would be required. Advisors should be permitted to note in their Part 2 if they emphasize a certain type of client, whether or not they "specialize" in that area.

   Moreover, an investment adviser may possess a large number of clients of a certain type, but this does not necessarily mean the investment adviser "specializes" in that area. In fact, the investment adviser may desire to actively market its practice to clients of a different type (such as retirees or small business owners), but the advisor may just not have accumulated a large number of clients of that type as of the date of the disclosure document filing.

   Accordingly, NAPFA does not believe that this disclosure of "specialist" provides meaningful information to clients. Such disclosures – whether of a "specialty" or "emphasis" – are better left to marketing materials, and as to Part 2 should be optional. However, if Part 2 does hold the investment adviser out as a specialist, then NAPFA would support the requirement that the education and experience and/or certifications underlying that specialty should then be discussed.

4. **Annual Delivery vs. Annual Access, Electronic Delivery.**

In the Proposing Release, the Commission notes that a registered adviser may deliver its brochure and amendments to clients, with their consent, electronically, such as via e-mail. In this regard, the Proposing Release refers to interpretive guidance provided by the Commission in 1996 regarding the use of electronic media to fulfill an adviser's disclosure delivery obligation. Electronic mail reduces the consumption of paper and energy, leading to a more "green" planet. Moreover, many of the clients of NAPFA-registered investment advisers have frequently complained about the volume of mail they receive related to their investments, and a large number have chosen to receive, from their custodians, electronic trade confirmations and statements, in lieu of mailed paper statements.

However, NAPFA concurs with the assessment found in the excellent comment letter submitted on May 2, 2008 by Terrance O'Malley of the firm of Fried, Frank, Harris, Shriver & Jacobsen, LLP, and we "believe that the Commission's 1996 interpretive guidance does not provide clear and concise guidance regarding the specific procedures that an adviser should follow in delivering its brochure and amendments electronically. We believe that this lack of clarity has limited the use of this option."[1]

Once the current Part 2 is posted on the IARD website, any individual with computer access will be readily able to view the advisor's current disclosure should he wish to do so. We therefore suggest that this electronic access plus a brief e-mail informing the client that the document exists, and providing a link to same, would be sufficient.

Furthermore, following sending of an e-mail, there should be no requirement that, once e-mailed, receipt be verified by the client, as keeping track of such receipts would require so much time that most advisers would choose to just mail Part 2 instead. We note that there is no requirement that documents mailed to clients have a return receipt. In addition, many e-mail users will nearly always decline to send a "return receipt" when their e-mail program asks for permission to send it, as a matter of course.

NAPFA concurs with the Commission's assessment that only the current version of the investment advisor's Part 2 should be made available to the public through the IARD system. The business practices, service levels, and fees of investment advisers may change over time. Providing information on past business practices would serve only to cause confusion among clients and potential clients, rather than provide meaningful information.

[1] Comment Letter submitted May 2, 2008 by Terrance O'Malley of the firm of Fried, Frank, Harris, Shriver & Jacobsen, LLP, available at http://www.sec.gov/rules/proposed/s71000.shtml.

5. **Disclosure of Arbitration Awards, Settlements and Claims.** The Proposing Release requests comment on a potential requirement for advisers to disclose arbitration awards, settlements and claims. We urge the Commission to specify that arbitration awards of less than $50,000 are not required to be disclosed. Otherwise, this requirement may be unduly prejudicial to advisers and have a chilling effect on the use of arbitration. Claims may be easily asserted, often without merit, but disposed of for payment of a nominal sum to the claimant as a means of avoiding the expense of pro-longed arbitration.

   Indeed, arbitration awards can be made in cases where no violation of law has occurred, especially in circumstances where the investment adviser's insurance carrier makes an economic decision to settle a pending case. If all arbitration awards, even small ones, must be disclosed, then every investment adviser would have the strong initiative to defend aggressively each and every claim, regardless of the cost of arbitration; this would drive up legal fees and insurance costs for investment advisers.

   In addition, NAPFA concurs with the assessment found in the comment letter submitted on May 2, 2008 by Terrance O'Malley of the firm of Fried, Frank, Harris, Shriver & Jacobsen, LLP, that "a requirement to disclose all arbitration claims may provide disgruntled or unscrupulous clients with unfair leverage in forcing an investment adviser to pay money exceeding actual damages in pre-arbitration settlements."[2]

   Hence, NAPFA suggests that disclosure triggered by arbitration awards in any amount of less than $50,000 not be required, in order to promote the speedy resolution of arbitration proceedings involving small claims.

6. **Disclosure of Risks To Investment Style.** NAPFA believes that disclosures of risks relating to the investment adviser's management style are best placed in other documents, such as an investment policy statement or an educational brochure. There are many, many risks relating to investing and investments. Certain risks may likely be compensated (through higher returns for the investment portfolio, or lower volatility, or both), while other risks may not be adequately compensated, even over the long term. Moreover, an overall portfolio may utilize what seems to be a "risky" asset class (such as micro cap stocks or emerging markets stocks or deep value stocks), but Modern Portfolio Theory and recent academic research into investing may reveal that the presence of such asset classes, as a portion of an investor's portfolio, may reduce the risk of the portfolio (as measured by standard deviation, one of many measures of risk) and/or aid in the long-term expected returns of the client's overall portfolio. Moreover, certain risks

[2] *Id.*

may be assumed (such as holding onto stocks in energy companies) in order to offset financial risks of a client (such as the risk of larger personal expenditures resulting from higher energy prices). Additionally, at times the risk of investing in particular investments or asset classes is higher than at other times, often "significantly" so.

Hence, NAPFA questions whether the requirement that advisers "that use primarily a particular method of analysis, strategy, or type of security would be required to explain the specific material risks involved, with more detail if those risks are significant or unusual" can be addressed appropriately in Part 2. This is especially true if brevity is one of the goals of the document. (The Division of Enforcement, armed with 20/20 hindsight, could always assert that a risk is "significant" even if, at the time of the recommendation, the risk appeared nominal.) NAPFA believes that all that should be required in Part 2 is a statement that "investing in securities involves a risk of loss."

NAPFA believes that investment advisers continue to adopt the policy of educating clients on various investment risks and utilize the "best practice" of formulating an "investment policy" for each client. New academic research appears each year which seeks to identify or better define or measure risks in relation to expected returns. NAPFA believes it is a prudent business practice to discuss risks with clients, in relation to the overall investment portfolio and circumstances of the client. However, for an investment adviser to identify and list each "significant risk" relating to an investment strategy or parts thereof would require many man hours of work and would greatly increase the estimated time to prepare Part 2.

Moreover, one of the greatest risks in investing is not the risks of the investments themselves, but imprudent moves made by a client in reaction to shorter-term market events. Education of the client is necessary to counter this risk; it is not enough that mere disclosure occur that the client's inability to adhere to the investment plan (due to certain behavioral bias) may render the strategy employed of less value.

Some NAPFA member firms may have several investment strategies which are made available to clients. We agree with the Commission's premise that required risk disclosure with respect to particular strategies could be made separately to those clients to whom such disclosure is relevant. However, NAPFA fails to see the logic of requiring a firm with only one "particular method of analysis, strategy, or type of security" to "be required to explain the specific material risks involved," while a firm with multiple strategies would not be required to make disclosures in Part 2. This seems wholly discriminatory against smaller advisory firms. If disclosure of all "significant" investment risks is *so important* that it be elevated to be included in Part 2, then disclosures should be required of the risks of all of the firm's strategies, whether such strategies are just one in number or are over 100 in number.

Again, NAPFA suggests that disclosure of "significant investment risks" should not occur in Part 2, but rather that discussion of investment risks a client may incur is properly left to the ongoing process of client education and consultation. Often education about risks is far better undertaken with the utilization of multiple charts and graphs in presentation materials, rather than through the use of a narrative disclosure in Part 2.

7. **Brochure Supplements.** The Commission would require that an adviser provide clients, in addition to Part 2, "brochure supplements" containing information about certain of an adviser's "supervised persons." The brochure supplement would contain information about every supervised person who "(i) formulates investment advice for that client and has direct client contact, or (ii) makes discretionary investment decisions for that client's assets, even if the supervised person has no direct client contact."[iii] As the Commission notes, a group supplement containing the required information about each such supervised person could be provided as an alternative. As a practical matter, and despite the Commission's attempt to narrow the circumstances in which this brochure supplement might be provided or its content, NAPFA believes that this requirement will place undue burdens upon investment advisers.

   In many of the investment advisory firms of NAPFA members, teams are formulated to serve clients. However, different teams are often formed for different clients. For example, Senior Advisor A may work with Junior Advisor X with respect to Client #1, but Senior Advisor A may work with Junior Advisor Y with respect to Client #2. Additionally, at times Senior Advisor A may be unavailable, and Senior Advisor B may step in to assist in the provision of investment advice to the client. Additionally, Senior Advisor C, who may possess a special expertise in an aspect of income tax planning or estate planning, may be called upon to assist the team with a decision which may impact the investment decisions for the client.

   The consequence of the "brochure supplement" requirement is to generate a potential huge cost to investment advisory firms, to ensure that each client receives the brochure supplement for each and every supervised person who has or may render advice to that client. For a mid-size firm with 20 advisors and numerous inter-changeable teams and cross-utilization of the expert skills of some advisors in multiple teams, investment advice could be formulated, and hence "provided," through the input of many different individuals. "Direct client contact" could occur by any advisor of the firm with a client of the firm through a group conference presentation, a casual meeting with a client, or a response to a client's e-mail or phone inquiry when the client's primary advisor, or advisory team, is unavailable. Hence, the only safe method of complying with the requirement imposed by this aspect of the rule would be to mail a "group supplement brochure" including each and every advisor of the firm. Any departure from the firm or addition to the firm would require a change to such a group brochure supplement. We

believe that this would generate significant costs for investment advisors which are not justified by this requirement.

Accordingly, we urge the Commission to take into account the practical realities of ensuring compliance with this requirement, and to weigh the substantial costs of this requirement against the benefits which may be provided. As noted in the comment letter submitted on May 2, 2008 by Terrance O'Malley of the firm of Fried, Frank, Harris, Shriver & Jacobsen, LLP, "the Commission considered a similar requirement in 1985, but declined to adopt that requirement. Instead, the Commission balanced all relevant factors and adopted the current approach of requiring disclosure of information about key personnel in response to current Item 6 of Part 2. We urge the Commission to reach a similar conclusion today."[3]

However, if brochure supplements are to be required, we suggest that brochure supplements be made available to clients (via mail or electronic mail) only upon request of the client, and only for the supervised persons for which such brochure supplements are requested by the client. Furthermore, in the instance of electronic mail, we suggest that the furnishing of an e-mail setting forth the web site section at which the information contained in the brochure supplements is made available would be sufficient, rather than e-mailing the brochure supplements as an attached document.

8. **Non-Disclosure of Fund and Other Investment Expenses.** In SEC Release IA-2711 the Commission states:

> We are not proposing a requirement that advisers must disclose the amount or range of mutual fund fees or other third-party fees that clients may pay. Commenters explained that these expenses vary so greatly that attempts to quantify them or describe their range likely would not be useful to clients. Several of these commenters further argued that these fees are typically negotiated directly between the client and the other service providers, the adviser does not always know the amount of the fees, and that the third party often discloses the fees directly to the client. Would our proposed requirement that advisers disclose information about mutual fund or other third-party fees, while not disclosing the range of those fees, adequately inform clients that they will bear other costs in addition to advisory fees?

NAPFA believes that full disclosure of all of the fees and costs relating to the receipt of investment advice and to investment products is important. However, given the utilization of different investment strategies and products for particular clients, disclosure of the "total fees and costs" relating to investments and the receipt of investment advisory services is best done on a personal basis and not in Part 2.

[3] *Id.*

NAPFA urges the Commission to move forward with its recent proposal on the Summary Prospectus, wherein NAPFA commented that fees and costs should include a more accurate calculation of portfolio turnover and quantification of costs relating to trading within a mutual fund.[iv] NAPFA also urges the Commission to move forward with proposed rules on “point-of-sale disclosures” for broker-dealer firms and their registered representatives.

9. **<u>Time Required to Update.</u>** NAPFA believes that the Commission fails to recognize all of the time and cost to fully implement and maintain Part 2. Before undertaking an amendment a registered investment adviser will require substantial education on the new requirements. The first time the new proposed rule, if finalized, is implemented by an investment advisers, the adviser will likely spend well over the 22 hours estimated by the Commission. NAPFA suggests that an approximation of sixty (60) hours is more likely for the first revision following the effective date of this rule, if adopted for a small investment adviser with only a few supervised persons and without the service of legal counsel. These higher time estimates for compliance with Part 2 requirements include not only the information-gathering, drafting, and review of the document each year, but also the time spent learning about the rule and how it is being administered from year-to-year.

   NAPFA urges the Commission to adopt a “rolling” procedure for implementation of the Proposed Rule. Many smaller advisers employ legal counsel and/or compliance consulting firms to aid in the updating and filing of their Part 2. Requiring all investment advisers to file at nearly the same time would likely substantially drive up legal fees and compliance costs, as securities lawyers and compliance consulting firms struggle to keep up with the increased workload. Since most mid-size and smaller investment advisers possess a December 31 fiscal year end date, most of these firms will be required to file a revised Part 2 by March 31st of the year following the effective date of this rule. NAPFA suggests that the Commission adopt some method to stagger the implementation in order that securities legal counsel and/or compliance consulting firms are not overburdened with work. The investment adviser community could be divided into four segments, with some advisors required to file an update by March 31st, others by June 30th, others by September 30th, and the remaining by December 31st.

   Additionally, NAPFA suggests a minimum 12-month period following the rule’s adoption for the first phase of its implementation. This will permit investment advisers with the time necessary to seek out legal counsel and/or become educated (through attending conferences, etc.) in order to seek compliance with the new requirements, without incurring unnecessary added undue expense.

10. **The Fiduciary Duty to Properly Manage Conflicts of Interest (Mere Disclosure of Conflicts of Interest Is Insufficient).** The Commission's release appears to infer that mere disclosure of a conflict of interest is sufficient for an investment adviser to fulfill his or her fiduciary duty to a client. NAPFA believes that this statement is contrary to established law and should be corrected in any release which adopts the final rule (with a detailed explanation provided for the benefit of investment advisers, so as to counter any erroneous understanding of investment advisers).

    Specifically, in SEC Release IA-2711, the Commission states that the federal securities law do not "preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts."[v] NAPFA believes that the foregoing statement may serve to mislead investment advisers that mere disclosure of a conflict of interest by a fiduciary investment advisor is all that is required. In reality, the broad fiduciary duties[vi] contained in the Investment Advisers Act of 1940 ("Advisers Act") upon registered investment advisers and their representatives require not just disclosure of material conflicts of interest, but also *informed consent* to proceeding in the presence of the conflict of interest, and even then such requires *proper management* by the investment adviser of the conflict.

    In analyzing the reason why disclosure alone of a conflict of interest is not sufficient, NAPFA observes that it is often believed by some regulators and securities industry participants that federal securities laws and regulations protect investors largely through requiring the disclosure of information – whether it be of material facts regarding an issuer of a security, or of compensation paid to a financial services intermediaries, or of conflicts of interest which exist as to financial services intermediaries. Indeed, it has been stated that in the United States, "federal securities law's exclusive focus is on full disclosure."[vii] However, under fiduciary law, the purpose of disclosure of a conflict of interest is to secure consent from the entrustor (client) to proceeding with a proposed action despite the presence of such a conflict, and such consent to be effective must be an *informed consent*.[viii]

    However, it should be noted that even with ample disclosure, individual investors possess substantial barriers, resulting from behavioral biases[ix], to the provision of informed consent. Indeed, as stated by several academic researchers, "not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but …. competitive pressures almost guarantee that they will do so."[x]

    Given the problems investment consumers face in providing informed consent, the securities laws (and fiduciary law in general) requires not only that disclosure of material conflicts of

interest occur, but also that all conflicts of interest be *properly managed* by the investment adviser. "Even with written disclosure and consent, though, the adviser must reasonably believe that the transactions are in the best interests of the clients – that is, **the adviser's fiduciary obligation is not discharged after disclosure and consent.**"[xi]

Indeed, the presence of substantial conflicts of interest may serve to infect and destroy the formation of an investment adviser–client relationship based upon trust and confidence. At some point the presence of so significant a conflict of interest, or the presence of a significant number of material conflicts of interest, may require recusal, as a reasonable client would not consent to such conflict(s). Hence, in order to preserve the integrity of the relationship between the investment adviser and the client, NAPFA believes that conflicts of interest should be minimized.

However, there are some conflicts that will inevitably occur, such as a person being licensed as a registered representative as well as an adviser. In these instances, the investment adviser must take great pains to clearly and accurately describe all material conflicts of interest and how the adviser will maintain impartiality in its recommendations to clients. Without maintaining such impartiality – i.e., keeping the clients' best interests paramount at all times by *properly managing* the conflict of interest – no client would grant to the fiduciary advisor the *informed consent* necessary to enable the investment adviser with the ability to proceed.

In summary, NAPFA observes that if the investment adviser were to proceed in the presence of a disclosed conflict of interest in a manner which was adverse to the interests of the client, no reasonable client would provide informed consent to so proceeding; hence, proper management of conflicts of interest is always required, even with disclosure and informed consent. NAPFA urges the Commission to more fully explain fiduciary law to investment advisers, including the requirements of disclosure followed by informed consent, at all times keeping the best interests of the client paramount.

11. **Financial Planning As A Distinct Profession.** NAPFA appreciates the Commission's recognition that "financial planning has become a distinct profession, and as such, we believe it merits detailed description in the adviser's brochure." NAPFA agrees with this statement, and that all of the core services of an investment adviser be described with a sufficient level of detail.

    However, NAPFA continues to express its concern over the Commission's misunderstanding that "financial planning" only exists when comprehensive planning services are provided. Financial planning denotes a broad range of activities. Financial planning occurs when only a discrete area of planning services is provided, such as accumulation planning for retirement needs,

establishing a plan for asset utilization during retirement years, education funding, etc. Indeed, as the Commission itself recognized these points in SEC Release No. IA-1092 (1987):

> Financial planning typically involves providing a **variety** of services, principally advisory in nature, to individuals or families regarding the management of their financial resources based upon an analysis of individual client needs. Generally, financial planning services involve preparing a financial program for a client based on the client's financial circumstances and objectives. This information normally would cover present and anticipated assets and liabilities, including insurance, savings, investments, and anticipated retirement or other employee benefits. The program developed for the client usually includes general recommendations for a course of activity, **or specific actions**, to be taken by the client. For example, recommendations may be made that the client obtain insurance or revise existing coverage, establish an individual retirement account, increase or decrease funds held in savings accounts, **or** invest funds in securities. A financial planner may develop tax or estate plans for clients or refer clients to an accountant or attorney for these services.

Hence, in footnote 40 of SEC Release IA-2711, NAPFA requests that the Commission delete the language "we recognize [financial planning's] most marked characteristic is that it seeks to address a wide spectrum of clients' financial needs" in any final rule, and to clarify in all future rule-making that financial planning need not be "comprehensive" to be considered "financial planning" and subject to the fiduciary duties imposed by the Advisers Act. Indeed, as stated in SEC Release IA-2711, the Commission implicitly recognizes that often financial planning services address specific needs, for the release stated that "our proposal simply acknowledges that a client likely would want to know whether an adviser provides specialized advisory services before engaging that adviser."

Again, 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 and fee-only financial advisors, we are available to respond to questions or submit further comments as you may desire.

Respectfully,

Tom Orecchio	Ellen Turf	Diahann Lassus,
Chair, NAPFA	CEO, NAPFA	Chair, Industry Issues Committee

Contact information:
Ellen Turf, CEO, National Association of Personal Financial Advisors (NAPFA)
3250 North Arlington Heights Road, Suite 109, Arlington Heights, IL 60004
Phone (toll-free): 800-366-2732
Phone: 847-483-5400

[i] NAPFA has more than 2,000 members across the United States. All NAPFA-Registered Financial Advisors must submit a comprehensive financial plan and undergo a thorough review of their qualifications prior to admission. NAPFA-Registered Financial Advisors all sign a Fiduciary Oath which states that the advisor will only work in good faith and with the best interests of the consumer at heart. NAPFA-Registered Financial Advisors are strictly Fee-Only®, which means they do not accept commissions or any additional fees from outside sources for the recommendations they make to their clients.

[ii] NAPFA's suggested disclosures for fee-only compensation, the result of a recent joint project of NAPFA's Compensation Committee and Industry Issues Committee, are not brief, and are set forth below:

1. A Candid Discussion of Conflicts of Interest. All financial and investment advisors have some types of conflicts. The vast majority of our clients pay our firm fees based upon a percentage of the assets we advise upon. This is a very common form of compensation for registered investment advisory firms and avoids the multiple inherent conflicts of interests associated with commission-based compensation (our firm does not accept commission-based compensation of any nature, nor does our firm accept 12b-1 fees). Asset-advised-upon percentage compensation method of compensation can still at times lead to conflicts of interest between our firm and our client as to the advice we provide. For example, conflicts of interest may arise relating to the following financial decisions in life: incur or pay down debt; gift funds to charities or to individuals; purchases of a (larger) home or cars or other non-investment assets; the purchase of a lifetime immediate annuity; expenditures of funds for travel or other activities; investment in private equity investments (private real estate ventures, closely held businesses, etc.), and the amount of funds to place in non-managed cash reserve accounts. We have adopted internal policies to properly manage these and other potential conflicts of interest. Our goal is that our advice to you remains at all times in your best interests, disregarding any impact of the decision to be undertaken upon our firm.

2. Conflicts Arising From Assets Managed-Based Compensation Arrangements. Our compensation is based on the amount of your assets which we have under management. This method of compensation creates conflicts in that our compensation may be enhanced in situations where you are depending on objective advice. These may include any situations which would decrease or increase the assets we manage, such as taking out a mortgage rather than using cash, using cash for paying off a mortgage, gifting to charities or children, recommendations to bring other assets, such as 401k accounts, under our management, etc. Each time such a potential conflict may arise, we will give you written notice of the conflict in that given situation if our advice regarding the proposed transaction would impact our compensation.

   This method of compensation does align our interests with yours, as our compensation increases when the assets we manage for you increase. However our revenue may also be increased or decreased due to market fluctuations determined predominately by economic factors beyond our control. Such extreme market fluctuations would not actually reflect the value we add to investment management. To counter these disadvantages, we will provide you on an annual basis a comparison of market performance to the performance of your account in easy to understand graph form, using appropriate indices. To make sure you are aware of the fees we charge, we will provide quarterly billing statements which detail the dollar amount you are being charged, even though these amounts are withdrawn directly from your account.

   Also since we are not directly compensated for other factors involved in comprehensive planning, such as tax planning, insurance planning, estate planning, goal setting, etc., it may be perceived that we are not diligent in fulfilling these obligations to you as comprehensive planners. To assure you of our professional diligence in these matters, each quarterly statement or other written information will summarize any non-investment financial advice or services we have provided during quarter. We will also review with you personally each year the impact your investments have on your tax, insurance, and estate planning as well as the progress toward your personal goals.

In addition, NAPFA has provided examples of "soft dollar" disclosures to its members:

1. Generally, Receipt of Indirect Compensation. As we seek to avoid material conflicts of interest, neither our firm nor its team members receive any third party direct monetary compensation (i.e., commissions, 12b-1 fees, or other fees) from brokerage firms (custodians) or mutual fund companies. However, some non-direct compensation is provided to our firm as a result of its relationships with custodian(s) and/or providers of mutual fund products. Our firm believes that the services and benefits actually provided to it by brokerage firms (custodians) and mutual fund providers do not materially affect the investment management recommendations made to clients of our firm.

2. Custodial Indirect Compensation. Our firm participates in the advisor services programs (ASP) of custodians (such as Schwab Institutional Fidelity Institutional and TD Ameritrade Institutional). While there is no direct linkage between the investment advice given and participation in the ASP program, economic benefits are received which would not be received if our firm did not give investment advice to clients. These benefits include (a) receipt of duplicate client confirmations; (b) receipt of bundled duplicate statements; (c) access to a trading desk serving ASP participants exclusively; (d) access to the investment advisor portion of the ASP

> web sites which includes practice management articles, compliance updates, and other financial planning related information and research materials; (e) access to other vendors (such as insurance or compliance providers, or providers of research or other materials) on a discounted fee basis through discounts arranged by ASP, and (f) permitting our firm to access an electronic communication network for client order entry and various account information. Participation in the ASP program also provides access to certain mutual funds which generally require significantly higher minimum initial investments or are generally available only to institutional investors.

[iii] SEC Release No. IA-2711, p.55.

[iv] *See* NAPFA comment letter dated February 28, 2008, regarding Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, File No. S7-28-07.

[v] SEC Release No. IA-2711, p.4.

[vi] Understanding fiduciary duties and the overriding obligation imposed upon the investment adviser to act in the best interests of the client at all times is necessary in order for the Advisors Act to be applied correctly for the protection of individual investors. As recently stated by a noted SEC staff member:

> Understanding 'fiduciary duty' is critical, because it is at the core of being a good investment adviser. In a very practical sense, if an adviser and the adviser's employees understand the meaning of fiduciary duty and incorporate this understanding into daily business operations and decision-making, clients should be well served, and the firm should avoid violations and scandal. Indeed, I believe that, even if advisory staff are not aware of specific legal requirements, if their decisions large and small and everyday are motivated and informed by doing what's right by the client, in all likelihood, the decision will be right under the securities laws …
>
> Some people think "fiduciary" is a vague word that's hard to define, but it's really not difficult to define or to understand … would suggest that an adviser, as that trustworthy fiduciary, has five major responsibilities when it comes to clients. They are:
>
> 1. to put clients' interests first;
> 2. to act with utmost good faith;
> 3. to provide full and fair disclosure of all material facts;
> 4. not to mislead clients; and
> 5. to expose all conflicts of interest to clients.
>
> These responsibilities overlap in many ways. If an adviser is putting clients' interests first, then the adviser will not mislead clients. And, if the adviser is not misleading clients, then it is providing full and fair disclosure, including disclosure of any conflicts of interest.
>
> How do the responsibilities of a fiduciary translate into an adviser's obligations to clients each and every day? This is a key question. Probably no statute or set of rules could contemplate the variety of factual situations and decisions that an advisory firm faces. Can you imagine the number of rules and releases and regulations that this would require? Instead, the Advisers Act incorporates an adviser's fiduciary duty under Section 206, and envisions that, in whatever factual scenario, the adviser will act in the best interests of his clients.

February 27, 2006 speech at the *Eighth Annual Investment Adviser Compliance Summit* by Lori Richards, Director, Office of Compliance Inspections and Examinations, SEC.

[vii] Thomas Lee Hazen, *The Law Of Securities Regulation*, Vol. 1, § 8.1[1][B], at 740 (4th ed. 2002).

[viii] As the recently issued Rand Study noted, one registered representative interviewed by Rand acknowledged that a client is going to sign something that a trusted adviser asks them to sign. Clients feel that the reason they engage a professional is so that they do not have to read all the accompanying literature. Therefore, for many investors, the fact that they were given disclosures was seen as meaningless. Rand (Preliminary) Report at p.21.

Disclosure permits a client to make an informed choice whether to continue the advisory relationship or, alternatively, whether to take action to protect against the adviser's specific conflict of interest. As stated in SEC Release IA-1092:

> An investment adviser is a fiduciary who owes his clients "an affirmative duty of 'utmost good faith, and full and fair' disclosure of all material facts." The Supreme Court has stated that a "[f]ailure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as the experience of the 1920's and 1930's amply reveals, the darkness and ignorance of commercial secrecy are the conditions under which predatory practices best thrive." Accordingly, the duty of an investment adviser to refrain from fraudulent conduct includes an obligation to disclose material facts to his clients whenever the failure to do so would defraud or operate as a fraud or deceit upon any client or prospective client. In this connection the adviser's duty to disclose material facts is particularly pertinent whenever the adviser is in a situation involving a conflict, or potential conflict, of interest with a client.
>
> The type of disclosure required by an investment adviser who has a potential conflict of interest with a client will depend upon all the facts and circumstances. *As a general matter, an adviser must disclose to clients all material facts regarding the potential conflict of interest so that the client can make an informed decision as to whether to enter into or continue an advisory relationship with the adviser or whether to take some action to protect himself against the specific conflict of interest involved.*

[*Emphasis added.*] SEC Release IA-1092 (October 8, 1987).

Does this sound paternalistic? Perhaps, but in many situations paternalism - the need to protect the client (entrustor) to advance the public good - is the reason behind imposition of fiduciary duties. As stated by Professor Frankel:

> Paternalistic protections, that is, protections of members of a class regardless of their own express and clear intent, are not limited to fiduciary law. Such protections are grounded in many and diverse principles, and exist in the law of contracts as well. Paternalistic attitudes can derive from the observation that most members of a particular class lack competence or sufficient bargaining power and are therefore incapable of independent consent to waive their legal protections or bargain around them. Further, members of a protected class may be "rationally apathetic" and fail to protect themselves. If the disappointment of members of a class, such as investors, can affect the system, for example, by a "run" on the financial markets, the investors' waivers may be ignored ... Another reason for mandatory fiduciary duties is the policy to provide fiduciaries with a level playing field, and to deter them from competing by dishonest treatment of entrustors or by providing less-than-acceptable quality of services. For example, the Securities Acts put market fiduciaries and contract actors on such a level playing field by prohibiting waivers of rights under the Acts.

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

Of course, Section 15 of the Advisers Act expressly prohibits waivers of duties arising under the Advisers Act. If mere disclosure of a conflict of interest were deemed sufficient to constitute fulfillment of an investment adviser's fiduciary duties to a client, in essence the furnishing of the disclosure would amount to an advisor-imposed mandatory waiver of a fiduciary duty by the client, which is prohibited under the Advisers Act. This is yet another reason why, when material conflicts of interest exist, they must be properly managed by the investment advisor for the benefit of the client.

[ix] In a law journal article entitled "Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future," 51 Duke L. J. 1397 (2002) [hereafter "Prentice Article"], Professor Robert Prentice provided key insights into behavioral bias which illuminate the inadequacy of informed consent in the context of securities regulation. Excerpts from this seminal article follow:

Companies Are Not Motivated To Disclose Information. "[C]ompanies, if left unregulated, will not disclose the socially optimal amount of financial information … they will disclose suboptimally because disclosure implicates two types of costs. First are operational costs (out-of-pocket expenses, diversion of staff time, etc.). Second, and more critical, are inter-firm costs that can put a disclosing firm at a disadvantage relative to its competitors …. [f]ull voluntary disclosure … rarely seems to occur in reality, and firms typically do not disclose more than regulation requires ... [T]here are limits to reputation. Even economists concede that providers of both goods and services with high-quality reputations are constantly tempted to provide a low-quality service at a high-quality price and thus earn a large return … Firms often can keep their defalcations and other errors quiet, especially because most disputes are handled through low-profile arbitration rather than more newsworthy litigation."

Tons of Information Do Not Equate To Elimination of Vulnerabilities. "Today investors have tons of information … Thanks to SEC disclosure requirements, EDGAR, and the Internet, even the most unsophisticated and dunderheaded investors have access to much the same information available to the most sophisticated of professional and institutional investors … what makes investors vulnerable often is not their lack of information, but a wide variety of limitations on human reasoning exposed by a substantial body of behavioral literature that … indicates that many if not most investors, even with more information, will be unable to adequately protect themselves under his system. Psychological factors often prevent investors from adopting sufficiently wary attitudes. Importantly, even sophisticated (issuer-level) investors tend to be subject to these limitations."

The Concept of Bounded Rationality. "[H]uman rationality is bounded. It is now widely recognized … that because they seldom have complete and perfectly accurate information and never have perfect capacity to process that information, people are intendedly rational, but only limitedly so. Because of bounded rationality, it is erroneous to assume that the parties usually will negotiate the most efficient possible contract." "The concept of bounded rationality reflects the recognition that people have limited cognitive capacities. As a result, people cannot attend to all available information or evaluate their choices fully, particularly with respect to complex decisions. Instead, they engage in satisficing—investing a level of effort that will produce a satisfactory, if not optimal, outcome. Bounded rationality is not, strictly speaking, a bias; it is a rational explanation for investor use of heuristics and other short cuts rather than more complete information." Jill E. Fisch, Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst, 10 Lewis & Clark L. Rev. 57, 69-70 (2006).

The Concept of Rational Ignorance. "It is reasonable for decisionmakers … who do not have unlimited time and unlimited resources, to choose not to gather all the relevant information for their decisionmaking. Decision-makers must choose among numerous demands on their time and attention and will often sensibly choose to 'satisfice' rather than to optimize their decisionmaking ... Because an intermediary likely will present [the investor] with a relatively detailed form contract (investor regulation invalidates the SEC's 'plain English' requirements, so the intermediary is free to inundate [the investor] with massive legal boilerplate), her ability to understand its obscure terms is bounded ... An investment of the time and mental energy needed to master the details of the contract may not be cost-justified, especially because the agent with whom [the investor] is dealing probably has no authority to alter the contract anyway. Therefore, rather than bargain extensively over the terms of the contract and how much she will pay for protection from fraud or unsuitable recommendations, [the investor] likely will sign the contract without meaningful negotiation and usually without reading more than a few parts of it. It is well known that investors typically do not read disclosure documents when investing in securities, and Professor Melvin Aron Eisenberg notes in the context of insurance contracts and other similar types of contracts that this is a sensible (if not optimally rational) strategy, concluding that 'most form takers will find it irrational to engage in search and deliberation on any given form.'"

Overoptimism. "Even if [the investor] reads the contract with the issuer and clearly sees and understands its limitation of liability provisions, [the investor] still may not bargain to change them. Humans are inherently overoptimistic in most settings; they think that good things are going to happen to them and that the bad things that happen to others will not happen to them … Studies indicate that the overoptimism bias affects humans in the sphere of investments as well."

Overconfidence. "[The investor's] optimism will be fueled by a Wall Street marketing juggernaut whose dominant message is simple: Wall Street can make you rich – and fast … optimism will tend to lead her to believe that she will succeed where others will fail, that she will know the right path where others will be misled, that she will be impervious to fraud where others are victimized. [The investor's] vulnerability to overoptimism will be reinforced by her overconfidence ... Educated

people and professionals are generally just as subject to phenomena such as overoptimism and overconfidence as are unsophisticated investors." [In an oft-repeated quotation in the finance literature, DeBondt and Thaler state that "perhaps the most robust finding in the psychology of judgment is that people are overconfident." Warner Debondt & Richard Thaler, Financial Decisionmaking in Markets and Firms: A Behavioral Perspective, in Finance, vol. 9 of HANDBOOK OF OPERATIONS RESEARCH AND MANAGEMENT SCIENCE , chap. 13, at 385-86 (1995).]

Insensitivity to the Source of Information. "Another reason [the investor's] tendency will be to fail to realize that she is being defrauded and to fail to contract to protect herself from that fraud is the general human insensitivity to the source of information … studies show that people have difficulty disregarding information, even when they learn that it is from an unreliable source ... [P]eople generally believe that they are good at detecting when they are being lied to, when the behavioral research shows that they are not ... [O]nce a broker successfully cultivates trust, willing reliance by the sophisticated investor -- imprudent though it may seem in hindsight -- is quite likely and, for that reason alone, worthy of some protection."

Oral Communications Trump Written Communications. "[The individual investor] will enter into a contract with a securities professional after a period of negotiation. These negotiations likely will be oral, either in person or via telephone, and eventually [the investor] will find a professional whom she trusts … Studies show that people whose success depends on the efforts of others tend naturally to form positive impressions of those on whom they depend. Once they decide to trust, they 'overdraw' on the information available; this simplifies life and allows customers to act as though they possessed real knowledge about a broker's future conduct. Only after that trust and positive impression are established will the securities professional provide the written adhesion contract for [the investor] to sign … Although [the investor] would be wise to read the contract in its extensive detail and to bargain for fraud protection, she probably will not do so. One simple reason is that in daily commercial intercourse, oral communications trump written communications." Stated differently, when the sellers of investment products present consumers with lengthy written contracts to sign, the individual investor, just like consumers of consumer products, tend to sign without reading them in any detail, especially after they have decided to trust the seller. Donald C. Langevoort, "Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers," 84 Cal. L. Rev. 627, 682 (1996). "Most sales pitches in the securities field are made orally, yet most adhesion contracts disclaim oral representations in legal boilerplate. Why? For competitive reasons, sellers have an incentive to make oral representations to buyers of securities and then to present the buyers with written contracts that disclaim those same representations." Robert Prentice, "Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis," U.Ill.L.Rev. 337, 419 (2003).]

Hesitation to Confront. "Other reasons that [the investor] will hesitate to confront the intermediary over its form contract (and likely elicit the 'What, you don't trust us?' response in an attempt to shame her into signing the contract immediately) include the availability bias … and her realization that failure to show trust poisons relationships."

Recency, Concreteness. "[Investors] would tend to give undue weight to their good relationship with the manager at the time of contract formation, because that relationship is vivid, concrete, and instantiated, as compared with the possibility that the manager would exploit the bargain at some point in the future, which is abstract, general, and pallid."

Representativeness Heuristic. "[P]eople … tend to judge probabilities by flouting numerous rules of statistics and to focus instead upon the degree of similarity that an item seems to bear to a category or parent population. Because of this influence, [the individual investor] would tend to overestimate the extent to which the present relationship with the [broker] is a reliable index of the future relationship."

[x] Robert Prentice, "Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis," 2003 U.Ill.L.Rev. 337, 343-4 (2003), citing Jon D. Hanson & Douglas A. Kysar, "Taking Behavioralism Seriously: The Problem of Market Manipulation," 74 N.Y.U. L. REV. 630 (1999) and citing Jon D. Hanson & Douglas A. Kysar, "Taking Behavioralism Seriously: Some Evidence of Market Manipulation," 112 Harv. L. Rev. 1420 (1999).

Disclosure and consent is the basis on which securities regulators have allowed industry participants to engage in transactions where there is a conflict of interest between the industry participant and the individual investors. However, for the reasons stated above the SEC should recognize that the efficacy of the disclosure and consent strategy is called into question by the reality that the documents delivered to investors are not being read, or when read are often not understood by investors.

The lack of understanding by most individual investors of conflicts of interest (and their potential effects), and of basic investment concepts, even with the diligent effort of the investment adviser to educate the consumer, is understandable. This is because, in the context of financial planning decision-making and investment decisions, it cannot be denied that the financial world of individual consumers of financial services has become increasingly more complex in recent years. As stated in the well-written consumer brochure, "Cutting Through the Confusion":

> While some people are comfortable handling their own investments, many are not. They find the idea of creating a plan for allocating their assets bewildering, choosing a mutual fund intimidating, and designing an investment portfolio to be one more thing for which they have neither the time nor the expertise. This is nothing to be embarrassed about. Investing can be confusing.

Cutting Through The Confusion, a brochure published in 2005 by the "Coalition on Investor Education," which consists of the Consumer Federation of America, the North American Securities Administrators Association, the Investment Adviser Association, the Financial Planning Association, and the CFA Institute.

Evidence of the lack of consumer understanding of even basic investment concepts abounds. For example, a 2002 Forbes Magazine survey finding that eighty-four percent of the surveyed investors believe that higher fund expenses result in higher performance by the fund. [Neil Weinberg, "Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs," Forbes Magazine, Oct. 14, 2002, at 220.]

The United States is not alone is the complexity of its financial markets. As stated over ten years ago in a report issued by the Financial Planning Association of Australia Limited:

> With the increasing complexity of the financial system, the wide range of choices available and the role of compulsory savings, advice is playing an ever important role for consumers … Deregulation has created a large number of investment alternatives and means of accessing them … that the first priority for most people is to seek advice on the financial strategy that best suits their circumstances. The selection of investment products is secondary, yet still this requires access not only to information on the numerous investments available in the market but also analysis and application of that information to individual circumstances … Strategy plays a key role in effective financial decision making and most consumers will not be in a position to develop their own strategy … *The average person will no more become an instant financial planner simply because of direct access to products and information than they will a doctor, lawyer or accountant.* Despite extensive information being available on drugs (via the internet and by other means) people still seek the advice of a doctor to determine an appropriate response to a medical problem and, where necessary, to prescribe the most suitable drug.

[Emphasis added.] Submission to the Financial System Inquiry by the Financial Planning Association of Australia Limited, December 1996.

While the modern financial world has grown increasingly more complex over the last several decades, recently substantial thought been given to the ability of individual investors to achieve adequate understanding in order to make informed decisions. These discussions repeat discussions held some seventy years ago. As stated by Professor Steven L. Schwarcz:

> Analysis of the tension between investor understanding and complexity remains scant. During the debate over the original enactment of the federal securities laws, Congress did not focus on the ability of investors to understand disclosure of complex transactions. Although scholars assumed that ordinary investors would not have that ability, they anticipated that sophisticated market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors.

Steven L. Schwarcz, "Rethinking The Disclosure Paradigm In A World Of Complexity," Univ.Ill.L.R. Vol. 2004, p.1, 7 (2004), citing "Disclosure To Investors: A Reappraisal Of Federal Administrative Policies Under The '33 And '34 Acts" (a.k.a. "The Wheat Report"), 52 (1969); accord William O. Douglas, "Protecting the Investor," 23 YALE REV. 521, 524 (1934).

While the U.S. Securities and Exchange Commission has put greater emphasis on "plain English" writing, and this is a welcome development, plain English writing primarily addresses the problem of overly legalistic writing. Plain English writing also does not provide a solution to achieving consumer understanding in an inherently more complex financial world. The investment, tax and financial worlds have become increasingly complex. The 20th Century saw an explosion of specialization, in response to

an ever-more complex world. Specialists exist as a means to guide consumers through a complicated undertaking, such as the development of a financial plan. Specialists exist in recognition that the vast majority of consumers will possess neither the time nor the knowledge and experience to tackle a complex field and make good choices. Accordingly, the SEC's emphasis on disclosure and its advice to individual investors to "do research and ask questions" may be misplaced.

Certainly, mere disclosure of a conflict of interest is, for a fiduciary, insufficient. Informed consent must be secured. And informed consent will not occur unless the conflict of interest is properly managed by the investment adviser.

[xi] "Regulation of Financial Planners," White Paper Prepared for the Financial Planning Association by Jonathan R. Macey, April 2002, at p.30, available at http://www.fpanet.org, under "Government Relations" / "White Papers", citing to *Rocky Mountain Financial Planning*, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2132 (Mar. 28, 1983).