Public Investors Arbitration Bar Association

September 3, 2010

VIA E-MAIL To: rule-comments@sec.gov

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Release No. 34-62577; IA-3058; File No. 4-606
Study Regarding Obligations of Brokers, Dealers, and Investment Advisors

Dear Ms. Murphy:

On behalf of the Public Investors Bar Association ("PIABA"), I thank the Commission for this opportunity to comment on the above-referenced study regarding the standards of care for brokers, dealers and investment advisors when providing personalized investment advice and recommendations about securities to retail investors. PIABA is a national, not-for-profit bar association comprised of more than 460 attorneys, including law school professors and former regulators, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. Accordingly, our members and their clients have a strong interest in the current standards and any action the Commission may take with regard to the standards referenced above.

PIABA recommends that the Commission create a uniform standard with regard to brokers, dealers and investment advisors when providing personalized investment advice and recommendations about securities to retail investors. Such standard should encompass the broad fiduciary duty that currently applies to investment advisors. Today, brokers[1] and investment advisors are regulated under two different regulatory schemes with different standards of conduct. Notwithstanding this distinction, the services each offers are marketed in a way that makes them indistinguishable to investors. To complicate matters further, brokers often use titles that contain the word "advisor", leaving customers with no clear guidance on what rules apply to the accounts they hold. This confusion is clearly set forth in the Treasury Department's report entitled "Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation"[2]:

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[1] As used herein, the term broker includes dealers as well.
[2] http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (June 17, 2009)

> Retail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment advisor and a broker who acts as an agent for an investor; the current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Brokers are allowed to give "incidental advice" in the course of their business, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker. In general, a broker-dealer's relationship with a customer is not legally a fiduciary relationship, while an investment adviser is legally its customer's fiduciary.
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> From the vantage point of the retail customer, however, an investment adviser and a broker-dealer providing "incidental advice" appear in all respects identical. In the retail context, the legal distinction between the two is no longer meaningful. Retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same

Case law has consistently held that the Investment Advisors Act of 1940 (IAA)[3] has established a "federal fiduciary standard to govern the conduct of investment advisers, broadly defined, see *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979)."[4] Therefore, if an account is being handled pursuant to the IAA, the adviser has a fiduciary duty to the customer. The IAA specifically exempts brokers who provide investment advice, so long as the advice is solely incidental to the brokerage services, and the broker does not receive special compensation for the advice.[5]

When it comes to the standard applicable to brokers, the answer is not as clear cut. There is no federal fiduciary standard that applies to brokers. Under the current regulatory structure, whether or not a fiduciary duty applies is dependent on state law, and as such, customers located in different states are owed different duties.

Courts have routinely held that when an account is discretionary, the broker has a fiduciary duty to the client. In *Leib v. Merrill, Lynch, Pierce, Fenner & Smith*[6], the court specifically set forth the duties a broker owed the customer when the account was a discretionary account:

> Such a broker, while not needing prior authorization for each transaction, must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history, *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978); (2) keep informed regarding the changes

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[3] 15 U.S.C. §80b-1 et seq.
[4] *Financial Planning Ass'n v. Securities and Exchange Commission*, 482 F.3d 481, 490 (D.C. 2007).
[5] 15 U.S.C. §80b-2(a)(11)
[6] 461 F.Supp. 951, 953 (E.D.Mich.1978)

> in the market which affect his customer's interest and act responsively to protect those interests (see in this regard, *Robinson v. Merrill Lynch*, supra) ; (3) keep his customer informed as to each completed transaction; and (5) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged, *Stevens v. Abbott, Proctor and Paine*, 288 F.Supp. 836 (E.D.Va.1968).

However, when the account is not discretionary, the standards of duty owed by a broker to a customer vary widely from state to state. Certain states recognize a fiduciary duty in every broker – customer relationship. See *Duffy v. Cavalier*, 215 Cal.App.3d, 1517, 1530 (1989). Other states vary in terms of when the broker – customer relationship is a fiduciary one. In *Marchese v. Nelson*[7], the court laid out the ways various courts have addressed this issue:

> [I]n *Leib*, the court indicated that in a nondiscretionary account, the "broker is bound to act in the customer's interest when transacting business for the account; however, all duties to the customer cease when the transaction is closed." *Leib*, 461 F.Supp. at 952-53. Notwithstanding this apparently limited duty, the *Leib* court identified six duties associated with nondiscretionary accounts: (1) the duty to recommend stock only after becoming informed about the stock; (2) the duty to promptly carry out the customer's orders; (3) the duty to inform the customer of the risks involved in a transaction; (4) the duty to refrain from self-dealing; (5) the duty not to misrepresent any fact material to a transaction; and (6) the duty to transact business only after prior authorization from the customer. *Id.* at 953.
> …
> The *Hotmar* [*v. Listrom & Co.*, 808 F.2d 1384, 1386 (10th Cir.1987)] court, in finding no fiduciary relationship, analyzed whether the broker agreed to manage or otherwise control the account, or rather, whether he merely rendered advice. *Id.* at 1387. Finding no agreement by the broker to monitor his clients' nondiscretionary accounts, the court found no fiduciary relationship. *Id.*
> …
> [T]he *Baker* [*v. Wheat First Sec.*, 643 F.Supp. 1420, 1429 (S.D.W.Va.1986)] court found a fiduciary relationship where the broker exerted "de facto control" over the account. *Baker*, 643 F.Supp. at 1429. To the *Baker* court, such de facto control existed when "'the client routinely follows the recommendations of the broker.' " *Id.* (quoting *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir.1980)).
> …
> Finally, other courts assume the existence of a fiduciary relationship even if the account is [non]discretionary [sic], and then analyze the facts to determine the scope of the duty and whether the broker breached the duty. See, e.g., *Romano v. Merrill, Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 530 (5th Cir.1987) (interpreting federal securities law). Applying this analysis, the Romano court found no breach where the customer, an alert and vigilant businessman, controlled his nondiscretionary account and made all decisions regarding activity in the account. *Id.* (citations omitted).

[7] 809 F.Supp. 880, 893 (D. Utah 1993)

In *Leib*, the court recognized that apart from discretionary and non-discretionary accounts, there exists a hybrid-type account. "Such an account is one in which the broker has usurped actual control over a technically non-discretionary account. In such cases, the courts have held that the broker owes his customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation."[8]

In addition to the discretionary-nondiscretionary nature of the account, the type of fees a customer pays is also relevant in determining whether or not a fiduciary duty exists. As mentioned above, the IAA specifically exempts brokers who provide investment advice, so long as the advice is solely incidental to the brokerage services, and the broker does not receive special compensation for the advice. In 1999, the Commission expressed concern that the various fee structures that brokerage firms had begun to offer would make firms subject to the IAA.[9] The Commission recognized that the nature of the services offered to the customer often did not vary depending on the type of account, but rather it was only the broker's compensation that varied. In light of this view, the Commission took the position that it did not believe that Congress intended these accounts to be covered by the IAA.[10] However, in 2007, the Court of Appeals for the D.C. Circuit struck down the rule, holding that the Commission did not have authority to broaden the exception set forth in the IAA.[11] Hence, brokers who offer fee-based accounts are deemed to receive special compensation under the IAA and are required to be registered as investment advisers and as such, are subject to the fiduciary obligations of the IAA.

The duties owed by the individual a customer is doing business with will vary widely depending on the individual's title, compensation structure, and the state in which the individual is located. Customers are left with differing degrees of protection. Because the services offered are so similar, customers should be afforded the same level of protection, regardless of whether they are dealing with a broker or an investment advisor. This may be done by either eliminating the broker exclusion contained within the IAA, or by adding language to the Securities Exchange Act of 1934 which mirrors that contained in the IAA. We believe the latter would alleviate any burden on brokers to additionally register as investment advisors. We would be supportive of any effort by the Commission to create high, uniform standards for investment professionals, regardless of the capacity in which they interact with customers.

If a uniform fiduciary standard is to be adopted, it must be a true fiduciary standard. A standard which is denominated "fiduciary" is not truly such, unless it has the historical hallmarks of fiduciary status. These include: (a) the duty of loyalty; (b) the duty to make full disclosure; (c) the duty to carry out the client's instructions faithfully; (d) the duty to act in the highest good faith; and (e) the duty to place the client's interest before the fiduciary's own interest. While a

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8 461 F.Supp. at 954

9 S.E.C. Notice of Proposed Rulemaking, 64 Fed. Reg. 61,228 (Nov. 10, 1999). The Commission adopted final rule 202(a)(11)-1 under the IAA on April 15, 2005. See, *S.E.C. Rel. No. 34-51523,* available at http://www.sec.gov/rules/final/34-51523.pdf. However, the Commission did not take any actions against firms which offered fee-based accounts between the issuance of the proposed rule in 1999 and the adoption of the final rule in 2005.

10 *Id.*

11 *Financial Planning Ass'n v. Securities and Exchange Commission*, 482 F.3d 481 (D.C. 2007)

uniform fiduciary standard is a good idea, it must not be a watered-down standard masquerading as a fiduciary standard.

Finally, we urge the Commission to consider creating a private right of action to pursue a breach of a federal fiduciary duty. Presently, only a limited private remedy is recognized pursuant to the IAA.[12] In order for a federal fiduciary duty to be meaningful, it is essential that aggrieved customers be permitted to pursue legal remedies for a violation of that duty. Additionally, the federal fiduciary duty should represent the minimum standard to which brokers must adhere. To the extent that individual states wish to impose higher standards on brokers, it is important that states retain that right. It should be explicit that any federal fiduciary duty does not preempt any existing or forthcoming state fiduciary duty.

We thank the commission for the opportunity to share our views on this topic. To the extent the Commission has any questions or would like any further information, please do not hesitate to contact me.

Respectfully submitted,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

/s/
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President

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[12] *Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis,* 444 U.S. 11,24, 100 S.Ct. 242, 349 (1979) ("For the reasons stated in this opinion, we hold that there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable.")