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Brent J. Fields
Secretary, Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number S7-07-18

Dear Mr. Fields:

Thank you for the opportunity to comment on the Securities and Exchange Commission's proposed Regulation Best Interest, released for public comment in April 2018 ("Reg BI").[1] I am a law professor who has dedicated her academic career to research and scholarship in the area of securities arbitration and broker-dealers' duties to customers. I am a co-author of the two-volume treatise Broker-Dealer Law and Regulation (Wolters Kluwer) (5th ed. 2018) (with James Fanto & Norman Poser).[2]

Reg BI, if approved, would "establish an express best interest obligation: that all broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, together referred to as "broker-dealer"), when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, act in the best interest of the retail customer at the time the recommendation is made without placing the financial or other interest of the broker-dealer or natural person who is an associated person making the recommendation ahead of the interest of the retail customer."[3]

[1] SEC Regulation Best Interest, Release No. 34-83062; File No. S7-07-18 (Apr. 18, 2018). Reg BI details how a broker can satisfy the requirements of the new regulation. *Id*. at 8-9.

[2] My full biography and a complete list of my publications is available at https://law.pace.edu/faculty/jill-gross. This comment letter expresses only my individual views, and does not represent the views of the Elisabeth Haub School of Law at Pace University.

[3] *Id*. at 8. For purposes of this position paper, as in Reg BI and unless otherwise indicated, the term "broker-dealers" includes the firm as well as natural persons who are associated persons of a broker-dealer.

Regulation Best Interest vs. Current Law

One of the premises of the proposal is that the new Regulation will *strengthen* the regulation of broker-dealers in their dealings with their customers. Indeed, when releasing the proposed rule, the Commission stated "we believe it is appropriate to make *enhancements* to the obligations that apply when broker-dealers make recommendations to retail customers."[4] However, according to my analysis of current law, Reg BI offers *less protection* than is available under the current law governing a broker-dealer's duties to its customers.

The leading case setting forth the obligations of broker-dealers to their customers under the common law is *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc*.[5] In *Leib*, the U.S. District Court for the Eastern District of Michigan reiterated the well-established rule that, if a broker-dealer has trading discretion in a customer's account, that broker-dealer is in a fiduciary relationship with the customer and owes broad duties of care to customers.[6] The *Leib* court further held that, even a broker-dealer for a nondiscretionary account, although not a fiduciary "in a broad sense," owes his customer six specific duties of a fiduciary nature[7]:

> (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis …; (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests …; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security …; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security …; (5) the duty not to misrepresent any fact material to the transaction …; and (6) the duty to transact business only after receiving prior authorization from the customer.…[8]

The distinction made in *Leib* between a nondiscretionary account, in which the broker's duties end upon the completion of each transaction, and a discretionary account, in which the broker has a continuing duty to further and protect his customer's interests, has been widely followed by courts.[9] However, even the *Leib* court pointed out that there is a "hybrid-type account" between the purely nondiscretionary account and the purely discretionary account, in which the "broker has usurped actual control over a technically non-discretionary account. In such cases, the courts have held that the broker owes his customer *the same fiduciary duties* as he

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[4] *Id*. (emphasis added).

[5] 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd mem.*, 647 F.2d 165 (6th Cir. 1981). Many federal and state courts across the country still follow the framework of broker-dealers' obligations set forth in *Leib*.

[6] *Id*. at 952-53.

[7] *Id*. at 953.

[8] *Id*. at 952-53.

[9] *See* de Kwiatkowski v. Bear Stearns & Co., Inc., 306 F.3d 1293, 1302 (2d Cir. 2002) ("It is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis … The client may enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention."); McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750, 766 (3d Cir. 1990); Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985); Gochnauer v. A. G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987); Berki v. Reynolds Sec., Inc., 560 P.2d 282, 286 (Or. 1977).

would have had the account been discretionary from the moment of its creation."[10]

Thus, in addition to when the customer has granted discretion to the broker, in most states, brokers owe enhanced duties to their customers if the broker has control over the customer's account,[11] sometimes referred to as "transformative circumstances."[12]

De Facto Control/ Transformative Circumstances

In a more recent leading case, the U.S. Court of Appeals for the Second Circuit recognized that in "transformative 'special circumstances,'" a broker may owe a broader duty to a client than a purely transactional one to prevent the brokers from taking "unfair advantage of their customers' incapacity or simplicity."[13] Such circumstances "that render the client dependent" include "a client who has impaired faculties, or one who has a closer than arms-length relationship with the broker, or one who is so lacking in sophistication that de facto control of the account is deemed to rest in the broker."[14]

A broker typically acquires *de facto* control over an account in one of two ways. First, the broker, without receiving discretionary authority from the customer, treats the account as if he had been given discretion, initiating trades for the account without obtaining the prior approval of the customer.[15] Second, the customer, without conferring discretionary authority on the

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[10] *Leib*, 461 F. Supp. at 954 (emphasis added); *see also* Hecht v. Harris, 430 F.2d 1202 (9th Cir. 1970); Burns v. Prudential Secs., Inc., 857 N.E.2d 621, 635-36 (Ohio Ct. App. 2006) ("if a nondiscretionary broker assumes control of his clients' accounts and performs transactions *at his own discretion* with the clients' approval, the broker must take on the duties of a discretionary broker, including the continuing duty to keep the clients informed of financial information that may affect their investments and the duty to disclose all material information to the clients") (emphasis in original); Crook v. Shearson Loeb Rhoades, Inc., 591 F. Supp. 40, 50 (N.D. Ind. 1983) (a broker-customer relationship is a fiduciary one, but where the broker "exercised de facto discretionary control over the account [he] had an even stronger fiduciary responsibility toward [the client]").

[11] Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1216-17 (8th Cir. 1990) (applying South Dakota law and stating that, when analyzing breach-of-fiduciary-duty claims arising from unauthorized trading of securities, the "crucial question is who exercised actual control over the account"); Caravan Mobile Home Sales v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561 (9th Cir. 1985); Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng, 901 F.2d 1124, 1128-29 (D.C. Cir. 1990); Holmes v. Grubman, 691 S.E.2d 196, 201–02 (Ga. 2010) (answering questions certified from the Second Circuit and stating that "the broker will generally have a heightened duty, even to the holder of a non-discretionary account, when recommending an investment which the holder has previously rejected or as to which the broker has a conflict of interest").

[12] De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1308 (2d Cir. 2002).

[13] *Id*. at 1308-09.

[14] *Id*. at 1308.

[15] *See* Anwar v. Fairfield Greenwich Ltd., 891 F.Supp.2d 548, 555 (S.D.N.Y. 2012) (when a broker "undertakes a substantial and comprehensive advisory role with respect to nondiscretionary accounts, ongoing duties may be triggered, such as a duty to monitor") (internal quotations and citations omitted); Burns v. Prudential Secs., Inc., 857 N.E.2d 621, 635-36 (Ohio Ct. App. 2006) ("if a nondiscretionary broker assumes control of his clients' accounts and performs transactions at his own discretion with the clients' approval, the broker must take on the duties of a discretionary broker, including the continuing

broker, nevertheless permits his broker to exercise control over the account. This typically occurs where the broker recommends investments to the customer and the customer, lacking the experience or sophistication to exercise his own judgment concerning his investments, routinely approves the broker's recommendations.[16] In both types of situations, the broker has the same fiduciary duties as he would if the customer had given him formal discretion over the account.[17] To determine whether a broker controls an account, courts consider factors such as whether the broker has acted as an investment advisor and whether the customer almost invariably followed the broker's advice, the sophistication of the customer, whether the broker and customer communicated frequently concerning the status of the account or the prudence of particular transactions, and whether the customer placed trust and confidence in the broker, with the broker's knowledge, to manage the account for the customer's benefit.[18]

Fiduciary Duties

Under the common law, if a broker is in a fiduciary relationship with a customer, the broker "must (1) manage the account in a manner directly comporting with the needs and objectives of the customer …; (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests …; (3) keep his customer informed as to each completed transaction; and (4) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged."[19] Notably, a broker may have a duty to monitor a customer's account, especially where the broker expressly assumes such a duty, even though the broker may not have discretion or otherwise control the account.[20]

Reg BI Weakens Existing Investors' Rights

As demonstrated by the authorities above, courts already recognize that a broker-dealer making recommendations to a customer may have enhanced obligations to that customer to act in the client's best interest, give ongoing advice, and even monitor the account in between

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duty to keep the clients informed of financial information that may affect their investments and the duty to disclose all material information to the clients");

[16] Paine Webber v. Adams, 718 P.2d 508, 517 (Colo. 1986) ("proof of practical control of a customer's account by a broker will establish that the broker owes fiduciary duties to the customer with regard to the broker's handling of the customer's account.")

[17] Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 803 F.2d 454, 460 (9th Cir. 1986); Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985); *Leib*, 461 F. Supp. at 954; Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 515-16 (Colo. 1986).

[18] *Adams,* 718 P.2d at 516-18; *see also* David K. Lindemuth Co. v. Shannon Fin. Corp., 660 F. Supp. 261, 265 (N.D. Cal. 1987) ("The key in determining control of the account is whether the customer can independently evaluate his broker's suggestions, based on the information available to him and his ability to interpret it"); Wallace v. Hinkle Northwest, Inc., 717 P.2d 1280, 1282 (Or. App. 1986) ("A stockbroker is a fiduciary if his client trusts him to manage and control the client's account and he accepts that responsibility").

[19] *Leib*, 461 F. Supp. at 953-54; Rupert v. Clayton Brokerage Co. of St. Louis, 737 P.2d 1106, 1109 (Colo. 1987).

[20] *See Vucinich,* 803 F.2d at 460-61 (California law); Khan v. BDO Seidman, LLP, 948 N.E.2d 132, 152 (Ill. App. 2011), *aff'd sub nom.* Khan v. Deutsche Bank AG, 978 N.E.2d 1020 (Il. 2012).

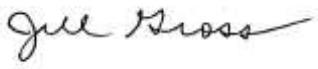
transactions, depending on the nature of the account. The notion set forth in proposed Reg BI that a broker does not have such obligations currently is simply not supported by the courts.

Moreover, the circumstances that create a fiduciary duty under the existing case law are present in the typical broker-dealer relationship. While customers may not explicitly grant discretion or control to their broker-dealers, many do hand over implicit control to the individual listed on the account. Many retail investors are incapable of evaluating recommendations on their own, rely on those individuals as "trusted advisors" (in fact they are told by broker-dealers' marketing materials to rely on them), and follow their advice without questioning what is best for them. They reasonably believe they are in long-term relationships of trust and confidence and that their "advisor" will monitor their account and keep them apprised of any changes that should be made. Based on how these relationships are marketed and work in practice, it is entirely understandable why investors expect that they will receive ongoing services from broker-dealers.

Additionally, Reg BI applies a mechanical approach to recommendations, such that there is *never* an ongoing duty. This approach defeats, rather than matches, retail investors' legitimate expectations. If the issue of whether a broker-dealer owes its customer an ongoing duty is adjudicated in court or in arbitration, it is reasonable to assume that a court or panel of arbitrators would look to the SEC standard for the applicable legal principles (the brokerage industry will certainly argue that it should). This would increase the risk that, despite the fact that the *case law* would apply a fiduciary duty to circumstances described above, *the SEC's standard* would not. To the extent a court or arbitration panel determines that the SEC standard should control rather than existing case law, investors' rights would be significantly weakened.

For all of the foregoing reasons, it is my opinion that Reg BI, if approved as currently drafted, will reduce current investor protections, rather than enhance them. Accordingly, I oppose Reg BI as currently drafted.

Respectfully yours,



Jill I. Gross