



January 9, 2008

Christopher Cox, Chairman
Paul S. Atkins, Commissioner
Kathleen L. Casey, Commissioner
Annette L. Nazareth, Commissioner
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Rand Report

Dear Chairman Cox and Commissioners Atkins, Casey and Nazareth:

On January 3, 2008, the U.S. Securities and Exchange Commission ("SEC") released the long-awaited report entitled "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers" (hereafter referred to as "the RAND Report"). This comment letter is issued by the National Association of Personal Financial Advisors ("NAPFA") for purposes of fostering discussion of the issues raised by the RAND Report, as they relate to the protections afforded to consumers of financial planning and investment advisory services. Our major points of discussion include:

- ***The RAND Report is limited in scope and fails to ask the right question.*** The RAND Report was very limited in its scope, and only asked the questions, "What Business Practices Exist Now?" and "What Is The Consumer Understanding Of These Business Practices?" The RAND Report was further limited in that it does not address the errant government policies which led to the current dismal state of affairs for consumers. We believe the right question to ask is: "How can existing laws be applied to best ensure a positive financial future for Americans?"

- ***The RAND Report confirms the huge knowledge gap between financial intermediaries and consumers, and that disclosures are insufficient to fill this gap.*** The RAND Report notes a huge knowledge gap exists between the client and advisor. Despite decades of attempts at investor education, this gap has only

widened with: (1) ever-more-complex tax laws relating to financial accounts and investment products; (2) significantly greater types and numbers of investment products, and in many cases increasingly complex products; and (3) the increased difficulties consumers face in determining the true total fees and costs of their investments. The RAND Report further provides evidence of the fact that disclosure alone is not sufficient to meet the needs of investors.

- ***The RAND Report confirms that fiduciary protections for consumers are essential.*** Consumers need, and deserve, the protections afforded by financial intermediaries operating under strict fiduciary standards of conduct. Titles and actions which imply fiduciary status, when in fact none exists, continue to mislead investors to their detriment.

- ***The RAND Report contains several errors.*** These errors undermine our confidence in the objectivity of the Report and its conclusion. We also note that the RAND Report fails to identify that non-application of the Investment Advisers Act of 1940 is the underlying root cause of consumer confusion which exists today in distinguishing between broker-dealers and investment advisers.

- ***The RAND Report fails to set forth an adequate explanation of fiduciary duties.*** The RAND Report seems to deemphasize the important duty of loyalty which lies at the heart of fiduciary principles. Furthermore, the RAND Report fails to note the important developments in state common law in which fiduciary duties are applied to financial and investment advisors as they enter into relationships based upon trust and confidence.

Given the limited scope of the RAND Report, and recent attempts by the U.S. Securities and Exchange Commission to carve out exceptions from the Investment Advisers Act of 1940, **NAPFA recommends:**

- (1) that the SEC host an annual forum on fiduciary standards of conduct; and**
- (2) that an *independent study commission* be formed by Congress** to further study the importance of fiduciary protections for consumers in today's complex financial world. The commission should further be aided by one or more forums seeking the views of securities industry participants, industry associations, academic researchers, regulators, consumer advocates, and other interested parties.

In the pages that follow, NAPFA examines the RAND Report and its findings and notes various deficiencies in the Report, many of which result from the manner in which the study was framed. This comment letter is issued by the Board of Directors of the National Association of Personal Financial Advisors, with the assistance of its Industry Issues Committee.

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cc: Andrew J. Donohue, Director, Division of Investment Management
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Chair, Ranking Member, and Members of the House Committee on Financial
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**NAPFA COMMENTARY: THE RAND STUDY AND THE IMPORTANCE
OF FIDUCIARY PRINCIPLES FOR THE PROTECTION OF RECIPIENTS OF
FINANCIAL PLANNING AND INVESTMENT ADVISORY SERVICES**

A. The Importance of A Focus On The Needs of Investors.

"I doubt whether investors will commit their valuable attention and time to judge the difference between honest and dishonest ... financial intermediaries. I doubt whether investors will rely on advisors to make the distinction, once investors lose their trust in the market intermediaries. From the investor's point of view, it is more efficient to withdraw their savings from the market." - Professor Tamar Frankel, "Regulation and Investors' Trust In The Securities Markets," 68 *Brook. L. Rev.* 439, 448 (2002).

NAPFA believes the focus of efforts to protect capital formation and enhance securities regulation should be squarely focused on the needs of the consumers. Financial intermediaries deal with *other people's money*. When consumers place their trust and confidence in financial planners and investment advisers, they have the need, and right, to expect that these financial intermediaries will act in the best interest of the individual investor at all times. Continued violations of this trust will only undermine our capital markets system, leading consumers who are ill-equipped to navigate today's complex financial world to flee the capital markets and make poor choices regarding their own financial futures. The consequences of such flight are severe, for if individual investors fail to make rational decisions regarding savings and investing then economic activity will dwindle and governments will be forced to intercede and lend support.

- B. The Very Limited Scope of Inquiry of the RAND Corporation's Study.** NAPFA first notes that the scope of RAND's inquiry was limited by the SEC. The RAND Corporation was only charged with the responsibility to examine investment advisers' and broker-dealers' practices in marketing and providing financial products and services to individual investors and to evaluate investors' understanding of the differences between investment advisers' and broker-dealers' financial products and services, duties, and obligations.

In essence, the SEC asked the questions: “What are the current business (i.e., marketing) practices of investment advisory (IA) and broker-dealer (BD) firms?” and “What is consumer understanding of the distinctions?” It is important to recognize that the SEC did not ask RAND Corporation to comment on the relative benefits of the “IA delivery system” or the “BD delivery system” to individual investors. Nor did the SEC request that RAND investigate whether the broad fiduciary standard of conduct required of investment advisers better serve the investment and financial advisory consumer than the much lower standard of suitability.

The very limited nature of the RAND Corporation’s investigation is in stark contrast to the original idea behind the study. As stated in SEC Release IA-2376 (April 12, 2005), the Commission set forth the following original objectives of the study:

The staff is also to report on options and recommendations for a study to compare the levels of protection afforded retail customers of financial service providers under the Securities Exchange Act and the Investment Advisers Act, and to recommend ways to address any investor protection concerns arising from material differences between the two regulatory regimes. The scope of the study would include, but not necessarily be limited to, questions such as:

- Should the Commission seek legislation that would integrate the existing regulatory schemes applicable to broker-dealers and investment advisers that provide services to retail clients?
- Should sales practice standards and advertising rules applicable to advice provided by broker-dealers be enhanced?
- Should broker-dealers who provide investment advice but who are excepted from the Investment Advisers Act nonetheless be subject to the fiduciary obligations imposed by that Act on investment advisers?
- Should obligations under the Investment Advisers Act applicable to dually registered broker-dealers be modified or streamlined in order to eliminate regulatory overlap and reduce regulatory burdens?
- Are there areas in which the Commission, alone or in concert with other agencies, can engage in investor education efforts to assist investors to better understand the duties and obligations of their financial service providers?

(SEC Release IA-2376, pp.67-8.) Several of the SEC’s original purposes of the study, which were to examine the appropriate “sales practices standards” and whether those broker-dealers providing investment advice should be subject to “fiduciary standards” were not expressly to be addressed by the RAND Corporation’s study.

The RAND Report represents a significant lost opportunity to quantify the benefits to consumers of the fiduciary standard of care.

- C. **The Knowledge Gap, The Limits of Disclosure, and the Need For Fiduciary Protections.** It is widely acknowledged that there exists a significant gap between the knowledge of financial intermediaries and the vast majority of investment consumers today – a gap made even wider by a proliferation both in types and numbers of investment products. The RAND Report notes that disclosures are inadequate as a means of addressing this gap:

Financial service providers present the required disclosures but do not take time to explain them. Many participants also mentioned that many investors do not take the necessary time and effort to fully read and understand disclosures. (RAND Report at p.21.)

One (registered representative) interviewee acknowledged that a client is going to sign something that a trusted adviser asks them to sign. Clients feel that the reason they engage a professional is so that they do not have to read all the accompanying literature. Therefore, for many investors, the fact that they were given disclosures was seen as meaningless. (RAND Report at p.86.)

The RAND Report noted that both broker dealers and investment advisers “acknowledged that their business relationships with clients are built on trust rather than investor understanding of the services and responsibilities involved and that it is crucial for the financial service industry to maintain that foundation of trust.” (RAND Report at pp.131-2.) In relationships based on trust and confidence, especially where superior knowledge is present, fiduciary duties serve to protect the interests of the client. As explained in a recent article examining fiduciary law:

[T]he justification for fiduciary duties is clear. When one person is authorized to act on behalf of another and to exercise discretion over critical resources belonging to the other, a duty of loyalty helps to align incentives ... As noted by Robert Cooter and Bradley Freedman, ‘Once a consensual relationship in which the principal relinquishes control or management of her asset to the agent is formed, the resulting separation of ownership from control or management creates opportunities for the agent to appropriate the asset or some of its value. Taking advantage of these opportunities whether by theft, diversion, conversion, or trespass would violate the agent’s duty of loyalty. (D. Gordon Smith, “The Critical Resource Theory of Fiduciary Duty,” 55 Vanderbilt L. Rev. 1399 (2002), at p.1497.)

Those financial services fiduciaries who seek to avoid conflicts of interest, such as fee-only financial advisors, embrace fiduciary principles in their truest form. “An ideal fiduciary is one whose interests do not conflict with those of the entrustor. A delegation of power to such a person would create little risk of

detriment to the entrustor.” Tamar Frankel, “Fiduciary Law,” 71 Calif. L. Rev. 795 (1983).

D. **Errors In the RAND Report, and The Real Reason Behind The “Blurring of the Lines.”**

NAPFA is disturbed by the RAND Report’s failure to mention the reasons behind the “blurring of the lines” between broker-dealers and investment advisers. The RAND Corporation apparently failed to understand the regulatory environment and its history, for it stated:

Our review of the regulatory and legal environment for broker-dealers and investment advisers suggests that current laws and regulations are based on distinctions between the two types of financial professionals that date back to the early 20th century and that these distinctions appear to be eroding today. Recently, the SEC attempted to clarify the boundaries between broker-dealers and investment advisers — namely in the 2005 rule, “Certain Broker-Dealers Deemed Not to Be Investment Advisers” (SEC, 2005); however, the ruling was challenged and eventually overturned.

NAPFA is surprised by this erroneous statement in the RAND Report. It is widely recognized that the 2005 Rule cited was not a *clarification* of the boundaries, but rather a misguided attempt by the SEC which would have substantially *eroded the distinctions* between broker-dealers and investment advisers. If the SEC had been successful, it would have reduced the protections afforded to individual investors by a proper application of the Investment Advisers Act of 1940. Indeed, in its opinion overturning the 2005 Rule, the U.S. Court of Appeals stated that the purpose of the Investment Advisers Act of 1940 (“IAA”) was to “protect consumers and honest investment advisers and to establish fiduciary standards and require full disclosure of all conflicts of interests of ‘investment advisers,’ broadly defined” and that the SEC’s 2005 Rule “would enable persons Congress determined should be subject to the IAA to escape its restrictions.” *Financial Planning Association vs. SEC*, Case No. 04-1242 (U.S.Ct.App., D.C. Cir., March 30, 2007).

Furthermore, the RAND Report notes the use by broker-dealers of titles that imply relationships based upon trust and confidence such as “financial adviser” and “financial consultant,” (RAND Report at p. 20), and notes that “much of the recent marketing by broker-dealers focuses on the ongoing relationship between the broker and the investor” (RAND Report at p. 20). Individual investors interviewed by

RAND Corporation cited as the source for their confusion “the interchangeable titles and ‘we do it all’ advertisements made it difficult to discern broker-dealers from investment advisers.” (RAND Report at p.xxiii.) However, the RAND Report fails to mention that the use of such titles and such misleading marketing activities are the direct result of non-application by the SEC of the Investment Advisers Act of 1940.

As a further indication of the RAND Corporation’s failure to understand the Investment Advisers Act of 1940, the RAND Report states:

The proscription on special compensation has traditionally meant that broker-dealers receive compensation from their brokerage clients in the form of commissions, markups, and markdowns on specific trades. In essence, then, investment advisers’ business practice of charging a general fee, rather than broker-dealers’ practice of charging transaction-specific fees, has evolved into one of the hallmark distinctions between investment advisers and broker-dealers. Although a broker-dealer could, in theory, charge a management fee and avoid being deemed an investment adviser by giving solely incidental investment advice, the judicial interpretation of solely incidental is fraught with ambiguity, and thus the mechanism by which broker-dealers and investment advisers charge clients for services has become a significant issue from a regulatory perspective. Consequently, over the past two decades, broker-dealers have begun to drift subtly into a domain of activities that (at least under the regulatory regime) have historically been the province of investment advisers. [Emphasis added.]

(RAND Report at p.15.) The statement underlined above is expressly contrary to the language of the recent U.S. Court of Appeals decision in *Financial Planning Association vs. SEC*, which stated: “The Committee Reports recognized that the statutory exemption for broker-dealers reflected this distinction; the Reports explained that the term “investment adviser” was “so defined as specifically to exclude ... brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions).” (Slip opinion at p.7.) (Emphasis added.) Hence, a broker-dealer cannot charge a management fee and escape the application of the Investment Advisers Act of 1940, for this would clearly constitute special compensation. The RAND Report’s statement to the contrary brings into question both the RAND Report’s reliability and objectivity.

The RAND Report also offered this conclusion: “[I]n the past few decades, the functional difference between investment advisers and broker-dealers has arguably become more blurred, thereby *calling into question the wisdom of traditional definitions and regulatory and legal distinctions between the two types of service providers*.” (RAND Report at p.22.) (Emphasis added.) Despite the fact that that

RAND Report was not charged with undertaking policy recommendations, nor granted the authority to explore the benefits of the fiduciary standard of conduct for the protection of individual investors, the RAND Report makes this unfounded conclusion. The RAND Corporation fails to note that the root cause of consumer confusion is the SEC's failure to apply the important fiduciary protections of the Investment Advisers Act of 1940 as Congress intended.

It was recently stated in a comment letter to the SEC: "The SEC has over many years steadily undermined the distinction between brokerage and advisory services that Congress recognized and codified, to the point where the distinction no longer bears any relation to the nature of the services provided." (Comment letter dated February 7, 2005, from Fund Democracy, Consumer Federation of America, Consumers Union, and Consumer Act, re: SEC proposed rule, "Certain Broker-Dealers Deemed Not To Be Investment Advisers"). NAPFA fears that by limiting the scope of the RAND Corporation's inquiry, and the failure of RAND Corporation to identify that non-application of the Investment Advisers Act of 1940 by the SEC is the underlying root cause of consumer confusion, the SEC may seek to utilize this report as another means to undermine the important fiduciary protections which investors both need and deserve when receiving investment advisory services.

- E. **Fiduciary Duties Poorly Distinguished In the RAND Corporation's Report.** The RAND Corporation sets forth its own understanding of the fiduciary duties of investment advisers at page 14 of the RAND Report. However, at no point in the discussion did the RAND Corporation set forth the commonly-referred-to triad of fiduciary duties applicable to investment advisers – namely, the duty of loyalty, the duty of due care, and the duty of utmost good faith.

The fiduciary duties of an investment adviser are much greater than the broker-dealer's duty to recommend products that are "suitable" for its customers. The vague standard of "suitability" is a very low standard of conduct behind which broker-dealer firms hide when investors are harmed. Unlike investment advisers bound by a fiduciary duty, broker-dealers and their registered representatives seldom possess the affirmative duty to consider minimizing the tax drag upon long-term investment returns, nor do they possess the duty to ensure product costs are reasonable. In essence, the RAND Report appears to minimize the distinctions between the broad fiduciary duties of registered investment advisers and their representatives.

Despite reviewing the law applicable to broker-dealers and investment advisers, the RAND Report also failed to make a key observation - fiduciary obligations arise under state common law in financial services relationships based upon trust and confidence. This omission may inadvertently lead many broker-dealer firms and their registered representatives to conclude that fiduciary duties are only imposed by the Investment Advisers Act of 1940 and certain other limited circumstances set forth in the RAND Report.

- F. **NAPFA's Recommendations.** While the RAND Report provides additional evidence of lack of consumer understanding of the distinctions between broker-dealers and investment advisers, and the large differences in their standards of conduct, the limited scope of the RAND Report and its several errors and major omissions cast doubt on the ability of the RAND Report to serve as the basis for policy recommendations. Furthermore, since the overturning of the broker-dealer fee-based accounts rule by the *Financial Planning Association vs. SEC* decision, the SEC has reacted with Temporary and Proposed Rules which continue to seek to limit the application of the Investment Advisers Act of 1940.

Given the importance of these issues, NAPFA recommends that:

(1) that the SEC host an annual forum, bringing together various representatives of industry and consumer organizations, and academics, to further explore fiduciary standards of conduct, in order to lead to greater understanding of fiduciary principles and their application as a means of providing important protections to consumers; and

(2) that an independent study commission be formed by Congress to further study the importance of fiduciary protections for consumers in today's complex financial world. This commission should undertake research into the disparate standards of conduct governing various financial intermediaries and explore the needs of consumers for trusted advice and protection. This independent, objective commission should consist of open-minded individuals who will objectively examine the best methods to aid consumers as they seek the returns the capital markets have to offer. The commission should further be aided by one or more forums seeking the views of securities industry participants, industry associations, academic researchers, regulators, consumer advocates, and other interested parties.

It is important for choices to be preserved for investors. Consumers should possess the ability to purchase directly from product manufacturers (such as directly from mutual fund companies), seek the assistance of a broker-dealer firm in connection with a product sale, or seek the fiduciary protections of investment advisors and financial planners. NAPFA believes that, by properly applying existing law, the SEC could restore functional regulation of financial intermediaries based upon the

services provided to the consumer, and in so doing eliminate the substantial confusion which has resulted from errant regulatory actions in the past.

Consumers are waking up to the fact that the value of a trusted fiduciary financial advisor, especially during times of market turmoil, should not be underestimated.

As our modern society has become increasingly complex and specialized, the fiduciary standard of conduct plays an even more important role in protecting those clients of professional financial advisors. The fiduciary principles embraced by Congress by the Investment Advisers Act of 1940 have greater relevance in today's even more complex financial world, not less.