

JOSEPH CAPITAL MANAGEMENT, LLC

A FEE ONLY INVESTMENT ADVISORY FIRM

April 5, 2004

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, N. W.
Washington, D.C. 20549

The Honorable Cynthia A. Glassman, Ph.D.
Commissioner
U.S. Securities and Exchange Commission
450 Fifth Street, N. W.
Washington, D.C. 20549

The Honorable Harvey J. Goldschmid
Commissioner
U.S. Securities and Exchange Commission
450 Fifth Street, N. W.
Washington, D.C. 20549

The Honorable Paul S. Atkins
Commissioner
U.S. Securities and Exchange Commission
450 Fifth Street, N. W.
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The Honorable Roel C. Campos
Commissioner
U.S. Securities and Exchange Commission
450 Fifth Street, N. W.
Washington, D.C. 20549

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

Re: File No. 34-42099
and
File No. IC-25925

**Re: Certain Broker-Dealers Deemed Not To Be Investment Advisers (proposed rule);
The Important Fiduciary Duties of Investment Advisers; and
Proposed SRO for Investment Advisers**

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To The SEC Commissioners

Comments Re: Proposed Rule: Broker-Dealers Not Deemed Investment Advisors; SROs

April 5, 2004

Page 2

Dear Chairman Donaldson and Commissioners:

I urge the U.S. Securities and Exchange Commission (SEC, or the Commission) to reconsider the proposed rule (Rule 202(a)(11)-1; File No. S7-25-99) (hereinafter "Proposed Rule" that would further reduce the protections offered by the Investment Advisers Act of 1940 (hereinafter "Advisers Act"), and instead:

- (1) adopt a new rule which clarifies the protections afforded to consumer under the fiduciary standards imposed by the Advisers Act, including the applicability of these protections to the advisory programs of broker-dealer firms;
- (2) establish a self-regulating organization (SRO) for registered investment advisers who serve individual investors, which SRO would act to enhance the investment advisory profession and undertake education of consumers on the fiduciary duty of registered investment advisers.

The SEC's image of championing the investor will be harmed by adopting the rule as it was proposed in 1999. I note that major consumer organizations, including the Consumer Federation of America and AARP, are strongly opposed to the proposed rule. Furthermore, If the rule is permanently adopted, the SEC's support of functional regulation of the financial services industry, as communicated to Congress during hearings on Glass-Steagall reform, may well be called into question by the Commission's subsequent support to exempt extensive investment advisory activities from the Advisers Act.

SEC inaction on this important regulation has allowed brokers to transform themselves into investment advisers, or at least market themselves as if they have, without triggering the regulatory protections appropriate to that role. The SEC must act promptly to ensure that consumers are not misled or confused. Investment advisers have a strict fiduciary duty that requires them to eliminate or disclose all conflicts of interests. Brokers who act like an investment adviser should be held to the same laws and standards that investment advisers are held to, for the protection for the consumer and in adherence to the Advisers Act.

These comments are more extensive and supplemental to the comments contained in my February 17, 2004 comments submitted to the SEC, previously posted on the Commission's web site under comments to this Proposed Rule as File Name "josephcap021704.txt."

A. The Need for Consumer Protection: Investor Confusion and The Presence of Undisclosed Conflicts of Interest.

1. Generally, The Arise of Fee-Based Brokerage Programs. In the late 1990's several full service brokerage firms introduced new types of brokerage programs that raise questions as to whether they are receiving special compensation and, as a result, whether they continue to be eligible for the broker-dealer exception to the Advisers Act. These programs raise the question of whether customers participating in these new programs should be treated as advisory clients. For convenience, I will refer to these programs as "broker-dealer fee-based programs."

Broker-dealer fee-based programs can provide benefits to the broker-dealer's customers by better aligning the interests of the customer with those of their broker-dealers. The broker-dealer fee-based programs are responsive to the best practices suggested in the Report of the Committee on Compensation Practices ("Tully Report"). Under these programs, broker-dealers' and their registered representatives' compensation no longer depends on the number of transactions or the size of mark-ups or mark-downs charged, thus reducing incentives for registered representatives to churn accounts, recommend unsuitable securities, or engage in high-pressure sales tactics. Consumers should welcome the introduction of these programs, which may reduce substantially conflicts between broker-dealers and their customers.

However, these broker-dealer fee-based programs also bring with them the potential for:

- consumer confusion as to which type of professional they are dealing with, and the role of that professional relative to the consumer;
- serious harm to the individual investor if the if the fiduciary standards of the Advisers Act are not imposed upon the broker-dealer.

2. Increased Consumer Confusion As To Titles of Financial Industry Professionals. As a result of the broker-dealer fee-based programs, there has arisen even greater confusion by the public as to whom they engage to assist them. This is in large part due to the broad variety of terms utilized by investment and financial professionals. Very few consumers can tell the difference between an "investment adviser," a "stockbroker", and a "financial planner."

Stockbrokers, or "registered representatives" of broker dealer firms, often hold themselves out (in today's world) as: "Financial Consultant" (Smith Barney); or "Financial Advisor" (Merrill Lynch, UBS, Wachovia, Morgan Stanley, Raymond James, etc.).

By contrast, an "investment advisor" is a "registered investment adviser" under the Investment Adviser's Act of 1940. An "investment advisor" may or may not also be a "registered representative." Investment advisors often hold themselves out as "wealth counselors" and "financial advisors."

Insurance agents are typically called "agents," but some refer to themselves as "Financial Representatives" (Northwestern Mutual) or "Financial Services Representatives" (MetLife).

What is a "financial planner"? This term is largely unregulated. It involves not only those who hold securities or investment advisory licenses but also insurance professionals, certified public accountants, and others.

On top of that, there are "trust officers," "estate planners," and many other terms used by various related financial services industry professionals.

The fact of the matter is that the typical consumer has very little, if any, idea with whom he or she is dealing. The SEC should act to clarify the distinctions between the professions and to educate the consumer on what standards apply to the relationship which is entered into.

3. The SEC's Own Educational Materials Foster This Consumer Confusion. Surprisingly the SEC's own educational materials foster additional confusion. For example, in the SEC's online brochure, *Get the Facts: The SEC's Roadmap to Saving and Investing*, under the section titled "How To Pick A Financial Professional," the SEC states:

Investment Advisers and Financial Planners. Some financial planners and investment advisers offer a complete financial plan, assessing every aspect of your financial life and developing a detailed strategy for meeting your financial goals. They may charge you a fee for a plan, a percentage of your assets that they manage, or receive commissions from the companies whose products you buy, or a combination of these. You should know exactly what services you are getting, how much they will cost, and how your investment professional gets paid. Smaller investment advisers are generally regulated by those states with the authority to do so.

Brokers. Brokers make recommendations about specific investments like stocks, bonds, or mutual funds. While taking into account your overall financial goals, most brokers will not give you a detailed financial plan. Brokers are generally paid commissions when you buy or sell securities through them.

Interestingly, nowhere in the foregoing document is a discussion of the different duties imposed upon these two distinct professions (i.e., the fiduciary duty of an investment advisor vs. the more limited duties of suitability, etc. of registered representatives). It would seem that the SEC should highlight this important distinction, not minimize it. Moreover, if brokers are to engage in the provision of financial advice without the Advisers Act applying to their activities (as contemplated by the Proposed Rule), then such a critical difference in the role of the broker should be noted.

In a different online brochure, *Invest Wisely: Advice From Your Securities Industry Regulators*, the SEC ignores registered investment advisors completely when it states:

This document provides basic information to help investors select a brokerage firm and sales representative, make an initial investment decision, monitor an investment and address an investment problem. It is intended to help you identify questions you need to ask and warning signs to look for in order to avoid possible investment problems.

Before making a securities investment, you must decide which brokerage firm – also referred to as a broker/dealer – and sales representative – also referred to as a stockbroker, account executive, or registered representative – to use. Before making these decisions you should ...

Understand how the sales representative is paid; ask for a copy of the firm's commission schedule. Firms generally pay sales staff based on the amount of money invested by a customer and the number of transactions done in a customer's account. More compensation may be paid to a sales representative for selling a firm's own investment products. Ask what "fees" or "charges" you will be required to pay when opening, maintaining, and closing an account.

Determine whether you need the services of a full service or a discount brokerage firm. A full service firm typically provides execution services, recommendations, *investment advice*, and research support. A discount broker generally provides execution services and does not make recommendations regarding which securities you should buy or sell. The charges you pay may differ depending upon what services are provided by the firm. *[Emphasis Added.]*

Again, by failing to clearly set forth the different duties imposed upon registered investment advisors and registered representatives, and by acknowledging that each type of professional can render "investment advice" (without noting that in broker-dealer firms that advice can only

be "solely incidental" to the sale of a product), the SEC adds to the confusion of individual investors.

4. Broker-Dealers Providing Investment Advisory Services: The Potential for Undisclosed Conflicts of Interest. If investment advice is to be given by broker-dealers under the Proposed Rule and the Advisers Act is not made applicable, there is enormous potential for undisclosed conflicts of interest. For example, if the Advisers Act is not made applicable to a broker acting as a "financial consultant" under a broker-dealer fee-based advisory program, then the broker and his or her broker-dealer would possess no obligation to disclose:

- ▶ mark-ups on sales of bonds for which the broker-dealer was acting as principal;
- ▶ fees paid to the broker-dealer firm by the investment product manufacturer, such as the often-criticized "shelf fees" and the fees received from trading undertaken by the broker-dealer firm for a mutual fund;
- ▶ fees paid to the broker-dealer firm (or its associated entities) arising from the sale of in-house manufactured products, including fees relating to management fees of mutual funds and hedge funds, fees derived from trading undertaken by the manager of the mutual fund, etc.

The need to both disclose and minimize the potential conflicts of interest which exist in the investment industry has been acknowledged by many leaders. As stated by Commissioner Glassman in her comments before the SIA Compliance & Legal Division's 35th Annual Seminar on March 23, 2004:

"Conflicts lie at the heart of many of today's scandals ... It is in your interest to minimize conflicts to the greatest extent possible and, for those that can't be eliminated, to manage and disclose them to customers and investors."

It is imperative that the consumer be afforded the full protections of the Advisers Act when the consumer is provided "financial counsel" or "financial advice."

B. The Limited Protections Afforded Consumers Under The Securities and Exchange Act

Brokers, of course, have their own burdens under the Securities Exchange Act of 1934 and the regulations promulgated thereunder. Among the limited safeguards afforded customers is that only suitable investments should be recommended and that customers should be treated fairly.

However, in the regulatory scheme Congress saw brokers as essentially different from investment advisors. Instead of acting as fiduciaries, brokers are agents of the firms for whom they work. While brokers may offer the odd stock tip or some occasional advice, that advice is incidental to a broker's main business of accumulating trades and commissions. A broker's first duty is to the firm, not the customer.

C. The Substantial Consumer Protections Afforded By The Advisers Act

There are fundamental differences between the laws and regulations governing broker-dealers and investment advisers. Most important from an investor's point of view, investment advisers are subject to a strict fiduciary duty. As stated in a 1978 release, the Commission noted that the protections afforded investors under provisions of the Securities Exchange Act of 1934 "may not be so broad as those afforded under the comparable provisions in Section 206 of the Advisers Act" and that such differences "are appropriately related to the obligations of persons required to be registered under the Advisers Act." In the same vein, the SEC's 1980 Inspection Manual states that: "[a]n investment adviser is a fiduciary who owes his clients undivided loyalty, and is prohibited from engaging in activity in conflict with the interest of any client." Broker-dealers, on the other hand, generally are subject to the standard of suitability in making investment recommendations and are subject to regulation by both the Commission and the National Association of Securities Dealers. Investment advisers are primarily regulated by the Commission (advisers with less than \$25 million in assets under management are regulated exclusively by the states). As described in the Commission's 1978 release, the bottom line is that "the Advisers Act provides individuals with certain protections not available under the Exchange Act"

There are at least four aspects of the Advisers Act and accompanying laws governing the conduct of investment advisers that are significantly different from those applicable to broker-dealers.

- First, as noted above, advisers owe a strict fiduciary duty to each of their clients that goes well beyond any similar legal obligation of broker-dealers.

- Second, section 206(3) of the Advisers Act prohibits an investment adviser from selling or purchasing any security to or from a client when acting as a principal for its own account, unless each such transaction is disclosed in writing to the client and the client consents to it. Many broker-dealers have an existing inventory of securities and thus they have a natural incentive to buy and sell such securities to and from clients on a principal basis.
- Third, the Advisers Act requires investment advisers to make certain disclosures that differ substantially in timing and content from current disclosures required by broker-dealers. These include requirements to deliver an informational brochure promptly and to make disclosures about an investment adviser's potential conflicts of interests, other business and activities and affiliations, disciplinary history, employees' educational and professional background, and, in some cases, financial condition.
- Finally, the Advisers Act flatly prohibits testimonials and past specific recommendations in advertising. Brokers frequently employ testimonials in advertising and such use appears to be increasing.

The protections afforded to consumers by the Advisers Act, especially the imposition of the fiduciary duty standard, are significant and should be emphasized in the current quest to restore investor confidence in our markets following so many recent scandals involving undisclosed conflicts of interest. Rather than seeking to make inapplicable the protections of the Advisers Act to the activities of broker-dealers and their representatives who seek to provide financial advice, the SEC should affirm the applicability of the Advisers Act to investment advisory activities, subject to the very narrow exception provided by the Advisers Act.

D. Purpose of the Advisers Act.

1. Definition Of An Investment Adviser. Under the Investment Advisers Act of 1940, "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." In other words, anyone who offers investment advice is supposed to be a registered investment adviser.

2. Limited Exception from Definition of Investment Adviser: Certain Activities of Brokerage Firms. Certain exceptions occur from the definition of investment adviser. Broker/dealer firms, and their registered representatives, are excepted from the foregoing definition of "investment adviser" if their "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.*" (*Emphasis added.*)

Furthermore, under the Regulations, Sec. 275.206(3)-1 "Exemption of investment advisers registered as broker-dealers in connection with the provision of certain investment advisory services," the following activities of a broker/dealer firm have historically (prior to 1999) been excepted from the applicability of the 1940 Act:

"(a) 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 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 ..." [*Emphasis added.*]

Under the Proposed Rule it appears that the SEC is attempting to have the limited exception set forth under the act for certain broker-dealer activities "swallow" the rule. As set forth in a combined letter commenting on the Proposed Rule from The Consumer Federation of America, the Certified Financial Planner Board of Standards, the Investment Counsel Association of America, and the National Association of Personal Financial Advisors, the illogic of this approach was revealed when the groups stated:

It seems *self-evident* that brokers who claim an exclusion from the Advisers Act based on the notion that any advice they offer is *solely incidental* to sales transactions should not be able to turn around and *advertise those same services as primarily advisory in*

nature. Our organizations believe strongly, therefore, that the rule should be amended to preclude brokers who claim the exclusion from marketing their accounts as advisory accounts or based on the advisory services provided.

3. SEC Rulemaking Authority Under the Advisers Act. The SEC is given the authority to make rules which interpret and apply the Investment Advisers Act of 1940.

Sec. 80b-11. - Rules, regulations, and orders of Commission

(a) Power of Commission

The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this subchapter.

In undertaking rulemaking under the Advisers Act the SEC "is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." Section 80b-2(c) of the 1940 Act.

While the SEC can and should promote competition in the marketplace, it should not do so when the protection of investors would be substantially lessened, as this Proposed Rule would effect. Again, the need to foster competition, a secondary consideration, should not overpower the need for investor protection, the primary consideration of the Advisers Act.

4. Purpose of the Advisers Act. In *S.E.C. v. Capital Gains Bureau*, 375 U.S. 180 (1963), in discussing the formation of the Investment Advisers Act of 1940 the U.S. Supreme Court noted this testimony before the Committees of the U.S. Senate by the president of the Investment Counsel Association of America, the leading investment counsel association:

"[T]wo 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."
Id. at 190.

Also, generally, an "important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983).

The Advisers Act, largely unchanged since its adoption, and founded upon the principles of unbiased advice and full disclosure of fees, provides important consumer protections. The Investment Advisers Act of 1940 should therefore be promoted and applied for what it is - a key Act and an essential part of our regulatory scheme for the protection of the public. Rather than attempt to circumvent the protections afforded consumers by the Advisers Act, the SEC should embrace the Advisers Act and its purposes as a tool for restoring confidence in our capital markets and in ensuring that consumers receive the better advice necessary to secure their own financial futures.

E. The Importance Of The Fiduciary Duty Standard.

1. Generally. The key aspect of the Advisers Act is in distinguishing advisers from stockbrokers. Advisers, the law holds, must act as fiduciaries--putting clients' best interests before their own and disclosing any conflicts of interest. As fiduciaries, investment advisers are expected to be on the client's side of the negotiating table in any deal.

Brokers, of course, have their own burdens under other rules, among them to offer customers only suitable investments and to treat them fairly. But Congress saw brokers as essentially different. Instead of acting as fiduciaries, they are agents of the firms they work for. They may offer the odd stock tip or some occasional advice, but regulators viewed that as incidental to a broker's main business of accumulating trades and commissions. A broker's first duty is to the firm, not the customer.

The fiduciary standard is a very strong one, but it remains largely undefined in the context of the Advisers Act. The SEC should utilize its rulemaking authority to identify and promote standards which should be adhered to in the application of this fiduciary duty to the conduct of investment advisers toward their clients.

2. Are Conflicts of Interest Inherent In the Provision of Financial Services? Perhaps the SEC fails to understand the true nature of a fiduciary duty. This is somewhat revealed in the September 9, 2003, "Remarks Before The National Regulatory Services Investment Adviser

and Broker-Dealer Compliance/Risk Management Conference,” in which Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities & Exchange Commission, stated:

“Conflicts of interest are inherent in the financial services business. When you are paid to act as an intermediary, like a broker, or as another’s fiduciary, like an investment adviser, the groundwork for conflict between investment professional and customer is laid. The historical success of the financial services industry has been in properly managing these conflicts, either by eliminating them when possible, or disclosing them. In the long run, treating customers fairly has proven to be good business.”

With respect, I would disagree that conflicts of interest are “inherent” in the financial services business. Does acting as a fiduciary to a client creates a conflict of interest between an investment professional and a customer? No. It is possible to structure a registered investment advisory firm to avoid nearly every conflict of interest (including the many cited by Mr. Cutler in his remarks). Perhaps the only conflict of interest which might remain is the need for the (fee-only) investment adviser to receive reasonable compensation. However, every “fiduciary” - whether a trustee, executor of an estate, or otherwise, has a similar “conflict of interest” as to how much they will get paid. This single remaining conflict of interest can be addressed by full and complete disclosure of the complete fees the client may be charged (in order that the client be able to make a fully informed decisions), and by imposition of a standard that any fees charged be reasonable for the services provided.

3. The SEC’s Recent “Code of Ethics” Proposal For Investment Advisers Recognizes The Importance Of The Fiduciary Standard In Bolstering Consumer Confidence. On January 20, 2004, the SEC proposed a rule calling for an Investment Advisor Code of Ethics. In their commentary, the SEC stated:

“The Commission is proposing for comment a new rule and related rule amendments under the Investment Advisers Act of 1940 that would require registered advisers to adopt codes of ethics. The codes of ethics would set forth standards of conduct expected of advisory personnel ... The rule and rule amendments are designed to promote compliance with fiduciary standards by advisers and their personnel ...

“Advisers are fiduciaries that owe their clients a duty of undivided loyalty [citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181-82 (1963)] ...

“We anticipate that advisory firm clients and the firms themselves would benefit from the proposed rules, though these benefits are difficult to quantify. Codes of ethics under proposed rule 204A-1 would impress upon supervised persons the significance of the fiduciary aspects of their professional responsibilities, formulating these into standards of conduct to which their employers will hold these individuals accountable.

“Since the proposed rule would apply equally to all registered advisers, we do not anticipate that it would introduce any competitive disadvantages. We expect that the proposed rule may indirectly foster capital formation by bolstering investor confidence.”

F. What Is A Fiduciary? Several definitions exist for this term. Normally, the term is synonymous to a trustee, which is the classic form of a fiduciary relationship. 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 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. Fiduciary responsibilities exist for persons other than trustees such as between solicitor and client and principal and agent.

In a position paper prepared by Donald B Trone of the Foundation for Fiduciary Studies, February 2003, Mr. Trone stated: “At the risk of oversimplifying a complex subject, an investment fiduciary generally is defined as a person who has the responsibility for managing someone else’s assets ... A financial planner may be considered an investment fiduciary when the financial planner provides comprehensive and continuous investment advice.” *When is a Financial Planner an Investment Fiduciary?* A position paper prepared by: Donald B Trone, Foundation for Fiduciary Studies, February 2003.

G. Defining Standards of Conduct for the Investment Adviser / Fiduciary.

1. The Lack of Clear and Specific Standards of Conduct. Despite the emphasis of the SEC on the fiduciary role of the investment adviser and the important safeguards this provides to consumers, the SEC has not acted to substantially clarify the conduct required to meet this standard. The imposition of the requirement of a Code of Ethics is an important step. However, many industry participants may remain uncertain as to what a fiduciary is and what specific standards of conduct are imposed upon fiduciaries.

Arising from the recent scandals which have plagued the investment industry, and in a response to corporate abuses of power and conflicts of interest, it is fair to predict that there will be an expansion of state and federal legislation and regulations to codify areas of liability and standards of fiduciary conduct. In fact, this has already occurred to some degree by the Sarbanes-Oxley Act, which imposed specific standards of conduct upon officers and directors of publicly held corporations in adherence to their duties as such. Nevertheless, the fiduciary duties of investment advisers are only somewhat defined at present.

2. "The Duty To Act In Best Interests of the Client." Generally speaking, the "fiduciary duty" is one which requires the fiduciary to act "in the best interests" of the person to whom the duty is owed. While this "best interests" standard is often described as "broad" and "strict" in its application to fiduciaries, the delineation of the extent of a "fiduciary duty" remains ill-defined and subject to interpretation.

3. Fiduciary Duty of Loyalty and Fiduciary Duty of Due Care. There is often said to exist two broad, separate duties contained within the concept of fiduciary duty - the duty of loyalty and the duty of due care. Each of these broad duties could then be said to encompass other specific duties or standards of conduct in the context of rendering investment advisory services. While some of these specific duties could overlap both the duty of loyalty and the duty of due care, an outline of these two broad fiduciary duties and some of the specific duties which may flow from them appear in the sections following.

4. The Broad Fiduciary Duty of Loyalty. The duty of loyalty is the basic rule designed to insure that fair decisions are made by investment advisors on behalf of their clients. Generally, purpose of the rule is to ensure, for the sake of the client, that the investment adviser's decisions are free from the corrupting influence of a material personal self-interest. In other words, the investment adviser should as a general rule not receive, as a result of the investment decision made, some material personal economic benefit not received by the client.

It should be noted that any breach of an adviser's fiduciary duty to his client may, ipso facto, give rise to a fraud action under the securities laws. Along these lines, the SEC has noted that "[a]n investment adviser is a fiduciary. As such he is required by the common law to serve the interest of his client with undivided loyalty ... [A] breach of this duty may constitute a fraud within the meaning of clauses (1) and (2) of Section 206 of the Investment Adviser Act (as well as the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934)." Release No. 40-40 (Jan. 5, 1945), Fed. Sec. L. Rep. (CCH) para. 56,374. Furthermore, both the SEC and the United States Supreme Court have held that the common law standards embodied in the antifraud statutes hold advisers to an affirmative duty of utmost good faith and full and fair disclosure when dealing with clients. Even a negligent misrepresentation or failure to disclose material facts (especially in the case of a conflict or potential conflict of interest) places the adviser in violation of the antifraud provision whether or not there is specific intent or gross negligence or malfeasance. *SEC v. Capital Gains Research, Bureau, Inc.*, 375 U.S. 180 (1963) (negligence alone gives rise to fraud liability under Section 206(2) of the 1940 Act - no need to show scienter); cf. *Steadman v. SEC*, 602 F.2d 1126 (5th Cir. 1979) (scienter is required under Section 206(1), but not under Section 206(2) of the 1940 Act).

Other various statutes, rules, and case law clarify the various specific aspects of this duty of loyalty of the adviser: As a result, various specific standards of conduct can be discerned which arise from the fiduciary duty of loyalty, including:

a. The Duty To Avoid Altogether Certain Conflicts of Interest.

(1) The Duty to Keep Client Accounts Separate From Those of the Fiduciary.

(2) The Duty To Avoid Use of Material Nonpublic Information (Insider Trading). A fiduciary duty which usually flows to all investors in the market, as opposed to the individual client of the investment adviser.

(3) The Duty To Avoid Use of Material Nonpublic Information (Avoid Front-Running).

b. The Duty to Minimize Conflicts of Interest. While the duty to minimize conflicts of interest is sometimes referred to in speeches by Commission staff, there do not appear to be any specific regulatory standards which apply. Rather, the duty to minimize conflicts of interest (which are not clearly prohibited) appears to be somewhat aspirational in nature.

c. The Duty To Disclose Conflicts of Interest Which Are Not Avoided. As to conflicts of interest which are not mandated to be avoided, disclosure is required.

(1) The Duty To Disclose All Fees and Compensation. Under the "brochure rule" the investment advisory representative of an investment adviser firm must provide to the client either Form ADV, Part II, or an equivalent brochure, which contains a multitude of disclosures about the RIA firm, its fees, and the investment advisory representatives and their compensation. Additionally, every client of an RIA firm must receive a written fee agreement. These requirements enable the client to ascertain, in advance:

- ▶ what kinds of services are available;
- ▶ who is providing those services;
- ▶ what fees and other expenses will the client be subject to and are they negotiable;
- ▶ whether the adviser is being compensated from other sources, and if so the nature and amount of such compensation;
- ▶ whether the adviser is affiliated with another adviser, a broker-dealer or an issuer of securities;
- ▶ whether, if a financial plan is prepared, the client can implement the financial plan anywhere or whether it can only be implemented through the adviser; and
- ▶ what other potential conflicts of interest exist that might affect the adviser's recommendations.

Form ADV, Part II is the reference tool with which the client or potential client can compare advisory firms for cost of services and for compatibility with their needs. The duty of disclosure of fees and all other compensation is the means of resolving the only conflict of interest which cannot be eliminated in the adviser-client relationship - that which exists in determining the compensation of the adviser.

(2) Duty To Disclose Fee Alternatives. It is required that the ADV disclose if fees are negotiable. Some states appear to require the adviser to disclose whether lower fees for comparable services may be available from other sources.

5. The Broad Fiduciary Duty of Care. The broad fiduciary duty also encompasses the duty to act prudently, or with due care. The duty of care requires the investment adviser to be diligent, utilize common sense, undertake informed judgments, and act reasonably.

a. Suitability: The Duty To Obtain Sufficient Information To Form A Rational Basis for the Investment Decision. An adviser possesses a duty to make recommendations based on a reasonable inquiry into a client's investment objectives, financial situation and other factors. This is the "suitability" standard similar to that imposed upon broker-dealer firms and their registered representatives. The suitability rule recognizes that investment advisers cannot use a cookie cutter approach to investing because their clients have different needs, levels of sophistication, objectives and risk tolerance. An investment plan which may be suitable for an unmarried twenty-something just entering the work force likely is not suitable for a retired 70 year-old with a fixed income. While those are extremes, the point is everyone's circumstances (e.g., financial and tax status, investment objectives and horizon) differ, and investment advisers are charged with inquiring into those circumstances before developing and implementing an investment plan. This duty of suitability also requires updating of information regarding the client's financial situation, investment experience, and investment objectives as necessary, but no less frequently than annually, to allow the adviser to adjust their investment recommendations to reflect changed circumstances.

b. Duty To Be Educated. Implicit in the suitability standard above is the further duty to be educated enough so as to be able to provide a reasonable basis for investment recommendations. Unfortunately, however, few federal or state regulatory requirements (other than Series 65 testing) address the need for initial and ongoing education of advisers.

c. The Duty To Diversify Investments. This duty exists under ERISA and under the Prudent Investor Rule applicable to trustees. The applicability of this duty to investment advisers appears dependent upon the circumstances.

d. The Duty To Adhere To An Investment Policy. While ERISA again imposes a duty to adopt and adhere to an investment policy, this fiduciary duty is not generally imposed upon all investment adviser - client relationships.

e. The Duty to Maintain Clear and Accurate Records. Implicit in the duty to provide due care is the duty to maintain clear and accurate records in support of the reasonableness of investment recommendations.

f. The Duty To Act With Care In Delegation of Investment Functions or Authority. If the investment adviser directs a client to another investment adviser, the fiduciary duty of

due care would seem to impose a duty to undertake such delegation only following some type of due diligence.

6. Is There A Common Set of Practices Which Investment Advisors Should Follow? As evident from the discussion above, there does not appear to be agreement on the minimal practices which must be followed to adhere to the registered investment advisor's fiduciary duty. While the courts and other tribunals (arbitration panels, perhaps) may ultimately determine the breadth and depth of the registered investment advisor's fiduciary duty, it would be helpful to more fully define practices which the advisory should either follow or avoid in order to meet the standard to "act in the best interests of the client." In this manner, educational sessions for investment advisors could be structured to promote adherence to such standards of conduct and practices, thereby enhancing both the profession of investment adviser and the protections afforded the public.

What standards of conduct might be imposed for minimal adherence to the fiduciary duty? While no uniform standards of conduct have been adopted, the Foundation for Fiduciary Studies has attempted to fill this breach by identifying the practices that define the details of a prudent process for investment fiduciaries. As it states on its web site: "To date, twenty-seven practices have been identified, each of which is substantiated by legislation, case law, and/or regulatory opinion letters. The practices address the procedures for: (1) analyzing a client's current investment position; (2) diversifying the client's portfolio; (3) preparing an investment policy statement; (4) implementing an investment strategy; and (5) monitoring the investment strategy. The practices are intentionally written to be equally applicable to investment committee members, trustees, and investment advisors." [The practices can be reviewed and critiqued at the Foundation's Website, www.ffstudies.org.] Other organizations, such as the AIMR, FPA, and CFP Board, possess standards or ethical rules which may be construed as standards of conduct for investment adviser fiduciaries.

H. Proposal For Self-Regulatory Organization. The SEC is necessarily involved in all aspects of the securities industry. As such, at times its resources are stretched thin. Broker-dealers have the NASD and the NYSE, but investment advisers have no self-regulatory organization (SRO). In order to devote the resources required for the important issues arising from the Advisers Act, an SRO for investment advisers appears to be appropriate. The SRO would generally seek to advance the professionalism of investment advisers, protect the public, and educate the public in the key distinctions between investment advisers and broker-dealers.

The specific purposes of an investment adviser SRO could include the following:

- ✓ To promote through cooperative effort the investment advisory business;
- ✓ To standardize the principles and practices of the investment advisory business, including the establishment of minimum standards of conduct in adherence to the strict fiduciary duty imposed upon advisers;
- ✓ To promote aspirational goals for investment advisers which extend beyond minimum standards of conduct;
- ✓ To promote and provide education to the public on the important fiduciary role of the investment adviser and its benefits for consumers;
- ✓ To promote and provide education for advisers in order to enable them to fulfill their duties of due care and loyalty;
- ✓ To encourage investment advisers to fully observe Federal and state securities laws through educational sessions and position papers;
- ✓ To provide a medium through which its membership (all federal investment adviser firms, at a minimum) may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment advisory and securities businesses;
- ✓ To facilitate the resolution of issues facing dual registrants (i.e., firms acting as both broker-dealers and investment advisers);
- ✓ To adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices;

- ✓ To promote self-discipline among members; and
- ✓ To investigate and adjust grievances between the public and members and between members.

For example, the SRO could adopt Rules of Conduct, as have been adopted for broker-dealers by the NASD. Of course, the Rules of Conduct for investment advisers would reflect the higher fiduciary standard to which investment advisers are subjected.

Additionally, the SRO could work to adopt a higher initial educational requirement for investment advisers, exceeding the often-criticized minimal education needed to pass the Series 65 examination. Uniform continuing education requirements could also be adopted.

The SRO should possess a strong leadership which is dedicated to the protection of the public interest and to the advancement of the investment adviser profession.

In summary, I support the observations contained in the Proposed Rule dated Feb. 5, 2003 ("Compliance Programs of Investment Companies and Investment Advisers") in which the SEC advanced the idea of an SRO of investment advisers. I believe an SRO will serve to educate the public on the benefits of investment advisers, enhance the education and services of investment advisers, and lead to a significant advancement in the role of the investment advisers within the securities industry regulatory scheme.

I. Conclusion.

Rather than blur the distinctions between brokerage and advisory services, those distinctions must be emphasized. It is critical to the reestablishment of trust and confidence by investors in Wall Street that registered representatives who also seek to provide investment advisory services adhere to the Investment Advisers Act of 1940. Rather than lessen the fiduciary role of those who seek to provide investment advisory services to clients, the Commission should act to clarify the fiduciary duty of broker-dealer firms who also seek to act under the Investment Advisers Act of 1940. Those who seek to provide investment advisory services should embrace the necessity to act in the best interests of the client, rather than seek to lessen their duties to the customer.

To The SEC Commissioners

Comments Re: Proposed Rule: Broker-Dealers Not Deemed Investment Advisors; SROs

April 5, 2004

Page 21

As existed in 1940, there is a growing need and demand for unbiased investment information and guidance. The fiduciary duty to act in the best interests of the client should not be compromised, as it would by this proposed rule. Rather, this fiduciary duty should be strengthened by a return to the fundamental goals of the Investment Advisers Act of 1940 - to protect investors by providing an avenue for the receipt of unbiased, objective advice. Registered representatives of broker-dealer firms who seek to offer investment advisory services should adhere to the strict requirements of the Investment Advisers Act of 1940, and should strictly adhere to their broad fiduciary duty to act solely in the best interests of the client. Additional regulations should strengthen the protections afforded investors by those who seek to provide investment advisory services, not weaken those protections.

The Commission should act to protect the interests of the individual investor (not the interests of broker-dealer firms) by revoking the Proposed Rule and instead adopting strict regulations which insure obedience to the broad fiduciary duty imposed by the Investment Advisers Act of 1940 by those who seek to provide investment advisory services. Furthermore, the Commission should act to publicize the distinctions between manufacturers and sellers of investment products and providers of investment advisory services, and the dramatic differences in the types of duties owed by each of the foregoing to the individual investor.

Additionally, in the long term the interests of both the investment adviser profession and the general public may best be served by the formation of an SRO for investment advisers. Through a SRO the profession of investment advisers will be advanced, for the dual benefit of both investment advisers and the consumer.

We are at a critical junxure in the evolution of our federal securities laws. In the past 35 years we have seen tremendous developments affecting the securities industry. The rapid dissemination of information made available by the media, including the internet, will continue to promote further changes. I predict that the role of the investment adviser, as a provider of objective advice under the banner of a fiduciary, will continue to expand. Such expansion, which will lead to dramatic improvement in the advice given to individual investors, should be fostered by the SEC through the establishment of an SRO.

Finally, "the best interests of the client" is not a standard which should be subjected to compromise. The SEC 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.

To The SEC Commissioners

Comments Re: Proposed Rule: Broker-Dealers Not Deemed Investment Advisors; SROs

April 5, 2004

Page 22

I would welcome the opportunity to further address this issue with the Commissioners or the Commission staff. I may be reached at 352.746.4460.

Sincerely yours,

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