January 26, 2018

The Honorable Jay Clayton
Chairman
United States Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Standard of Conduct for Investment Advisers and Broker Dealers

Dear Chairman Clayton:

I write, as president of the Institute for the Fiduciary Standard*, in response to your request for comment on standards of conduct for investment advisers and broker dealers. This letter addresses conflicts of interest. It argues that conflicts should be avoided if possible, and – if not avoided – must be carefully managed and properly disclosed, if fiduciary duties are to remain effective.

The Commission has a unique and vital role in overseeing over 12,000 registered investment advisers with trillions of dollars in assets held by 54% of U.S. households, according to Gallup. Fiduciary duties serve to guide adviser conduct; the Commission edits and publishes the guide. Your guidance is critical for advisers seeking to know they meet the standard and to 'self-police' their actions tight away.

Fiduciary rules are vital. Stringent fiduciary duties are vital for relationships of trust and confidence. Fiduciary law exists to restrain the conduct of experts who render socially important services or advice in relationships of trust and confidence. Fiduciary duties serve to mitigate the knowledge gap or information asymmetry that separates the two parties. The fiduciary is obligated to be loyal, render due care and act in utmost good faith. The fiduciary must adopt the client's ends. The need for "investment counselors" to eliminate conflicts in order to deliver sound advice is repeatedly stressed by industry leaders weighing in on the Advisers Act. Understandably so. Fiduciary conduct facilitates investor *trust,* the central pillar on which capital markets and the market economy depend.

As law professor Tamar Frankel notes, "The strictness of fiduciary law conflict-of-interest rules depends mainly on the level of entrustors' (clients) risks from the fiduciaries abuse of trust." Fiduciary duties increase as the knowledge gap widens, and the gap between brokers and retail investors is widely acknowledged as large. Research reveals retail investors are sharply limited in their understanding of investing, markets and the role of advisors and brokers, suggesting a firm legal basis for applying the most stringent fiduciary duties.[1]

*The Institute for the Fiduciary Standard is a nonprofit formed in 2011 to advance fiduciary principles in investment and financial advice through research, education and advocacy. We are honored that many respected scholars, former regulators and leading advisors participate in our programs and support our work. More information about the Institute may be seen here. www.thefiduciaryinstitute.org.

Conflicts are harmful. Material conflicts of interest inherently undermine fiduciary duties.
In 2012, Carlo V. di Florio, then Director, SEC Office of Compliance Inspections and Examinations, spoke about why conflicts of interest are so important to the SEC. *"Conflicts of interest can be thought of as the viruses that threaten the organization's well-being. … These viruses come in a vast array of constantly mutating formats, and if not eliminated or neutralized, even the simplest virus is a mortal threat to the body."* [2]

Conflict disclosure gets an "F". Conflict disclosure alone doesn't work. It fails to "neutralize" conflicts. The DOL notes, "Disclosure alone has proven ineffective to mitigate conflicts in advice." [3]. Research from management professor, Daylian Cain and colleagues, explains why investors do not generally discount conflicted advice from disclosures, and why disclosure can actually be harmful to investors by legitimizing bad advice. [4] Cain also explains this "perverse" consequence. [5]

Conflict management is not "easy". "Gene Gohlke, former Associate Director of OCIE, once quipped, 'they are everywhere', (such that) clashes of interests do not lend themselves to easy management,"[6] writes attorney Michael Koffler. Koffler's sober assessment may actually understate the difficulty. Research and experience both suggest client biases complicate addressing conflicts. Still, to help brokers or advisers "neutralize" conflicts' harms, here are five steps that the Commission should require.

1. Disclose in writing all material conflicts of interest. Material conflicts are conflicts that, according to the Commission, "Might affect (the client's) decision whether or how to act."

2. Prohibit certain compensation practices. Consumer Federation of America's Roper and Hauptman offer guidance. They point to practices that "Can reasonably be expected to cause advisers to base recommendations on their own financial interests rather than the best interests of the customer."[7] These include sales quotas for proprietary products, differential compensation, compensation based on a "retroactive, ratcheted payout grid" and upfront signing bonuses.

3. Require compensation that's transparent, reasonable and level. The Institute Best Practices Board discusses how these three criteria can reduce the scale and scope of conflicts, especially noting the importance of full and complete transparency on 'all-in' fees and expenses. [8]

4. Require: certain disclosure on key issues. In a uniform standard, the Commission is necessarily overlaying the values and practices of the commercial market place on relationships of trust and confidence. This raises new questions the SEC should address. For example, certain facts about broker-dealers should be disclosed and may include: a) the fact that broker-dealers are hired by issuers to offer and sell securities. b) that they get paid only if they are successful in their sales efforts. c) that their "advice" must be "solely incidental" to their distribution services performed on behalf of the issuer. d) that the forgoing means their allegiance is primarily to their issuers.

5. Require: rigorous disclosure and 'informed consent' protocols. Disclosure means very different things to different people. Disclosure protocols vary widely. A casual oral disclosure alone (with no other provisions) is weak, while a plainly written disclosure explained in person and requiring written consent that is informed and independent is far more rigorous.

Disclosure and Informed Consent Protocols. The steps required to fulfill the stiff requirements of the Advisers Act of 1940 are far more than mere that casual "disclosure" and "consent." Professor Ron Rhoades explains how these acts are "in and of themselves, wholly insufficient to prevent a breach of fiduciary obligations." If these are insufficient, what else is required?

Rhoades notes disclosure must be detailed, it must include essential material facts and also be timely and written plainly. Further, the adviser must act as the responsible party to ensure the client understands the conflict so that his/her consent is informed. Also the transaction must be deemed to be fair. [9] In summary, this means:

1. Disclosures must be affirmative. The adviser or broker is responsible for proactively delivering disclosures. Professor Rhoades notes, "Clients do not generally possess a duty of inquiry."

2. Disclosures must include "specific facts". The Commission emphasizes that conflicts must be disclosed "with sufficiently specific facts so that the client is able to understand (them) … and can give informed consent to such conflicts or practices or reject them." The "specific facts" requirement is important. Research underscores that many clients today are cost conscience of fees and expenses and seek to learn what they pay in investment costs. This is significant for product sales. It suggests "specific facts" should include a written good faith estimate of total fees from the transaction paid to the adviser or broker and the firm by the client and third parties.

3. Disclosures must be understood. This means that specific facts are necessary, but may be insufficient. This means the nature of how the disclosure is written and delivered also matters. Disclosures must "Lay bare the truth … in all its stark significance", as Justice Cardoza wrote. The Commission noted, "In the Matter of: Arlene W. Hughes", there is no one single appropriate disclosure method, and no 'one size fits all' because "The method and extent of disclosure depends on the particular client involved…. " [10]

   In discussing the case, former SEC Chief Counsel, Louis Loss, underscored that the fiduciary obligation cannot be delegated to a client through a disclosure, as he said, "In all cases, however, the burden is on the firm which acts as fiduciary, to make certain that the client understands." 11

4. Informed consent must be attained. Written client consent must be "clear and specific to the transaction" and intelligent, independent and informed."

5. The transaction must be fair and reasonable. Even with client consent, "the proposed recommendation must be fair and reasonable, because as professor Tamar Frankel writes, "Courts will generally not enforce an unfair and unreasonable bargain."

The bottom line is that mere "disclosure" and "consent" is insufficient. The broker or adviser bears responsibility for client understanding of what the conflicted transaction means for the broker or adviser and client, such that a truly informed consent – or rejection – may occur.

Disclosure management methods should be tested. Research and experience underscores that effective disclosure management and consent protocols are difficult to achieve. Client biases and shortcomings and lack of substantial financial knowledge present impediments to reasonably dealing with conflicted advice from a "trusted" adviser or broker. As such its' important the Commission test any disclosure management methods before implementing them.

Conclusions. For generations, the Advisers Act of 1940 has served well as a "contract" between advisers and their clients. The Commission's rulemaking here effectively puts this "contract" under review and renewal.

Sincerely,

Knut A. Rostad
President

XC: The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner
The Honorable Hester M. Pierce, Commissioner
The Honorable Robert J. Jackson, Jr., Commissioner

Notes

1. Institute for the Fiduciary Standard 2012 letter to SEC Chairman Schapiro, http://www.thefiduciaryinstitute.org/wpcontent/uploads/2013/02/913ConcernsApril92012final.pdf
2. http://www.sec.gov/News/Speech/Detail/Speech/1365171491600#.VRBoKI4sq6U
3. EBSA, DOL, Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 81 Federal register, 20946 (April 8, 2016).
4. See Rostad, Fogarty, "Fiduciary Duties Advanced in 2015…." page 6. http://www.thefiduciaryinstitute.org/wp-content/uploads/2016/02/Fidcuiary-Duties-in-2016-Jan-28.pdf
5. http://www.thefiduciaryinstitute.org/wp-content/uploads/2017/07/Daylian-Cain-Knut-NYU-Final.pdf
6. Modern Compliance 2017, "Conflicts of Interest", Chapter 24, by Michael Koffler, page 38.
7. September 14, 2017 letter to Chairman Jay Clayton, page 68.
8. Institute for the Fiduciary Standard Best Practices Board, Best Practices for Financial Advisors Guidance, Attachment A, December 2016.
9. http://scholarfp.blogspot.com/2013/05/musings-custodial-support-services.html
10. Commission decision, In the Matter of: Arlene W. Hughes. https://www.sec.gov/litigation/opinions/ia-4048.pdf
11. https://www.sec.gov/news/speech/1948/031648loss.pdf