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August 7, 2018

Via email to rule-comments@sec.gov

Brent Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Proposed Rule –Regulation Best Interest 17 CFR Part 1240
File No. S7-07-18; RIN 3235-AM35
Release No. 34-83082
Response to Request for Comments Regarding Regulation Best Interest

Dear Mr. Fields:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules which govern the conduct of those who provide advice to investors.

On May 9, 2018, the Securities and Exchange Commission ("SEC") published a Notice of Proposed Rulemaking in the Federal Register, regarding a proposed "best interest" standard for securities broker-dealers and their associated persons (collectively "brokers") and sought public comment regarding its proposed rule ("the Rule"). PIABA is in complete agreement with the premise and intent of this proposed rulemaking to heighten the standard of conduct required of brokers when they recommend securities and securities strategies to retail customers. However, PIABA believes that the Rule can and should be clarified and improved in order to protect customers while remaining consistent with the SEC's intent. PIABA's concerns and suggestions are discussed in detail below.

I. The Rule Must Respect State Sovereignty and be Treated as the Minimum Level of Consumer Protection

As is evidenced by the thousands of breach of fiduciary duty cases filed each year by investors, the majority of American investors believe their brokers to be their fiduciaries.¹ Unfortunately, as many of these investors find out once in an arbitration forum, their brokers were never their fiduciaries nor were they required to act in their client's

¹ See, FINRA Dispute Resolution Statistics, available at <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics>.

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best interests. Consequently, it is imperative that states who have enacted stronger protections for their citizen investors retain those protections. Similarly, states who wish to enact stronger protections in the future should be allowed to do so. The Rule, as drafted, is ambiguous on those points and requires clarification. Specifically, the Rule indicates, in footnote 43, that it is not intended to supersede the body of case law holding that brokers who exercise discretion or control over customer assets owe customers a fiduciary duty. PIABA does not believe that a footnote is sufficiently robust to make it clear to the securities industry that the Rule does not alter fiduciary duties that exist under current state law, or prevent states from imposing higher standards in the future. This is especially true because the Rule explicitly states in the body that: "Regulation Best Interest would not alter a broker-dealer's existing obligations under the Exchange Act or any other applicable provisions of the federal securities laws and rules and regulations", but makes no mention of state statutes and common law which currently impose a fiduciary duty on brokers.²

For example, in California, it is a long-settled rule that a stockbroker owes a fiduciary duty to his or her customer.³ Further, the existence of a broker's fiduciary duty in California does not depend upon a showing of special facts, such as whether or not the broker serves as an investment advisor or controls the account, or whether the customer was "sophisticated", and/or whether the account was discretionary. On the contrary, under California law, ALL securities brokers are fiduciaries, without exception.⁴ Missouri courts have also uniformly held or stated that a stockbroker owes a fiduciary duty to his customer.⁵ In South Dakota, its Supreme Court held that securities brokers owe a fiduciary duty to the investors who employ them.⁶

The Rule should make it clear that States are free to create and enforce a higher standard of conduct on brokers for several important reasons. Under the Tenth Amendment to the Constitution, powers not enumerated to the Federal government are reserved to the States or the people. As a result, although the SEC may create a best-interest rule for the financial industry, it cannot, as an administrative agency of the federal executive branch, create a rule that interferes with a State's interest in protecting its citizens from tortious conduct. Therefore, the SEC should clarify that the Rule will not be a substitute for state law and that it cannot be used to argue that States cannot legislate within the same arena or enforce more stringent requirements. A Rule which overrides States' power in this regard would be unconstitutional because it would impede a key tenet of States' rights, exceed the scope of the SEC's rulemaking powers under the Dodd-Frank Act, and over-extend the reach of the Rule.

Further, States should retain the right to enact more stringent rules if its legislators or judiciary concludes that an enhanced level of investor protection is warranted based on the needs of the State. That has been the law for over fifty years. No reason has been advanced to change it, let alone a compelling reason. If States are unable to legislate to increase investor protections, then broker behavior that arguably meets the standards imposed by the

² Those States include California, Florida, Missouri, Pennsylvania, South Carolina and South Dakota.

³ *Ashburn v. AIG Financial Advisors, Inc.*, 234 Cal. App. 4th 79, 100-101 (2015); *Brown v. Wells Fargo Bank, N.A.*, 168 Cal. App.4th 938, 961(2008); *Duffy v. Cavalier*, 215 Cal. App. 3d 1517, 1539-1540 (1989); *Hobbs v. Bateman Eichler, Hill Richards, Inc.*, 164 Cal. App.3d 174, 201 (1985); *Twomey v. Mitchum, Jones, & Templeton, Inc.*, 262 Cal. App. 2d 690, 698, 708-710, 720-722 (1968).

⁴ *Duffy, supra*, 215 Cal. App. 3d at 1534, 1539-1540.

⁵ *E.g. Leuzinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 396 S.W.2d 570, 575 (Mo. Banc 1965); *752 Mercantile Trust Co. v. Harper*, 622 S.W.2d 345, 349 (Mo.App.1981); *Roth v. Roth*, 571 S.W.2d 659, 668 (Mo.App.1978).

⁶ *Dinsmore v. Piper Jaffray*, 593 N.W.2d 41 ¶19 (S.D. 1999)

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Rule may still lead to investors not being completely protected from predatory sales tactics which are not addressed by the Rule. Moreover, prohibiting State action in this arena may prevent States from being able to legislate as industry practices evolve in reaction to the Rule.

PIABA's concerns in this regard are not idle speculation. The industry already contends, in FINRA arbitrations, that state law standards of conduct do not apply. Take for example the case of Grant & Dorothy. Grant and Dorothy are a retired couple. They worked hard, scrimped and saved, lived frugally, and trusted that their broker Jarrod would invest their hard-earned life savings in an appropriate fashion. What they got, however, were accounts traded to produce outstanding returns for the broker and his firm. They had three accounts, bearing cost to equity ratios of almost 37%, almost 14%, and almost 11%. In English, that means that the accounts would have had to produce 37%, 14%, and 11% in annual returns just to break even. Obviously, just achieving such returns, much less doing so using moderate or conservative investments, is impossible. Grant and Dorothy live in California, which meant Jarrod was a fiduciary under state common law. However, after they sued Jarrod and his firm, the firm denied any such duty. The firm simply ignored what the common law stated. Fortunately, the arbitration panel followed California law. However, Grant & Dorothy had to litigate the issue of whether their broker owed a fiduciary duty because the matter was in FINRA arbitration.

Based on the foregoing, PIABA has every reason to believe that the securities industry will seek to use the Rule to argue that they no longer owe a fiduciary duty to investors in California and other states which impose a fiduciary duty, and that this duty has been supplanted by the Rule. It is therefore essential that the Rule does not displace the important system of state regulation and common law that currently exists. In States where there is a higher duty than that proposed by the SEC, those citizens, like Grant and Dorothy, should be able to rely on the heightened standards.

For the foregoing reasons, PIABA believes that the SEC should make it clear that the Rule does NOT preempt existing or future state statutory and common law which creates stronger protections for investors within their own jurisdictions. This can be easily accomplished with the following proposed language: "Regulation Best Interest would not alter a broker-dealer's existing obligations under the Exchange Act or any other applicable provisions of the federal securities laws and rules and regulations, or any applicable state statutory or common law which imposes a higher standard of conduct than Regulation Best Interest."

II. The Proposed Rule Should Provide Standards Regarding the Broker's Best Interest Obligations

The Rule includes three general obligations: (1) the Duty of Disclosure; (2) the Duty of Care; and (3) the Duty to Avoid and/or Mitigate Conflicts of Interest. As an initial matter, we believe that the final rule should expressly state that a broker must comply with all three of the foregoing obligations in order to comply with the Rule. The language of the release suggests that this is the SEC's intent.

We agree with the SEC's efforts to raise the standard of conduct for brokers through a framework that imposes a best interest obligation. However, as discussed in detail below, we believe that the standards for meeting that obligation should be clarified in a manner that reflects the realities of the broker-customer relationship.

A. The Disclosure Obligation

The Disclosure Obligation requires the broker to “reasonably disclose to the retail customer, in writing, the material facts relating to the scope and circumstances of the relationship with the customer, including all material conflicts of interest that are associated with the recommendation.”⁷ The operative question, and the one of greatest concern to PIABA, is what constitutes “reasonable disclosure”.

The Rule, as currently written, suggests that the duty of disclosure could be discharged by providing the customer with a form, the Customer Relationship Summary (“Form CRS”). PIABA is very concerned about whether any form can provide effective disclosure to retail investors. As we have previously described, there are numerous studies showing that cognitive biases and lack of financial literacy, among other factors, greatly diminishes the effectiveness of written disclosures.⁸ Retail customers often receive voluminous written materials when making a securities transaction, including account opening documents, prospectuses, and contracts. The volume of paperwork is equivalent to the documentation one receives when closing a real estate transaction. The experiences of our members and their clients reflect that retail investors frequently become overwhelmed by the information and will simply rely on what their broker tells them. In such cases the disclosure is no longer a resource for the investor, but instead, a “gotcha” disclaimer for the broker-dealer.

For example, Kathy, a recently widowed manufacturing employee who lost her job during the financial crises in 2008, contacted broker Herbert to help her establish an investment plan. Kathy’s only assets outside of her modest home were approximately \$180,000 of savings in annuities and bank certificates of deposit (“CDs”). Herbert recommended to Kathy that she liquidate the annuities and CDs and trust him to place them in investments that would grow and generate income for her expenses. Instead, Herbert placed nearly half of Kathy’s limited savings in a non-traded Real Estate Investment Trust (“REIT”) and a high risk oil and gas limited partnership. Both investments paid significant commissions to Herbert. When Kathy sued, the broker-dealer claimed that Kathy understood the risks because she signed the REIT’s subscription agreement with risk disclosures – buried in over 30 pages of documents Herbert had provided to Kathy.

As another example, Paul and Ann are two retirees who lost nearly all of their life’s savings after placing their trust in their neighbor, Rick, who was also their broker. Together they built a nest egg of about \$250,000, which they held in bank certificates of deposit – until they met and became friendly with Rick. Rick lived nearby and occasionally helped Paul with difficult tasks around the house. Rick touted his investment expertise and told Paul and Ann that he could invest their savings so that they could earn higher returns than the banks paid. Paul and Ann had no prior investment experience and, trusting their friend and broker, Rick, they signed all the account opening and other paperwork that Rick presented to them. The documents included subscription agreements with boilerplate risk disclosures, but given their trust in Rick, Paul and Ann simply signed and initialed all the documents where indicated. Rick placed all of their savings into four high risk private placements that were being pushed by his broker-dealer and which paid high commissions; one of the issuers was in fact seized by an SEC receiver because it turned out to be a Ponzi scheme.

⁷ *Id.* at 405.

⁸ PIABA August 11, 2017 Comment Letter to Chairman Clayton’s Request for Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers, at 18-19 (citations omitted).

The foregoing two examples are illustrative of the situations our members often see where customers signed forms to purchase high risk investments without reading them because of their trust in their brokers. Consequently, we do not believe that simply presenting yet another document to a customer, in addition to the many documents the customer already receives, will be sufficient because of the volume and complexity of the documents, and the customers' natural inclination to trust what is stated to them verbally. As the above examples reflect, it is common for a customer to receive and sign documents without reading their contents because they are relying on the broker to act in their best interest.

This does not mean that it is impossible to satisfy a disclosure obligation, but rather that it cannot be satisfied solely by presenting the customers with an additional document. We believe that the appropriate way to discharge the disclosure obligation is to require the broker to have a verbal conversation with the customer in which the broker explains the relationship, any conflicts, how the broker is paid, and the features, benefits and risks of the recommendation, in a way that is understandable to the customer. This conversation should then be confirmed by a letter or email from the broker documenting the discussion, which is signed or confirmed as being accurate by the customer, and retained in the customer's file. It should be noted that the procedure described above is one that is already followed by several brokers and advisors. It is also consistent with "engagement letters" that are utilized by other professionals to set forth and confirm the nature, scope, conflicts and fees associated with the relationship. Adoption of this procedure would ensure that the relevant information is not only disclosed, but heard, and that it is presented to the customers uncluttered by layers of distracting documents.

We also urge the SEC to explicitly state in the final Rule that the Disclosure Obligation extends to the recommendation. Specifically, brokers should be required to disclose the risks, benefits, and ramifications of the recommendation in a way that is understandable to the customer. As discussed above, we do not believe that this duty can be sufficiently discharged with documents because many customers do not realize that their brokers are not already verbally providing them with the necessary information, or have difficulty understanding the documents. Requiring a documented verbal conversation will ensure that the customers truly understand the recommendations.

In addition, we believe that, consistent with the language of the proposed rule, the disclosure should make it clear that a broker cannot disclaim its duties under the other two obligations of the Best Interest Rule – the Care Obligation and the Conflict of Interest Obligation. Similarly, the disclosure should make it clear that the rights and obligations of the parties are governed by both industry rules and applicable state and federal law.

Lastly, PIABA does not believe that there can or should be any "one size fits all" document that is used to satisfy the disclosure obligation. For one, several States impose a fiduciary standard upon brokers. Use of a standard form in those States could be construed as overriding that State's laws governing the broker's duties, which we do not believe is the SEC's intent.⁹ In addition, use of one standard form fails to recognize that the scope of the broker's obligations and the level of disclosure required to ensure customer understanding will vary depending upon the customer and the relationship. For example, the relationship that a customer has with a full service brokerage firm will be different than the relationship a customer has with an online brokerage firm that only offers self-directed accounts. Similarly, the communication that is required for a recommendation will be more extensive for a complex product such as a variable annuity than it is for a Treasury Bond. Accordingly, the standard for disclosure should not be handing a customer an additional boilerplate document but rather making reasonable efforts to talk to the customer about the relationship, the fees, and the recommendations, in a manner that is understandable to the customer.

⁹ Also see discussion in Section I above

B. The Care Obligation

The Care Obligation requires the broker to exercise reasonable diligence, care, skill, and prudence to: (a) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers; (b) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks and rewards associated with the recommendation; and (c) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile."¹⁰

The Care Obligation embodies many of the principles of the FINRA "Know Your Customer Rule" and the FINRA "Suitability Rule". To the extent those rules overlap, we believe that it would be appropriate for the SEC to clarify that the FINRA Rules are affirmed and expressly incorporated by reference into the Rule, so as to avoid any argument that the Rule has less stringent requirements than the current FINRA Rules.

It also appears that the SEC intends to impose a higher standard of care than what is currently required by FINRA Rules. We believe that clarification as to what that standard entails is necessary and appropriate to ensure that the Rule accomplishes its intended goal of ensuring that recommendations are in the customers' best interests.

Specifically, the Care Obligation provides that the customer's investment profile, including "the retail customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the retail customer may disclose to the broker-dealer or associated person must be considered."¹¹ Accordingly, customer due diligence is paramount to satisfy the duty of care. Usually, customer information is recorded on a form when a new account is opened. Firms are required to send this information to a customer within 30 days of account opening, and no less frequently than every 36 months thereafter.¹² However, there is often little documentation as to how and when the firm or the broker obtained the information on the profile. It is not uncommon for the customer to sign boilerplate documents which purport to contain information about the customer that is not accurate, without review or discussion, because they trust the broker and believe he or she is acting in their best interest. Sometimes the customers sign the forms with the information left blank, and it is then filled in by an assistant who does not have all the information or whose information is incorrect. All too often, we see firms use new account documents with manifestly inaccurate customer information, which was not written in the customer's handwriting, in a "gotcha moment" to blame the victim for approving or ratifying bad investments under some type of contributory negligence theory.

Take Donna, for example. Donna was a 58-year old single person with a high-school education. When her stockbroker of many years transferred her account to another firm, the broker completed the account application paperwork showing Donna as an investor with a six-figure income and extensive investment experience, seeking an aggressive investment strategy, and having a high tolerance for risk. The broker knew none of it was true. Donna signed the paperwork without question or discussion because she trusted her stockbroker. The firm sent her a 40-

¹⁰ *Id.* at 405-06.

¹¹ *Id.* at 407.

¹² 17 CFR 240.17a-3(17)(i)(B)(1).

page “welcome” packet that included her profile information, and informed Donna to contact her broker with questions or corrections. Overwhelmed by the sheer volume, she did not read the false paperwork. After the stockbroker lost most of Donna’s money through imprudent, high risk investments, Donna filed a claim. The central pillar of the firm’s defense was Donna’s false customer profile, which had given them, in effect, free rein to act contrary to her best interest. Gotcha!

In short, we do not believe that the burden of ensuring accurate recording of customer information should be on the customer. In order to avoid this problem, we suggest that opening account documentation regarding the customer’s information be completed in the customer’s own hand to the extent possible, and that brokers be required to verbally explain what is in the customer profile, and keep a record of the conversation that is acknowledged by the customer. For example, the broker should talk to the customer about what having “extensive investment experience” means. It should not mean simply that the customer has had a brokerage account for a long time, but that the customer has had experience in analyzing and making independent investment decisions. In addition, there should be a discussion as to what it means to have an aggressive investment strategy with a high tolerance for risk of loss, and why such a high-risk strategy is in the best interest of the customer. A discussion of what is meant by an investment objective of “growth” is also appropriate. Many customers do not understand that “growth” means equity investments which carry more risk.

Brokers should also be required to take reasonable steps to verify that the financial information provided by the customer is accurate. In that regard, the Care Obligation should require the broker to obtain and review documents to verify the customer’s income and/or net worth. These could include bank statements, brokerage account statements, pay stubs, or IRS forms that report the customer’s income. The rule should require the broker to review the information with the customer verbally and in writing on a periodic basis, and whenever the broker may become aware of a material change in the customer’s circumstances that could affect liquidity needs, time horizon, or risk tolerance. Such review should be documented and maintained as part of the firm’s books and records.

In addition, with respect to trust accounts, brokers should be obligated to consider the profile of the trust beneficiaries, rather than that of the trustee. When the trust is managed for the benefit of the beneficiaries, it is their profiles which are relevant to determining whether a recommendation has been made in the best interest of the customer. However, firms will often point to the knowledge or sophistication of the trustee to defend aggressive and inappropriate investments for the Trust. Further, our members have run into situations where the broker did not even know who the beneficiaries of the Trust were, nor anything about the beneficiaries’ situation.

Product due diligence is also critical to satisfy the duty of care. We believe the Rule should make it clear that due diligence goes further than reviewing a prospectus or a brochure or asking a few questions of the wholesaler. This form of inquiry is contaminated with its own conflicts of interest, as the individuals answering the inquiry are often focused on their own best interests. As stated by FINRA, “In general, however, a broker-dealer ‘may not rely blindly upon the issuer for information concerning a company,’ nor may it rely on the information provided by the issuer and its counsel in lieu of conducting its own reasonable investigation.”¹³ The Rule should require independent investigation to comply with the reasonable basis inquiry obligation.

The Rule should also require that the broker have an understanding of the risks and rewards of the recommendation, which “would generally involve consideration of factors, such as the costs, the investment objectives and characteristics associated with a product or strategy (including any special or unusual features, liquidity, risks and

¹³ Id. at 4.

potential benefits, volatility and likely performance in a variety of market and economic conditions), as well as the financial and other benefits to the broker-dealer.”¹⁴

The Rule explains that consideration of the costs associated with the recommendation is a central requirement under the Care Obligation and, therefore, an enhancement of the broker-dealer’s existing obligations.¹⁵ To the extent a broker recommends a “more expensive” security or investment strategy, the broker-dealer must have a reasonable basis that the recommendation is justified given the characteristics or features of the security or strategy and the customer’s profile and investment objectives.¹⁶ PIABA agrees with the foregoing language but notes that it is not expressly stated in the text of the Rule defining the Care Obligation, or anywhere else in the Rule itself. The rule simply includes a vague reference to consideration of “risks and rewards.”¹⁷ We strongly urge the SEC to include in the Care Obligations an express reference to the requirement that a broker consider the cost of the recommended transaction or strategy (and disclosure of those actual costs to the investor as discussed above). To the extent there are less expensive alternatives available, the disclosure should include an explanation to the investor of why the recommended security transaction or investment strategy is nevertheless in the investor’s best interest given other factors associated with the recommendation.¹⁸

Finally, the Rule should make it clear that brokers cannot satisfy the Care Obligation merely by providing the customer with a prospectus or offering document. Otherwise, the broker can neglect their best interest duty and shift the burden to the customer to assess the merits and risk of the investment. Such behavior happens all too frequently, and undermines the purpose of the securities laws, which were intended to eliminate the “buyer beware” environment that existed prior to their enactment.

C. The Conflict of Interest Obligation

The Conflict of Interest Obligation would require broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to: “(a) identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendations; and (b) identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.”¹⁹ We agree with the foregoing, but believe that the Rule should go further, and prohibit certain “financial incentive” conflicts altogether.

¹⁴ Release No. 34-83062, at 143.

¹⁵ *Id.* at 135, 143.

¹⁶ *Id.* at 56-57.

¹⁷ Proposed §240.15l-2(ii)(B), 17 CFR Part 240, Release No. 34-83062, at 406.

¹⁸ Release No. 34-83062, at 56.

¹⁹ *Id.* at 406.

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For example, the SEC has suggested eliminating compensation incentives within a product line.²⁰ FINRA has also examined whether differential compensation structures should be prohibited with respect to proprietary products.²¹ FINRA has also considered whether product specific sales contests should be prohibited.^{22 23}

There are significant problems associated with sales contests. For example, Scottrade is alleged to have conducted sales contests in 2017 which “perversely incentivized Scottrade agents to bring in new assets from customers, including through the rollover of retirement assets,” as well “make recommendations and referrals to its investment advisory program in order to qualify for particular prizes.”²⁴ Such contests “could be reasonably expected to cause Scottrade agents to make recommendations in their own best interests rather than the best interests of their customers.”²⁵ Other firms have used improper financial incentives as well. Morgan Stanley consented to a \$1 million fine for utilizing incentive programs for initiating lending relationships with Morgan Stanley Private Bank.²⁶ Notwithstanding Morgan Stanley’s internal prohibition against sales contests, the incentive program proceeded.²⁷

Additionally, Senator Warren has highlighted the sales practices of a number of firms within the annuity industry which create conflicts of interest because of the incentives provided to sell their products.²⁸ Many firms offered lavish vacations to high end resorts around the world to the top sellers. For example, one firm provided a week-long trip to Playa Del Carmen, Mexico to the top 15 annuity agents.²⁹ Another held its “Leaders’ Conference,” for the broker and a guest, at the Westbury Hotel in Dublin, Ireland.³⁰

Most importantly, brokers are paid higher compensation for selling certain types of products, such as alternative investments and variable annuities, than they are for selling other products with lower internal costs and fees.

For example, Bob and Janet met their broker, Shawn, after hearing his radio show. Shawn often talked about alternative investments on his show, touting them as providing safe and secure income without all of the volatility of stocks. As Bob had significant health problems, he was concerned about his ability to provide for Janet into retirement. Bob reached out to Shawn to ask for his help managing the couple’s modest savings. Shawn ultimately recommended a number of non-traded REITs and Business Development Companies (BDCs). These investments are highly speculative, risky, and illiquid investments. Shawn presented them as safer and more diverse than the stock

²⁰ *Id.* at 182.

²¹ NASD Notice To Members 99-81, “*Salesperson Compensation Practice*,” at 607 (Sept.1999), <http://www.finra.org/sites/default/files/NoticeDocument/p004080.pdf>.

²² See NASD Notice to Members 05-40, *Sales Contests and Non-Cash Compensation* (June 2005).

²³ FINRA Reg. Notice 16-29, *Gifts, Gratuities and Non-Cash Compensation Rules* (August 2016).

²⁴ Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, *In the Matter of: Scottrade, Inc.*, Docket No. E-2017-0045 at 4 (Feb. 15, 2018).

²⁵ *Id.*

²⁶ Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, *In the Matter of: Morgan Stanley Smith Barney LLC*, Docket No. E-2016-0055 (Apr. 7, 2017).

²⁷ *Id.*

²⁸ Senator Elizabeth Warren, *Villas, Castles, and Vacations* (Feb. 2017).

²⁹ *Id.* at 4.

³⁰ *Id.*

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market. Shawn did not mention the lucrative fees such investments pay to firms and brokers. These investments often have up-front costs and fees of 10 – 15%, a significant portion of which is passed along to the brokerage firm and its brokers. It is clear Shawn recommended these products because of the benefits he would receive, not because they were appropriate for Bob and Janet. Shawn knew Bob and Janet were relying on him to act in their interests, but Shawn violated their trust.

We believe that a rule can and should be crafted which would ensure that the conflicts of interest discussed above are eliminated or, at minimum, fully and fairly disclosed.

Specifically, we suggest that the Rule should specifically prohibit compensation structures which would incentivize a broker to: recommend a proprietary product or recommend one type of product line over another; and/or which would reward the sale of certain products within a product line. Such practices put the broker's interests at odds with the customer's interests, and should not be permitted. This includes a specific prohibition on sales contests which improperly incentive the sale of particular products or encourage behavior at odds with the best interests of the customer. Other compensation and bonus structures within firms appropriately reward advisors for a job well done without putting pressure on advisors to sell more of a particular product or providing them with a financial incentive to do so.

Further, the disclosure of fees, charges and compensation that are associated with the recommendation needs to be clearer and simplified. Currently, a customer needs to comb through lengthy prospectuses (often several of them if multiple products are recommended) in order to ascertain the fees and charges associated with the recommended investment or investment strategy. Even then, it is not always clear how those fees and charges impact investment performance or how they compare to other available investments. We believe that customers should be provided with clear and concise information that fully and fairly discloses the specific charges the customer will incur as a result of the particular recommendation, prior to or at the time the recommendation is made. In addition, the broker should provide a clear and understandable explanation as to the other lower cost investments which are available, and why the higher cost investment is being recommended.

III. When the Best Interest Obligation Arises and the Length of Its Duration Should Be Clarified

A. The Rule Should Clarify that the Best Interest Obligation Can Arise Before A Specific Securities Recommendation Is Made

The Rule states that the best-interest standard of conduct arises "when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer". PIABA agrees that the best interest standard should always arise when a broker recommends a securities transaction or investment strategy involving securities. However, PIABA believes that the Rule, as currently written, is overly restrictive because it could be construed to mean that the best interest standard under this rule does not apply to any other financial recommendation, regardless of the circumstances. Such a result ignores the reality that brokers sometimes recommend other financial courses of action preceding the recommendation of a particular security or investment strategy in order to earn the client's trust and cause the client to entrust their assets to the broker for management.

A prime example of such a scenario is when a broker recommends to a prospective client that they retire early and/or elect a lump sum payment in lieu of a defined benefit pension which is then turned over to the broker for investment. Obviously, the broker has a financial incentive to recommend such a course of action.

This is not a hypothetical situation. By way of example, in the late 1990's and early 2000s, broker SK gave "retirement planning" seminars onsite at Pacific Bell offices throughout Northern California for Pacific Bell retirees

who had been offered early retirement packages. At these seminars and in one on one meetings which followed the seminars, SK advised the prospective retirees to take the early retirement packages, elect a lump sum payout in lieu of a pension, and invest the lump sums through the broker-dealer with whom she was affiliated. SK told the prospective retirees that her investment prowess would produce an income stream that was larger than their pensions, but just as safe, while also allowing them to leave an inheritance. SK then recommended to the early retirees that they invest those lump sums into variable annuities, and earned commissions from those sales. SK did not disclose the amount of commissions she received. In a published case in 2015, the California Court of Appeals, First Appellate District, held that the same fiduciary standard³¹ which governed investment recommendations also applied to SK's advice to take early retirement and elect the lump sum because such advice constituted personalized financial advice about retirement planning.³²

Another example of a situation where financial recommendations unrelated to a specific securities recommendation may properly give rise to imposing a best interest standard of conduct is when a brokerage firm's personnel provides generalized financial advice to prospective clients for an extended period of time before the customer has met with a broker. Specifically, in a published case from 2008, the California Court of Appeals, Second Appellate District, held that the brokerage firm's fiduciary duty had arisen before any specific securities recommendations were made, because the firm's personnel had managed the financial affairs of an elderly couple who were in declining health and had vision problems, and had provided general financial advice and recommendations for estate planners and CPAs to that couple, for a six month period preceding the couple's first meeting with the firm's broker.³³

In short, it is important to recognize that certain financial recommendations, including recommendations to elect a lump sum in lieu of a pension, although not securities recommendations of themselves, are a necessary precursor to a broker obtaining control of assets which can then be invested through the broker. As such, those recommendations should trigger the same duties as the specific securities recommendations which inevitably follow.

It is equally essential to recognize that brokers do not merely pick investments or devise investment strategies. On the contrary, brokers often purport to offer retirement planning advice and/or a wide spectrum of financial advice and services. This is borne out by firm advertising. In a study conducted by PIABA in 2015, PIABA examined the websites of nine different brokerage firms, including Allstate, UBS, Morgan Stanley, Berthel Fisher, Ameriprise, Merrill Lynch, Fidelity, Wells Fargo, and Charles Schwab. PIABA found that the firms' advertising presents the image that the firms are doing far more than simply recommending a specific investment or investment strategy.³⁴ The following examples are illustrative.

³¹ In California, brokers and broker-dealers are fiduciaries, although the scope of the fiduciary duty varies depending upon the facts. (*Ashburn v. AIG Financial Advisors, Inc.*, 234 Cal. App.4th 79, 100-101(2015); *Brown v. Wells Fargo Bank, N.A.*, 168 Cal. App.4th 938, 959-961 (2008); *Duffy v. Cavalier*, 215 Cal. App.3d 1517, 1539-1540 (1989); *Hobbs v. Bateman Eichler, Hill Richards, Inc.*, 164 Cal. App.3d 174, 201 (1985); *Twomey v. Mitchum, Jones, & Templeton, Inc.*, 262 Cal. App.2d 690, 698, 708-710, 720-722 (1968)

³² *Ashburn v. AIG Financial Advisors, Inc.*, 234 Cal. App.4th 79, 100-101 (2015)

³³ *Brown v. Wells Fargo Bank, N.A.*, 168 Cal. App.4th 938, 959-961 (2008)

³⁴ See PIABA, *Major Investor Losses due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty; Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard* (Mar. 25, 2015) (the "PIABA Study"), available at <https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf>.

Ameriprise:

Personalized advice and recommendations on an ongoing basis

Perhaps the best thing about working with a personal financial advisor is that your financial plan is custom made for you. The financial advisor you choose to work with knows all about you. When and if you experience a life change, your priorities shift or you have a pressing financial question, you can contact your advisor for information and financial advice that's meaningful to you. You may meet a few times during a year and have several discussions. Your advisor will make every effort to be available to you when needed.³⁵

Wells Fargo:

The center of the Wells Fargo homepage features the statement: "Helping Clients Succeed Financially. We provide advice and guidance to help maximize all elements of your financial life, whenever and however you need it." A prospective client who clicks on the "Why Invest With Us" tab will find the following statement under the "Our Advisors" heading: "A Financial Advisor can provide the advice and guidance you need to focus on your short- and long-term goals while navigating life's financial opportunities and turning points. Start planning now for the future. Choose a Financial Advisor from the firm that lives and breathes a client-centered approach to advice."³⁶

Charles Schwab:

The homepage of the firm's website features the question: "How will you help me with my financial goals?" The answer, in big, bold font: "A Schwab Financial Consultant can help you create a plan tailored to your needs." It continues: "It starts with a conversation and a fresh perspective, discussing your long- and short-term goals. We evaluate your current investments then create specific recommendations." The website describes the benefits of meeting with a financial consultant this way: "Your Financial Consultant can work with you to create a holistic plan with specific investment recommendations and a clear explanation of the benefits and risks....Your plan will reflect your priorities, from retirement income and estate planning to insurance and debt management. And you can meet regularly to keep your plan up to date as your life evolves."³⁷

Given the foregoing realities, we believe that the Best Interest Rule should: a) always apply to recommendations of any securities transaction or investment strategy involving securities to a retail customer securities transactions; and b) also apply in any situation where the broker offers generalized retirement planning, financial or investment recommendations to a prospective customer which are designed to encourage the customer to open an account with the firm and/or to bring additional assets to the firm for investment, specifically including, but not limited to, recommendations to take early retirement, recommendations to elect a lump sum in lieu of a defined benefit pension, and/or recommendations to meet with a broker from the firm.

B. The Rule Should Clarify that a Broker's Best Interest Obligation May Extend Beyond the Point of Sale Under Certain Specified Circumstances

The Rule provides that the broker's duties under the best interest standard will end after the consummation of the recommended transaction. PIABA believes that, while that may be appropriate for certain types of transactions, it is not appropriate for investments or investment strategies where the broker is continuing to be compensated for

³⁵ *Id.* at 11.

³⁶ *Id.*

³⁷ *Id.* at 7.

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the transaction after the sale has occurred. Such investments include managed money and investments which pay commission trails such as variable annuities and mutual funds.

PIABA also believes that periodic monitoring of recommended investment strategies to ensure that they remain in the client's best interest should be required because client circumstances and what is in their best interest often change over time.

Specifically, many brokers offer fee based investments where they are paid a percentage of assets under management for managing the clients' monies on a quarterly basis. In other words, the brokers receive compensation for managing money, not just for recommending a specific transaction. Under those circumstances, the broker should be subject to an ongoing best interest obligation because he/she is receiving payment for ongoing customer and management services and not just for a specific transaction.

The same is true for brokers who are receiving commission trails for selling variable annuities and/or mutual funds. The reason why variable annuity issuers pay trails is because variable annuities are long term investments which require ongoing management, including repositioning of sub-accounts based on the clients' needs, adding or terminating riders, determining when an income rider should be utilized, updating beneficiaries, and multiple other services. Similarly, mutual funds are long-term investments which require ongoing management, including the repositioning of assets within fund families. Simply put, the management of a variable annuity or mutual fund, and the payment to a broker for such management, does not end when the customer purchases the product. Consequently, the broker's duties to a customer should not end with the purchase. On the contrary, the same duty of disclosure, duty of care and duty to mitigate and avoid conflicts of interest should apply for as long as the broker is continuing to be compensated for that recommendation.

PIABA also believes there should be a continuing duty on the part of the broker to periodically assess a recommended investment strategy to determine whether its objectives remain in the customer's best interest. Customers often maintain their accounts with a broker for years and even decades. During that time, a customer's investment profile can change, sometimes dramatically. Likewise, the investment strategy that will be in the customer's best interest can also change. For example, a customer who initially invested while he/she was employed but has since retired will most likely need a more conservative investment strategy than what was originally recommended. Similarly, a customer who was single when he/she opened her account but has since gotten married and had children is likely to have different objectives. Accordingly, an investment strategy cannot satisfy the best interest rule unless there is a periodic assessment and update of the customers' situation. Indeed, many firms require brokers to update the clients' investment profile on a periodic basis ranging from every 1-3 years. However, these periodic updates are not required by current law or by the Rule. Requiring such updates and a documented assessment of whether and why the investment strategy continues to be in the customer's best interest will ensure that the customer's best interests and needs continue to be met, without imposing an overly onerous burden on the industry.

For the reasons stated above, PIABA proposes that the Rule provide that the Best Interest Standard will remain in effect for as long as the broker is continuing to be compensated as a direct or indirect result of the recommendation, including, but not limited to, the period during which the broker is receiving commission trails for selling the recommended product. PIABA further proposes that the Rule require brokers to contact the clients at least annually to update their investment profile, assess whether their current strategy is still in the clients' best interest, recommend any appropriate changes, and document the update/assessment in the client's file.

IV. Brokers Who are Dually Registered as Investment Advisors Should be Subject to the Fiduciary Standard Applicable to Investment Advisors as to all Securities and Financial Recommendations

Many financial advisors are dually registered as investment advisors and as brokers. To the extent a financial advisor is acting in a dually registered capacity, we believe that individual should always be held to the higher standard – a fiduciary duty – when conducting business with customers. Customers do not differentiate between the various accounts they hold with a financial advisor. They do not realize that financial advisors who are dually registered as investment advisors, and who are paid a management fee for some of their accounts, will then claim that they are not fiduciaries with respect to recommendations to purchase securities on which they are paid commissions, or to purchase insurance and/or real estate investments that are not securities. The customers are doing business with an individual, and reasonably expect that individual to treat them the same regardless of how they are getting paid for particular recommendations.

PIABA's concern in this regard is not hypothetical. For example, Marie put herself through college and law school, working as a police officer. After saving over the course of her career practicing family law, she managed to accumulate a nest egg of approximately \$1 million. She sought out investment advice, because, although she was well educated, she was unfamiliar with the market. In the market downturn of 2008, Marie lost money. She was looking for someone to manage what was left of her portfolio. Marie met James, a dually-registered broker and investment adviser. Marie opened both brokerage and advisory accounts with James and his firm. Over time, James over-concentrated Marie's accounts in index annuities and non-traded REITs, both investments with limited liquidity and extended investment horizons. Marie understood that James was a fiduciary – he was obligated to act in her best interests, but when Marie took action against James, James asserted that she was wrong. Instead, James claimed that he was only acting as a fiduciary as to Marie's advisory accounts, and that, when it came to the index annuities and non-traded REITs, he was only acting pursuant to the lower suitability standard applicable to brokers. Marie had no way of knowing that.

Notably, courts nationwide have agreed with PIABA [and Marie] that investment advisors who are dually registered as brokers owe a fiduciary duty to their customers for ALL financial recommendations they make. For example, courts nationwide have held that investment advisors who provide investment and retirement planning advice, and who induce their customers to trust and rely upon them, owe a fiduciary duty with respect to all their financial recommendations, including recommendations to purchase annuities recommendations to make real estate investments, recommendations to invest in bank loans, and/or recommendations to purchase whole life insurance policies.³⁸ Indeed, many courts nationwide have held that the fiduciary duty of an investment advisor extends to recommendations to purchase products that are not even considered to be securities.³⁹

³⁸ See e.g. *Prodigious Ventures Inc. v. YBE Hospitality Group LLC*, 2017 US Dist. LEXIS 49130,*20-23 (E.D. North Carolina 2017); *Abbit v. ING United States Annuity and Life Insurance Company*, 999 F. Supp. 2nd 1189, 1199 (S.D. Cal. 2014); *Kettle v. Leonard*, 2012 US Dist. LEXIS 132205, 35-36 (E.D. North Carolina 2012); *Ruderman v. Bank of Am., N.A.*, 2011 U.S. Dist. LEXIS 58785 at *12, 15, 18, (N.D. Ill. June 1, 2011); *Fischer v. Aviva Life and Annuity Company*, 2010 US Dist. LEXIS 94537, 15-17 (E.D. Cal. 2010); *Sanchez v. Aviva Life and Annuity Company*, 2010 US Dist. LEXIS 64264, 15-17 (E.D. Cal. 2010); *Gilmour v. Bohmueller*, 2007 US Dist. LEXIS 64967, at *87-88 (E.D. Penn. 2007); *In Re National Western Life Insurance Deferred Annuities Litigation*, 467 F. Supp. 2nd 1071, 1087 (S.D. Cal. 2006); *Negrete v. Fidelity and Guar. Life Ins. Co.*, 444 F. Supp. 2nd 998, 1003-1004 (C.D. Cal. 2006); *Estate of Migliaccio v. Midland Nat'l Life Ins. Co.*, 436 F. Supp. 2d 1095, 1108 (C.D. Cal. 2006); *Murphy v. Northwest Mutual Insurance Company*, 2005 US Dist. LEXIS 43627, at *11-14 (W.D. Missouri 2005)

³⁹ *Id.*

Simply put, investment advisors should not be allowed to escape their fiduciary obligations simply because they recommend investments in securities which pay commissions rather than advisory fees, or because they recommend investments in insurance or real estate investments which are not considered to be securities. To find otherwise elevates form over substance and renders the fiduciary relationship illusory, as it places greater importance on the specific financial product that was recommended rather than upon the nature of the relationship itself.

For the foregoing reasons, PIABA believes that the Rule should follow the common law set forth by courts nationwide, and make it clear that investment advisors who are dually registered as brokers are fiduciaries as to ALL recommendations they make, regardless of how they are compensated. Similarly, the Rule should make it clear that investment advisors cannot evade their fiduciary obligations by recommending commission based products in separate accounts, and/or by recommending insurance or other products which might not be deemed to be securities.

V. Adoption of The Best Interest Rule with the Standards Proposed Above Will Not Harm Small Investors

The securities industry has frequently protested, and continues to protest, that adoption of any type of best interest standard will harm small investors by preventing them from obtaining personalized financial advice. This begs the question of why any investor would be better off receiving conflicted financial advice, or advice that is not in their best interest, than in receiving no advice at all. We simply do not understand how or why continuing to allow brokers to recommend costly products which primarily benefit the brokers rather than the customers serves the needs of any investor, regardless of the size of their accounts. Small investors have just as much of a right to be protected from financial abuse as larger investors. Indeed, many smaller investors have a greater need to preserve the money that is invested and cannot afford to lose their money. These investors are also at a disadvantage if they do lose money, because they are often not able to afford counsel, or to obtain any meaningful recovery against the advisor or the firm. Most importantly, the industry's argument that a best interest standard will drive brokers out of business, or result in the cessation of financial services for smaller investors, is not borne out by reality.

Specifically, as discussed in Section I above, several states have long considered brokers fiduciaries under state common law.⁴⁰ Investors in those states have full access to investment advice and services. This was confirmed by a 2012 study which examined whether there were differences in the services available to investors in states that have fiduciary standards and those who do not. The study found no statistical difference between the two types of states when it came to servicing lower wealth clients, including the ability to provide a broad range of products such as those that provide commission based compensation.⁴¹

Likewise, the SEC has also previously found that, even if a fiduciary standard was adopted for brokers, retail investors would "continue to have access to the various fee structures, account options, and types of advice that investment advisers and broker-dealers provide."⁴²

⁴⁰ See, e.g. California, Georgia, Florida, Missouri, Puerto Rico, South Carolina, and South Dakota.

⁴¹ See, Michael Finke and Thomas P. Langdon, "The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice" (Mar. 9, 2012), available at <https://www.onefpa.org/journal/Pages/The%20Impact%20of%20the%20Broker-Dealer%20Fiduciary%20Standard%20on%20Financial%20Advice.aspx>.

⁴² See, "Staff Study Recommending a Uniform Fiduciary Standard for Conduct for Broker-Dealers and Investment Advisers" (2011), available at <https://www.sec.gov/news/press/2011/2011-20.htm>.

The costs of compliance associated with a fiduciary duty standard are also not meaningfully different from those associated with a mere suitability rule. The same 2012 study found that there is no statistically significant increase in compliance costs in states in which there is a clear fiduciary standard and ones in which there is no fiduciary standard.⁴³

The foregoing is also reflected by what actually occurred after the Department of Labor promulgated a fiduciary rule for retirement accounts in April of 2016. Following the adoption of the Department of Labor's Conflict of Interest Rule (the "DOL Rule"), firms continued to offer a wide variety of options to retirement investors, including commission-based alternatives.⁴⁴ The vast majority of brokerage firms and financial advisors stated, without equivocation, that they would continue to offer the full panoply of financial products to small investors, once the DOL Rule went into effect.⁴⁵ In fact, an April 2017 survey of representatives affiliated with 14 major independent brokerage firms found that 74% of such advisors/brokerage firms had not reduced the number of products that were available to their transaction – based customers as a result of the DOL Rule.⁴⁶ These same representatives reported that they believed they could operate in the best interest of their clients while still offering commission based products which are available to small investors.⁴⁷

Indeed, when the DOL Rule was enacted, several brokerage firms, including Merrill Lynch, Edward Jones, LPL Financial, and Charles Schwab, reduced their fees for small investors and/or their account minimums. As a result, the fiduciary standard enacted by the DOL benefitted small investors by providing them with lower fees, and access to services and accounts, which they did not previously have.⁴⁸

⁴³ See, Finke and Langdon.

⁴⁴ Michael Wursthorn, *A Guide to Brokers' Retirement-Account Plans*, Wall Street Journal (May 23, 2017), available at <https://www.wsj.com/articles/a-guide-to-brokers-retirement-account-plans-1495558474?tesla=y&mg=prod/accounts-wsj>.

⁴⁵ Morgan Stanley Press Release, *Morgan Stanley to Preserve Client Choice for Retirement Accounts* (Oct. 26, 2016), available at <https://www.morganstanley.com/press-releases/morgan-stanley-to-preserve-client-choice-for-retirement-accounts>; Andrew Welsch, *Raymond James Follows Morgan's Lead in Keeping Commissions Under Fiduciary Rule*, OnWallStreet.com (Oct. 27, 2016), available at <https://www.onwallstreet.com/news/raymond-james-follows-morgans-lead-in-keeping-commissions-under-dol>; Andrew Welsch, *Fiduciary Ready: Edward Jones Unveils Compliance Plans*, OnWallStreet.com (Aug. 19, 2016), available at <https://www.onwallstreet.com/news/fiduciary-ready-edward-jones-unveils-compliance-plans>

⁴⁶ Diana Britton, *Delay or not IBDs Moving Toward a Fiduciary Future*, WealthManagement.com (Apr. 5, 2017), available at <http://www.wealthmanagement.com/industry/delay-or-not-ibds-moving-toward-fiduciary-future>.

⁴⁷ *Id.*

⁴⁸ Greg Iacurci & Christine Idzelis, *Broker-dealer Split on Commissions in Wake of DOL Fiduciary Rule*, Investment News (Oct. 30, 2016), available at <http://www.investmentnews.com/article/20161030/FREE/161029902/broker-dealers-split-on-commissions-in-wake-of-dol-fiduciary-rule>; Welsch, *supra* note 71; Janet Levaux, *LPL Cuts Prices, Account Minimums Ahead of DOL Fiduciary Rule*, ThinkAdvisor.com (Mar. 16, 2016), available at <http://www.thinkadvisor.com/2016/03/16/lpl-cuts-prices-account-minimums-ahead-of-dol-fidu>; Charles Schwab Press Release, *Schwab Announces Schwab Intelligent Advisory* (Dec. 13, 2016), available at <http://pressroom.aboutschwab.com/press-release/schwab-investor-services-news/schwab-announces-schwab-intelligent-advisory>

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In short, there is substantial evidence that small investors have not suffered any disadvantages when fiduciary rules have been enacted by the states or when the fiduciary rule was enacted by the Department of Labor. There is also no evidence that a fiduciary rule or best interest standard will hurt small investors or prevent them from obtaining financial services.

Simply put, a best interest rule benefits all investors. The only "harm" it does is to those in the securities industry who wish to continue to be able to take advantage of their customers to their own benefit.

VI. Conclusion

PIABA thanks the SEC for the opportunity to comment on this important issue. PIABA looks forward to the SEC's final rulemaking designed to require that brokers act in their clients' best interests.

Very truly yours,

A handwritten signature in black ink, appearing to read "Andrew Stoltmann". The signature is fluid and cursive, with a long horizontal stroke at the end.

Andrew Stoltmann
PIABA President