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BINGHAM PRESENTS 2010:

Harmonization of Regulation of Investment Advisers and Broker-Dealers

ERIK SIRRI: Good afternoon and welcome to Bingham Presents 2010, broadcast live from Bingham McCutchen LLP's offices in New York and online at www.sechistorical.org, the virtual museum and archive of the history of financial regulation. My name is Erik Sirri, and I am Professor of Finance at Babson College in Massachusetts. From 2006 to 2009, I served as Director of the Division of Market Regulation, later the Division of Trading and Markets, at the U.S. Securities and Exchange Commission.

The Bingham Presents series debuted in 2009 and is made possible through a partnership between Bingham McCutchen LLP and the SEC Historical Society. Bingham McCutchen offers market leading practices focused on the financial services industry encompassing everything from bank, securities and investment law and regulation to financing, structured transactions and restructuring. Its 1,100 lawyers serve in 12 locations including financial and regulatory centers such as New York, Washington, London and Tokyo. The SEC Historical Society shares, preserves and advances knowledge of the history of financial regulation through its unique virtual museum and archive at www.sechistorical.org. The museum is free and accessible worldwide at all times and currently welcomes more than 22,000 visitors a month.

I serve on the Museum Committee, advising on the growth and outreach of the museum. Both the Society and the museum are independent of and separate from the U.S. Securities and Exchange Commission and receive no funding from the public sector. The Society is grateful for the support of the support and assistance of Bingham McCutchen in making this program possible.

Last year's Bingham Presents looked at the new world of financial regulation and the global financial crisis of 2008. A year later, that new world is becoming a reality with the passage of the Dodd-Frank Act.

Tonight, we will look at one aspect of the changing world, the harmonization of the regulation of investment advisers and broker-dealers. I am delighted to welcome my distinguished fellow presenters who will join me in this discussion. These are people I have known for years and I have had the pleasure of working with when I was at the Commission. On my immediate left is Hardy Callcott, a partner of Bingham McCutchen and a member of the Society's Board of Advisers. On his left is Michael Sharp, General Counsel for Jefferies & Company. And on Michael's right is David Tittsworth, Executive Director and Executive Vice-President of the Investment Advisers Association.

Our discussion today will look at such issues as: the standard of care - fiduciary duty or suitability, and is there a difference?; are the disclosure obligations for broker-dealers and investment advisers appropriate?; an ultimate regulator and examiner for broker-dealers and advisers, the role of state supervision versus SEC oversight and is there a role for FINRA?; and regulation beyond the standard of care, and is there a level playing field?

Before we begin our program, I would like to state that the views of the presenters are their own and do not reflect those of Bingham McCutchen or the SEC Historical Society. The Society is responsible for the selection of the moderator and presenters. We presenters have determined the questions that will guide the content of our discussion.

So let me start this off and talk about where we find ourselves right now. The FPA decision dealt the SEC a bit of a setback in 2007 with regards to its approach to fee based brokerage accounts that provided a certain amount of advice. The SEC regrouped and as part of its process of regrouping, it commissioned the RAND Corporation to do a report, which became known as the RAND Report. Out of that voluminous report came a number of findings. Let me tell you about what I think are the most salient ones very briefly. First, investors had a difficult time in distinguishing among who is an investment adviser and who is a broker-dealer, especially in light of the "we do it all" positioning of the providers. Second, investors like certain traits of investment advisers; they like the disclosure requirements, the legal duties and the compensation structure. On the other hand, investors also liked traits of the broker-dealer model. They liked the account minimums; they liked the industry certifications, as well as the low costs of the model. Investors generally tended to be happy with their financial service providers and they seemed to value the personal service and the attentiveness over the expertise in the performance that was conferred on their accounts. Investors acknowledge that they do not really understand the fees they pay for investments and for services. What I think is perhaps most interesting, which I think many of us knew, financial service participants also acknowledge that investors don't read the disclosures even if they are well written, which I think is something to keep in mind as we go forward here.

So let me start us off. I will start by turning first to Hardy to ask him to open by discussing what he sees as the benefits, as well as the shortcomings, of the broker-dealer regime for retail investor accounts.

HARDY CALLCOTT: The regulatory scheme for broker-dealers is a very extensive, very rule-based regulatory regime. There are big FINRA manuals that includes NASD-FINRA and NYSE rules. Now there's a big SEC set of rules. It is very detail oriented and there are a lot of cops on the beat, policing that brokerage model. Broker-dealers are subject to examinations by the SEC and by every SRO that they are a member of. If you do business with members of the public, then you are required to be a member of FINRA and you are subject to examination by the states in which you do business. So there are three levels of cops policing this very detailed set of rules. Broker-dealers have pretty explicit guidance about what they are supposed to do in different kinds of circumstances. And as I said, there are a lot of people enforcing those rules.

ERIK SIRRI: What about the shortcomings of the broker-dealer model? If you were to list them how would you think about them?

HARDY CALLCOTT: I would say the shortcoming of both the broker-dealer and the investment adviser model, to be frank, is there is too much non-compliance with the rules. Every SEC Commissioner, when you ask them "what was the most surprising thing that you learned when you came to the Commission," it is that there are so many cases. There are so many violations and many of the violations are not technical violations but straight out and out fraud violations. There are several hundred a year by the SEC against both the adviser industry and the broker-dealer industry which doesn't account for more than 1,000 cases a year that FINRA brings against the broker-dealer industry. So that to me is the biggest shortcoming. Even after all the resources the industry has put to compliance and supervision, there is not the end result that you would hope to see.

ERIK SIRRI: David, can I ask you the same question with regard to investment advisers?

DAVID TITTSWORTH: Absolutely. I am not sure I heard any weakness there the broker-dealer regime. But I will start with what I think, Erik, is the weakness for the investment adviser profession. The SEC right now does not have enough resources to police a growing industry. We put out a report for the last ten years, ever since investment advisers have had file Form ADV Part 1 electronically. What it shows is a steady growth of advisers from about 7,000 in 2001 to more than 11,000 today. The SEC resources, at least post-Sarbanes-Oxley, have stayed relatively constant at 450 examiners to oversee 11,000 advisers and 9,000 investment companies. That's not enough. Dodd-Frank will change that. You are going to more than double the SEC resources going from 1.1 billion to 2.25 billion by 2015. They are also going to reduce the number of advisers significantly when you shift 4,000 or so investment advisers from SEC to state regulation. So I think that the SEC is well on its way to having more resources to deal with this growing population. But going to the strengths of investment adviser regulation - it is less rules-based, certainly much more of a principles-based scheme. I think that's appropriate for the profession. Yet, with broad anti-fraud authority vested with the SEC, you have an over-arching fiduciary duty that I have a feeling we will probably be talking about somewhat today.

But I also would point out there's lots of rules, from insider trading to proxy voting, to codes of ethics, to advertising, to custody, to record keeping, Form ADV, and pay to play. The list is growing larger every day and it sure as hell is not going to get any shorter after Dodd-Frank. And on top of that, you have what's known as the compliance program world that the SEC adopted in 2004 that fills in all the spaces and says, "Every investment adviser will have policies and procedures based on their characteristics to prevent violations of the securities laws." So I think, given the diversity of the investment adviser profession and its historical evolution, that this principles-based scheme is very appropriate.

ERIK SIRRI: I wonder if you could each spend a little bit of time talking about the question of suitability versus fiduciary duty, understanding that this can be a bit of a false comparison. I wonder if you could highlight how you think about the aptness of that comparison and maybe you don't think it is apt at all.

HARDY CALLCOTT: I will start with what I think is the broker-dealer perspective. I think most of the broker-dealer industry has stated through their trade associations and individually that they are not opposed to having a fiduciary duty standard. I think what many people in the brokerage industry have concluded over the last ten years, is that the majority of disputes with customers get resolved in a arbitration forum now at FINRA in front of non-lawyer arbitrators who don't really understand the legal difference between suitability and fiduciary duty. The result is brokers generally think that they are held to something that is very close to a fiduciary duty already. So certainly you can point to legal cases where a court found a violation of fiduciary duty but wouldn't have found a violation in suitability duty. I think the practical reality for most people in the brokerage industry has been that there hasn't been that much of a difference. That being said, the primary comment from the broker-dealer industry, again coming from this very rules-based environment in commenting to the SEC on its study about this issue has been, "give us as much specific guidances you can about as many different circumstances you can and we will comply with that guidance."

ERIK SIRRI: So before I turn it to David, let me ask you about point. Isn't a rules-based environment counter to the approach one would take toward what is and isn't allowed when behavior is governed by fiduciary duty? Doesn't it contradict what David said with regard to the principles-based approach?

DAVID TITTSWORTH: I am happy to handle that one; it's the softball. There is a difference clearly between suitability and fiduciary duty. It isn't that one is bad and one is good. And by the way, Hardy, absolutely, I guess the way I look at this debate. I mean there has been a lot of rhetoric on both sides that I think is unfortunately fortunate, both investment advisers and broker-dealer are comprehensively regulated. All you have to do is go out, as I do, and talk to broker-dealers. I was at a conference yesterday and investment advisers who are members of our organization talked to their compliance people, there are lots of headaches on both sides. So I think there is this sort of underlying thing of, "is investment adviser regulation bad or just not it's weak?" I think that's nonsense and I think it would be nonsense to say that broker-dealer regulation is weak or non-existent.

If there wasn't a difference between suitability and fiduciary duty, I am not sure we would all be sitting here today. The insurance industry is absolutely adamant in saying fiduciary duty is something we don't want to have imposed, why? All you attorneys out there, it's because of potential liability, it's because they are scared that they are going to be limited on the brokerage side by the principal trading restrictions under the Advisers Act and they don't want to make the disclosures that the advisers are required to make that is part of what makes fiduciary duty different from suitability. But simply stated, fiduciary duty on the adviser's side, its been settled by law since 1963 when the United States Supreme Court ruled that there is a fiduciary duty under the Advisers Act. The words never appear in the statute, but they said under Section 206, the anti-fraud provision, it is part of the Advisers Act, it is the duty, at all times, to put the interest of your clients ahead of your own. This idea that it is so squishy that nobody understands it, I believe is also erroneous and false. I testified a year ago and had the pleasure of sitting before the House Financial Services Committee and at my table were the head of the state securities regulators, the head of FINRA, a consumer advocate, a representative from SIFMA, brokers and an insurance industry representative and myself. The ranking Republican, Spencer Bachus, asked, "Listen, I have heard all these arguments about suitability and fiduciary duty. I want to know, is there is a difference and is fiduciary duty a higher standard?" And every person at that table said, "Yes, fiduciary duty is a higher standard. There is a difference."

ERIK SIRRI: Mike, in the various things that you have done over time you have had boots on the ground in various capacities, both where you are now at Jefferies and in the past in some of your other positions. How do you think about these issues?

MICHAEL SHARP: First of all, just to get to the earlier point with respect to the shortcomings on both the investment adviser side and the broker-dealer side. Saying that the shortcoming with the law is that people violate the laws is like saying that the shortcoming with red lights is that people drive through them. People who adhere to the red lights stop their cars. The laws, if people adhere to them, make people act properly both from the adviser side and the broker-dealer side. I think there is a difference between investment advisory and the practical difference between investment advisory and broker-dealer is how the Street reacts to it. And for those of you who are on this side of the business and for those of you who regulate this side of the business, you know that what you see is that the smarter, more sophisticated FAs are the ones who do investment adviser work. And those who can't pass certain standards on the broker-dealer side are not allowed to do investment advisory work. And so there certainly is difference between suitability and investment advisory, that is, there is a higher standard of care, I couldn't tell you because I am not smart enough to define what that standard is. What it comes down to in practice is that you push the people who can't meet the advisory standard onto to the broker-dealer side. There are a lot more safety nets on the investment advisory side with performance being a key indicator of what's going on which you don't have on the suitability side. People look at performance. You are not going to get people changing habits, changing practices usually on the broker-dealer side based on performance.

ERIK SIRRI: You said something I hadn't heard before, with the point that there is almost a sorting that goes on within a large firm. That, if the people haven't been thinking properly about the issues or they are not really up to snuff on some of their requirements, they are less likely to become an adviser. They are more likely to carry the broker hat.

MICHAEL SHARP: Yes.

ERIK SIRRI: That's interesting. That's not something I had heard before. One of the things in Dodd-Frank, as many of you probably know, is a requirement that the SEC do a study about the harmonization of the adviser and the broker-dealer standard and to look for some kind of a uniform standard of care, that's Section 913. I wonder if folks could discuss for me what they think about the points that are listed, that Dodd-Frank describes that study should entail. What are the most important questions the SEC should both ask and answer when they do the study, given that the RAND study has already come and gone? This is really a very different study, isn't it?

DAVID TITTSWORTH: It's certainly a comprehensive or extensive set of questions. I think there are fourteen; I have got the statute right here. We filed a very extensive comment letter on August 30th; it ruined summer vacation for some of my good attorneys. A lot of other people filed comment letters as well. I think Congress is asking the SEC to look a lot of the important questions for a six-month study they may have asked the SEC to answer more questions than is reasonable under the circumstances. But we know that our friends at the SEC have been looking at this issue. There's a task force from Chairman Schapiro's office, the Divisions of Investment Management and Trading and Markets, Office of Compliance and Inspections, General Counsel's Office and other divisions as well. We had a meeting with them last week. The insurance people were walking out as we we were walking in. I think they are asking the right questions and the questions they are asking have to do with what investors think, are they confused about the standards that are out there and the activities of broker-dealers and investment advisers? Clearly the answer to that is yes. But then they are also asking, are there gaps or shortcomings or overlaps between the broker-dealer and the investment adviser regime? And that's where you can get into a lot of discussions well beyond fiduciary duty which has been the highly visible issue out there. But it will be very interesting. Then you look at the statute, what you had was actually the House when it passed the bill, it required the SEC to do a rule making on various aspects of harmonization but it highlighted fiduciary duty in the context of personalized investment advice to retail customers. But then the Senate punted and had a study in what you see the Congress often does, it just kind of mash the two together, the two approaches together in conference, and you end up with this. They went from a one-year study to a six-month study. They don't require a rule making, they authorize a rule making, there are bells and whistles beyond the personalized investment advice to retail customers and commission side of per se violation of fiduciary duty, et cetera. It would be very interesting. I certainly don't envy the task of the SEC in trying to sort all that out as it moves forward during rule making. It probably will result in a rule making. I think Hardy and I agree on that.

HARDY CALLCOTT: I think some of the issues that the SEC is directed to look at and should look at we have talked about: differences in enforcement and examination, resources, and differences in the substance of regulatory schemes between advisers and broker-dealers. The issue that I think is very important that is in the statute and that the SEC does need to look at is the issue of cost and availability of investment advice to individual investors. One of the findings from the RAND Report, that I thought was a little surprising, and I think the SEC was a little surprised was, for a very large number of the individuals who RAND surveyed, the investors surveyed said, either they themselves or people they knew or family members had trouble getting investment advice at all, either from the brokerage side or from the investment advisory side. I think historically the investment advisory side has had higher minimum net worth requirements and the question is for the beginning investor or the middle class investor who doesn't have a substantial net worth, what can the SEC do to make quality investment advice available to more people? And there is a tension. The cost of regulation to some extent has caused some firms to get out of the business of providing individualized financial advice because of the liability issues. And so the question the SEC has to face is, how can they raise the standard? I think at a legal level, I would answer the question yes as well. Fiduciary duty is a higher legal standard than suitability, but how can you do that without causing even more ordinary Americans to be pushed out of getting investment advice at all?

ERIK SIRRI: Getting more granular about terms in the study. The statute defines what it means to be a retail investor. It also talks about the term "personalized investment advice." I think it is somewhat of a key phrase because this question about duty in the uniform standard of care relates to the receipt or the delivery of personalized investment advice. How should we think about what that means within this context? Should we be picking up things that are essentially advice if they are prepackaged such as in the form of tools? Is it clear that if it's a tool, that can't possibly be personalized? Is that just the way it is or is that somewhat ambiguous? How should we think about what it means to have personalized investment advice? You have a full-blown financial plan on one side, maybe at the other extreme you have plain old market color. How should this be divvied up?

DAVID TITTSWORTH: I think there isn't a definition, so the SEC is on its own. But I think when you look at it, it's advice that is tailored to an individual. So you have got a lot of questions, Erik, but I would say if I am a broker-dealer, I am just putting research out there that is non-specific about emerging markets or fixed income or whatever the heck it might be. To me that's not personalized investment advice. If you come to me with $50,000 and say what should I do, and I make a specific recommendation of a security, that's clearly personalized investment advice, there are gradations in between, I get it.

ERIK SIRRI: So let me push you. If I am the adviser/broker and I say 60/40 stocks and bonds, that's personalized investment advice?

DAVID TITTSWORTH: I think asset allocation absolutely is investment advice. I believe the SEC is being consistent about that for a long time. That's not quite as specific as saying, "I want you to buy 500,000 shares of Sirri International."

HARDY CALLCOTT: I agree with David, I think the generalized research reports are not personalized investment advice. I would argue that investment tools where an investor could go online and run kind of different scenarios where it's the investor who's making those choices not the financial adviser – that's not personalized advice. The question that came up a lot in the comments to the SEC is, can you give personalized investment advice and then step back and be a broker again? So you have someone come in and get a one-time snapshot financial plan without thereby having an ongoing duty to monitor what that customer does in their account. Are they doing what you advised them to do? If they are doing unsolicited trades that are contrary to what you had advised them - do you have a duty to step in and say, "Wait a minute, I didn't advise you to do that." I think it's that ongoing obligation after the financial advice is provided, that is the area where there is the greatest level of ambiguity and where the SEC would do well to provide some more clarity.

MICHAEL SHARP: I have a slightly different view on this. In my mind personalized investment advice is the sort of opposite way of saying advice incidental to providing broker-dealer services. It's not any different. You talked about the RAND study. I bet if you were to go back and look at the proposing release talking about the RAND study, you could probably do a CompareWrite and many of these same questions were being asked back then. And in my mind, the study is a way of punting six months down the road some hard questions that people were not willing to answer right now. I think it's very easy to define what personalized investment advice is. That's because the Street has been doing it for decades, the SEC has been doing it for decades. It may not have been memorialized in a certain way until now. Make it more memorialized, make it more codified but I think that when it comes down to it, it is a relatively easy thing to do. I think to some degree there is - underlying all of this - I think there is certainly some… there should be perhaps investor confusion that can be cleared up some with disclosure with other means. But I think the biggest issue to be frank is that the Street has strenuously avoided taking on fiduciary responsibility for silly reasons in my mind. And when the Street has dealt with these issues, it's dealt with it sloppily, it's dealt with it by… on one level every firm, all the big wire-houses will publicly say that investors need a choice and things need to be done so investors have choice, which I buy completely. I have said that myself. But what those firms don't do enough, or what they do internally, they will push their people to be investment advisers because it's better business, it's smarter business. But there is a disconnect between what they push their people to do internally - because it's good for business - and the public positions they take which causes all of these questions to be raised that, when it comes down to it, have been asked and answered. And this study will show nothing more, I think, than the RAND study came out with. But I do think that you have to have the study because Congress said you have to do it. But I think at the end of the day, you will come to a model that is not much different from where we are right now. Because you could drive a truck around what personalized investment advice means in the same way you can drive the truck through what incidental advice means right now.

DAVID TITTSWORTH: Could I jump in? Maybe get a little more granular here and first start with a more generalized point. Our organization, the Investment Advisers Association, has said the brokers who are doing the same thing as investment advisers should be treated the same way under the law. In general, most of us could hold hands and agree that people doing the same things should have the same legal obligations. So we are not saying, by the way that brokers should be a fiduciary in all situations, it's only when they are providing investment advice. Brokers do a lot of things other than providing investment advice. A broker is a person who is effecting securities transactions.

ERIK SIRRI: Let me interrupt. I want to ask you something about a previous point you made. In your view, "Could a broker ever make a solicited trade and have that not be advice the way you are formulating advice?"

DAVID TITTSWORTH: I think that is the million dollar question, right? I am going to answer it by giving a longer answer.

ERIK SIRRI: So long as you answer it.

DAVID TITTSWORTH: I want to see if Hardy agrees with these but I think there is a continuum. Discretionary advice, I think everybody would agree. If anyone gives discretion to an adviser, a person who calls himself a financial adviser, broker-dealer, whatever, I think that that is fiduciary duty standard.

ERIK SIRRI: Let's stop. Do you all want to caveat that? Okay, you got one.

DAVID TITTSWORTH: Okay, hurrah. I am looking at Schwab's comment letter on the Section 913 study and they start out at the high end comprehensive wealth management including discretion to trade, as well as comprehensive planning advice across a range of non-investment financial matters. Another one, discretionary investment portfolio or account management; two, non-discretionary investment advice or program for a fee. I think that we would all agree that that is subject to the fiduciary duty under the Advisers Act.

HARDY CALLCOTT: With the caveat that the fiduciary duty itself is a sliding scale. I would argue you have higher duties to a discretionary account than you do on a non-discretionary account.

DAVID TITTSWORTH: Maybe we can agree or I will try to get closer agreement thereby. But I will give you my hypothesis which is that I think the fiduciary duty under the Advisers Act is the fiduciary duty under the Advisers Act 1963, five decades worth of jurisprudence actually several decades before that but the SEC courts interpreting this federal fiduciary standard. But I think that just because someone has fiduciary duty doesn't mean that you accept ongoing portfolio management responsibilities. Even if you are a fiduciary you come to me and say, "Here is my money. What should I do with it?" I say, "Look, I am willing to give you some advice right now but I am not going to monitor this account on an ongoing basis. I think I can do that as a fiduciary but I am telling you upfront." So, to me it's more like saying, "Will you and I, the client and the adviser, the person giving advice can have that scope of fiduciary duty." And if that's the sliding scale you are referring to Hardy I think we are more in agreement than not.

HARDY CALLCOTT: Why I should with disagree that point? I think that is a sliding scale.

DAVID TITTSWORTH: We were close.

MICHAEL SHARP: I think that is not a sliding scale. I think if you have discretionary account that is full discretion on you and the client doesn't make the decision that's fiduciary. I think if you have a non-discretionary advisory account that has equal fiduciary responsibility and when you see that client not taking your advice – when you see that client moving away from what you are advising him to do, as a fiduciary you have to fire the client. That client is rejecting your advice, and as a fiduciary doing that which is in the best interest of your client, you can't get paid.

ERIK SIRRI: I just want to echo what you said, Mike. When we were working on this at the Commission a number of people from large firms came in and made that point. That point about when you fire your client reflects the firm's need to protect themselves.

MICHAEL SHARP: Absolutely.

HARDY CALLCOTT: I will see you in 1963 and raise you to 1943, SEC v. Chenery Corp. Fiduciary duty isn't the end of the analysis; it is the beginning of the analysis. The question is what is the scope of the fiduciary duty? What is the nature of the breach? What is the remedy for the breach? Fiduciary duty isn't really a uniform standard. A fiduciary duty in for example a trust context, where you have got duties to beneficiaries that may not even have been born yet, is completely different from a fiduciary duty in a non-discretionary advisory account. It is in my view fully permissible to say I am going to give you advice today and then six months later we are going to sit down again and I am not going to talk to you in the intervening six months. The law allows you to negotiate the scope of fiduciary duty. But fiduciary duty has become a sort of slogan when in fact it is, in my view, a much more complicated concept than a slogan really allows for.

ERIK SIRRI: I am going to interject it with something. There is a letter that was written by the current Chairman of the SEC, Mary Schapiro, to the Commission. This is when she was at FINRA and she describes fiduciary duty in responding to an FPA position. I don't mean to take this out of context, but I want to read you a very short portion of the letter. Those of you who are interested should go back and read the entire letter. But in the list pointing out her views about how accurately FPA characterized FINRA's position, the letter says, "The contours of an adviser's 'fiduciary duty' are imprecise and indeterminate. Indeed, these contours have been developed unevenly over time and much of what the FPA describes as an adviser's fiduciary duty is more implied than expressed." The comment was made within the context of Chairman Schapiro's previous job. I don't know how to evaluate that comment today.

DAVID TITTSWORTH: I believe that letter is April 2005.

ERIK SIRRI: It is indeed.

DAVID TITTSWORTH: It was filed with the SEC in the broker-dealer exclusion context that the FPA decision unfortunately invalidated. I have certainly wondered about that as well, Erik, and I hope that all the Commissioners keep an open mind. I would disagree with the notion as I read that letter and you have just read one sentence from it. But to me it basically says the broker-dealer regime is better than the investment adviser regime. I guess that's where I take issue. I think brokers are comprehensively regulated; I think advisers are comprehensively regulated. There are differences. Some of them are historical, some of it's because it's appropriate to each industry. Are either one of them perfect? Probably not. Can we improve them? Absolutely. But I think it's counter productive to start this discussion of one is better than the other. That's what to me what that letter says and that's too bad.

I think that's a key point. That is what generates this argument is investment adviser better than broker-dealer. It's different. It's more expensive and you get more for your money. But if you don't want that, than you go on to a broker-dealer model. It's that simple.

ERIK SIRRI: Hardy, I think you mentioned this at one point a little earlier. You talked about costs. And as I read Section 913 of Dodd-Frank, it clearly contemplates and asks questions about costs, which goes hand in hand with the other thing it mentions, which is choice. I think the statute clearly is concerned that if you don't get things right, choice can be curtailed. Take the broker-dealer model. Is it going to be cheaper than the adviser model? If you elevate the standard, you run a risk of cutting off a basket of services that is clearly valued by a segment of society. On the other hand, within that basket, you may be essentially delivering some modicum of advice that you would call advice and you've got to make a trade off. Do you want to cut off that valuable portfolio of services which are low cost and efficient, but some amount of advice may go with it? That seems to me essential in trying to figure out. Maybe you can talk about this with respect to the principal transaction question. 206(3) is not talked about in this portion of the Dodd-Frank. Given your experience, how do you think about the principal transaction?

MICHAEL SHARP: It's not talked about but they do expressly state that you wouldn't be violating their proposal by having the ability to sell principal products and they don't use 206(3). I think that, after the FPA decision and the whole change in the law to what is now the non-discretionary advisory model, the question was answered that you really can't do this without allowing principal trades. What you have in place right now is a regime that is unworkable. You cannot have a non-discretionary advisory model where you have to get trade by trade written consent.

HARDY CALLCOTT: But that goes way at the end of this year and the SEC said they are not going to renew it.

MICHAEL SHARP: That's fine. What's happening right now is that the Street is mobilizing. You can't have an advisory program, certainly non-discretionary advisory program, without principal trading. And I think you cannot have an effective discretionary advisory model without principal trading. What you need to be careful about is double charging people or overcharging people. I mean if you have a discretionary advisory model you can't buy IPOs, you buy them but then you… they sit in a separate broker-dealer account for some number of months before they go in, so you don't charge people too much. You are missing very useful structured products. There are many many things that having that ban will make it unworkable to have no principal trading, and if you don't allow principal trading you will not have the ability to give sound investment advice.

HARDY CALLCOTT: I guess the other area that people regularly point out to is fixed income: bonds, municipal bonds and to a lesser extent, corporate bonds. For retail investors who are buying and selling small lots, you don't get good prices if you have to do agency trading away from your firm. And so, if the result of adoption of a fiduciary duty standard is worse executions for retail customers on fixed income, that's a bad result and the SEC should try to avoid that.

DAVID TITTSWORTH: I met an investment adviser who used to work for a brokerage firm yesterday, and she was saying that she got tired of selling fixed income products that were marked up by her brokerage firm. So I think it goes both ways. Look, to me, the 206(3) and the Advisers Act restrict principal trade and you have to get the consent of the client on a transaction by transaction basis. A lot of people tell me that that is effectively a ban on principal transactions; it's very difficult to get that. But what I don't understand is the SEC has brought exemptive authority under 206, so if all these wonderful things that are talked about in principal trading involves an inherent conflict of interest. You are selling or buying something for your customer from your own account; that is an inherent conflict of interest. Now maybe there are all sorts of reasons why those conflicts can be mitigated or disclosed. But why doesn't anybody go in and ask for exemptive relief from the SEC?

HARDY CALLCOTT: They have.

DAVID TITTSWORTH: Okay.

MICHAEL SHARP: And it's been turned down.

HARDY CALLCOTT: Although I will say a lot of firms relied on the temporary rule 206(3)-3 which is going to expire and the SEC Division of Trading and Markets has suggested, "Okay firms, come in and get individual exemptive relief, now we will be open to that." But I think there are clearly situations where you need principal trading. I am from California. We have very high state taxes. California State Bonds are very desirable investments. For a firm to be able to go out and buy some of those and have them in inventory for customers if they want them, that's a benefit to customers. And as I say when the customer wants to sell and you are selling five bonds or 10 bonds, if you have to go out and bid that to the street as opposed to having the firm be able to buy it into inventory, you are just not going to get a good price. And as I say if the result of fiduciary duty is worse executions for customers, that's a bad result.

ERIK SIRRI: I guess we have to remember why we are doing this - at some level investor protection and investor welfare. If you are costing them more money on the execution side, then don't forget 206(3) was not so much about executions as it was about the research conflict, the idea that the quality of the paper going in the portfolio was somehow known not to be beneficial. The broker still has a best execution obligation. Since you have got the execution side covered, if we do this if we go down this path where 206(3) remains so the adviser still has the principal trading prohibition. Yet under this enhanced broker-dealer story, the broker-dealer can perhaps, with upfront disclosure, consummate the principal trade. Now we are left with that distinction. If you are comfortable with that, then somehow you believe that upfront disclosure with regard to the principal conflict gets you off the hook with the broker-dealer. So why are you leaving it with the adviser who may have a non-discretionary account? What would the logic be? Haven't we just kicked the can down the road and now just left the principal trading problem?

MICHAEL SHARP: Absolutely but I don't think it is workable. It makes no sense today and it certainly makes no sense having a bifurcated role.

ERIK SIRRI: Let me turn to something else that has recently been in the air, not often associated perhaps with the IABD question but I think is interesting. Most of you know that Buddy Donahue at the SEC and the Commission properly have proposed revisions to Rule 12b-1, that does many many things. Among the things it does is to cap 12b-1 payments. Now, a number of people who had come in to the Commission pointed that in the debate between business models of IA versus BD, one of the great things about the BD model was the flow of 12b-1 fees and that was one of the reasons to be a broker-dealer. In a world where an enhanced standard of care arises and 12b-1 fees are capped, are any of you at all worried that these are both forces that drive us away from a vibrant broker-dealer model and into the advisory space?

HARDY CALLCOTT: 12b-1 fees have typically been a way for load funds, put aside no load funds, which present a different set of issues. For load funds, 12b-1 fees have been a way that customers can pay for advice over time, as opposed to paying an upfront payment, they pay over time. And I think they have worked for the mid-level investors who can't afford an investment adviser; they don't have a high enough net worth to be of interest to registered investment advisers. I think the issue is, there is an inherent conflict there and there have been situations where broker-dealer have sold load funds to customers in a situation where the customer would have been better off in a different kind of account relationship. They ended up over time paying a lot more through the 12b-1 fees than through alternative kinds of arrangements. So one of the issues that comes up both on the brokerage side and on the advisory side is finding an account structure that is the right account structure for a particular customer and the right way to pay for their advice. And its a hard line to draw but I would argue that there is a group of investors for which load funds has been the only way, where they can effectively get any kind of investment advice.

MICHAEL SHARP: The biggest flaw of 12b-1 fees is the name. If you just call them ongoing sales charges, you would be much clearer to people. And no matter what you call an ongoing sales charge or rule 12b-1 fees, the market will demand a certain amount of money to exchange a transaction, and what we need is just more clarity and more transparency.

ERIK SIRRI: I think that's one of the things that the new rule hopes to do with the account level charges. It's when Hardy characterized the 12b-1 fees as paying for advice, I think a fund person might have pointed out that they pay for distribution. I think we get the parallel but it's sort of an interesting way to look at it. Let me go back to something in the RAND Report that I mentioned earlier and I would be curious to get your thoughts. This is the question of disclosure. Keeping in mind that all this is about improving the quality of services that come to investors, if you take the RAND Report at face value, then disclosure is not read, even if crafted well. And that's a statement that comes from industry professionals. As you and many other people have pointed out, disclosure is really an important part of the fiduciary duty because it is part of shaping and describing it in a very active way. How should we think about relying more or leaning on fiduciary duty in a world where the retail investor, which is the subject of the study, a subject of what we are talking about here, is fundamentally not reading the disclosure? Does that disturb you at all?

DAVID TITTSWORTH: It disturbs me. I think it disturbs everybody. But I don't know of a better way to deal with this and I think this is something that everybody has to work on. I talked to members of our organization and they want sophisticated clients. They want people to understand what they are doing. So you have to read some stuff to get to that point, to be a sophisticated investor, to make intelligent form choices. I don't know how you solved the problem that you have eloquently stated. I know that it's a problem. It's a problem for me. I get stuff in the mail from banks and my modest investments and most of it I throw in the trash can. So I am guilty as charged. People tend to trust their adviser and whether that's a broker, a planner or an investment adviser, it's human nature and we don't want to read that stuff. I think the SEC has to but I don't think you throw disclosure out the window. Those of you who are familiar with the investment advisory profession, you know that the SEC has just adopted a final rule on Form ADV Part 2, a plain English disclosure. But you always have this tension between full disclosure and is it understandable or readable much less is anybody going to read it? So I wish I had the solution, Erik. I think it's education and you keep trying to pound that. And it's you working as a college professor and it's law firms and regulators, it's everybody. It's something everybody can agree on, but I don't know how you solve the issue.

HARDY CALLCOTT: I have a couple of thoughts on disclosure. It is generally true again under the Restatement of Agency that with full and fair disclosure a client can consent to a conflict of interest on behalf of the agent. That being said, there are limits to that proposition, and you can't disclose your way out of a conflict if the client doesn't have a basic understanding of what is being disclosed. There are some products that are sufficiently complicated that there are some investors who, even if you put the full disclosure in front of them, they are just not going to understand it. I don't think you can go forward and sell that product just because you have made a disclosure. Beyond that, under state law, there's a prudent investor standard that applies to fiduciaries and that's a substantive standard. And you can't disclose your way out of that standard. So, disclosure is helpful but I don't think that disclosure is at the end of the day, the panacea for brokerage firms, even as a legal matter, putting aside the issue which you raise, which is a very good one, which is that a lot of customers don't bother to read the disclosures they get now.

MICHAEL SHARP: The notion that people don't read disclosure doesn't bother me a little bit. Disclosure is a liability limitation for the Street and what you really need is the right disclosure. That people choose not to read it - it is a caveat even in a fiduciary setting and the notion that people don't read disclosure will never change. I have never read a prospectus unless I had to litigate one. But I just want to point out this doesn't just cut against the advisory model. I think you start to read some of the comment letters that have come in, it points out that folks who are favoring the brokerage model say, "You need to streamline that which is in 206(3), you can't go with trade by trade disclosure for principal trade. You need to perhaps upfront this." Well, in a world where people aren't reading disclosure, what good is up fronting disclosure? No, but people do read disclosures. And again when we built the non-discretionary model there was a special box, they had to sign multiple times. And one of the boxes they had to sign was, “Please understand that we will be trading as principal.” But then you have other backstops in place that protect the client and you if the client decided just to sign the bottom-line. The disclosure issue is a pet peeve of mine; people don’t read it – it’s just you will never fix that.

ERIK SIRRI: That would strike fear in the hearts of the ex-Commission employees.

MICHAEL SHARP: I understand that.

ERIK SIRRI: It’s a fair point. We are almost out of time; let me quickly touch on one other topic. This is a question that’s often brought up in this space. I think it harkens back to something Hardy said earlier about the broker-dealer model. It’s the question of an SRO for advisers. I know it’s a bugaboo, we could spend an hour on it. But it is clearly something that is in the air once again. So let me start with David. Are belts and suspenders unnecessary? It’s been written about for years. Enlighten us briefly about where we are today. Do we need it?

DAVID TITTSWORTH: Absolutely unnecessary. It’s an extra layer of bureaucracy and costs; self-regulation by definition involves an inherent conflict of interest. Good friends of FINRA are obviously lobbying actively to become the SRO for investment advisers. There is no secret about that. I think FINRA especially is poorly suited to regulate the investment adviser profession: lack of transparency, lack of accountability, a bad track record, the costs involved and perhaps most important a bias favoring the broker-dealer model.

ERIK SIRRI: Let me turn to Hardy. I think you said FINRA might not be the best entity to do it. And then there is a question generally of: could FINRA be fixed up to make it the best entity; or could another SRO rise? They are really separable.

HARDY CALLCOTT: I will go back to what I said earlier. More cops on the beat are better than fewer cops on the beat. The last several years, the SEC has examined only about 9% of SEC registered investment advisers. A number of states prominently including New York don’t examine state registered investment advisers at all because they don’t have authority to do it. David said and I think we all agree that the SEC should get more resources to be able to do more examinations on the investment adviser side. But right now, there is only one cop on the beat for any investment adviser. And in many states and at the federal level, that cop is not on that beat nearly often enough and that problem needs to be solved. And if the SEC had gotten self funding in Dodd-Frank maybe the SEC could have solved it. It needs to be solved some way and my personal opinion is, an SRO that has the ability to fund itself from the industry as opposed to having to go to Congress for appropriations is the only way that effort is going to get solved.

ERIK SIRRI: Mike, any last word …

MICHAEL SHARP: I think where you stand depends on what you sit. Being at a large wire-house for a while and being at other places, the notion of FINRA not regulating investment advisers – well, I don’t believe it. It happens all the time. When we were building non-discretionary advisory models, we went with a dog and pony show to everybody, including FINRA, because we knew they would come in and look at it. And it is true that they don't go to pure investment advisers, but I do think it's better to have more cops on the beat than not.

ERIK SIRRI: I think we could continue on this topic but in all fairness our time is coming to an end. Hardy, Mike, David, thank you for joining me today for this discussion. We can only wait and see as a rule making process is finalized early next year if what we envision becomes reality.

On behalf of the SEC Historical Society I would again like to thank Bingham McCutchen for its generous support and assistance in making today's program possible. It has been a privilege to partner with you. An audio of today's program is now available at www.sechistorical.org and a transcript will be ready soon in the virtual museum and archive. Thank you again to our audiences both here at the Bingham offices here in New York and online at www.sechistorical.org. Good evening.