How the Large Modern Financial Services Firm Can Better Compete as Financial Advisors and Clients Migrate to a Fiduciary Business Model

by Ron A. Rhoades, JD, CFP®[1] December 1, 2009

It's no secret that the word "fiduciary" has provoked a range of emotions in the financial services industry, including "fear." Indeed, a *bona fide* fiduciary standard poses certain challenges for product-sales-driven business models, especially in large and diverse financial services firms. Also, many smaller firms (the author's included) have, in recent years, utilized their fiduciary status as a tremendous marketing advantage[2] in the competition for clients. In this outline, I review the major developments of the last several decades affecting the provision of financial and investment advisory services.[3] I then suggest ways that a forward-thinking, large financial services firm could embrace a *bona fide* fiduciary standard of conduct – and use it to their advantage to more effectively compete against the smaller registered investment adviser (RIA) firms. Larger firms possess the opportunity to gain, rather than lose, market share and increased shareholder value, if effective long-term business strategies are embraced.

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[2] If SIFMA is successful in its efforts to "harmonize" BD and RIA regulation under a "universal standard" (a.k.a. "new federal fiduciary standard") – which this author believes is anything but a true fiduciary standard – the existing business model of large financial services firms will continue for a time. However, large financial services firms will inevitably continue to lose market share. Independent RIA firms, such as the author's own, may have to rephrase their message a bit, such as by encouraging clients to ask more precise questions when evaluating potential financial advisors. However, the core message of the independent RIA firm – objective advice, free of many of the conflicts of interest present in many large financial services firms, remains quite strong. In fact, if SIFMA "wins" the battles in Congress, and thereafter at the SEC, this author's RIA firm possesses a more prosperous long-term future. This is because, in essence, the independent RIA firm will not face any increase in true competition.

[3] While many commentators cite past and potential future changes in the regulation of financial services as a driver of change, this author believes that the drivers of change are driven primarily by the evolution of consumer needs preferences as well as advisor desires as to choice of business model. These preferences result, in turn, from more fundamental changes, including the shifting from defined benefit to defined contribution retirement plans, the increasing number and complexity of investment strategies and products, and the greater recognition of the impact of fees, costs and taxes upon returns secured by individual investors. As discussed herein, the application of broad fiduciary standards of due care, loyalty, and utmost good faith upon financial advisors is but part of a larger trend to apply fiduciary standards in a more complex financial world in which specialists provide expert services which public policy promotes.

A. THE EVOLUTION OF FINANCIAL & INVESTMENT ADVISORY SERVICES.

Many major developments have occurred in recent decades which materially affect the delivery of financial and investment advisory products and services. These developments have spurred on the application of broad fiduciary duties of due care, loyalty and utmost good faith upon the providers of investment advisory and financial planning services.

A.1. Today's Consumers Face a Far More Complex Financial World.

The world is far more complex for individual investors today than it was just a generation ago. Greater responsibility exists for the average American to save and invest for his or her future financial needs, such as retirement, and for the management of any accumulated retirement nest egg.

In addition, there exist a broader variety of investment products, including many types of pooled investment vehicles[4] and/or hybrid products which employ a diverse range of strategies. This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor's portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true "total fees and costs,"[5] investment characteristics, tax consequences, and risks.

U.S. tax laws relating to investment income and returns have also increasingly become more complex, presenting not only opportunities for the wise through

> "The current battle on [securities law reform] is being waged on political lines. The points at issue are not neatly drawn in business or legal terms. The arguments on both sides are often distinguished by their emotional quality rather than by any deep insight into the requirements for protection of investors and for control of the security business. Those in opposition to [securities law reforms] frequently point with alarm to certain of its dire consequences … New capital cannot be obtained … The upshot is that this [securities law reforms will retard economic] recovery. These points are argued, not proved. Little or no substantiating evidence is offered …These arguments are often earmarks of stubborn and resentful opposition, not of informed judgment. On the other hand, supporters of [securities law reforms] often as not are unconcerned with that the [reforms do] to … brokers, dealers, and bankers. They also lose sight of what it really does for investors. They visualize [securities law reform] as a corrective of the evils that obsessed the financial world in the last decade. They assume that [reforms] would prevent the recurrence of many if not all of the discreditable things which have occurred. Those discreditable things are associated in their minds with big business men and bankers. In those two groups they have lost confidence. The Securities Act is their attack on the citadels of high finance. The religious fervor of their attack is equaled only by the obstinate resistance of their opponents."
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> - William O. Douglas, Protecting the Investor, Yale Review, 1934.

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[4] At the end of 2008, U.S.-registered investment companies as a whole were the largest group of investors in U.S. companies, holding 27 percent of their outstanding stock. In addition, U.S. registered investment companies held 33% of U.S. municipal debt securities and 44% of U.S. commercial paper. Investment Company Institute, 2009 Investment Company Fact Book, p.11. U.S.-registered mutual funds, closed-end funds, exchange-traded funds and unit investment trusts totaled 16,262 at end of 2008. *Id.* at p.15.

[5] Pooled investment vehicles often possess substantial "hidden" fees and costs which are not included in the fund's annual expense ratio and of which most individual investors are unaware. For a review of the literature on this issue and for a methodology for estimating these fees and costs, *see* Ron A. Rhoades, Estimating the Total Fees and Costs of Stock Mutual Funds and ETFs (April 2009), a white paper available at www.JosephCapital.com, under "Resources."

proper planning, but also a plethora of tax traps for the unwary.

A.2. Academic Research Reveals Insights into Investment Strategies. Nearly six decades ago we saw the emergence of Modern Portfolio Theory.[6] Over four decades have passed since the Efficient Markets Hypothesis was promulgated[7] and academic studies first indicated that active managers, on average, underperform their benchmark indices.[8] Only three decades ago, a comprehensive database of securities values first became available,[9] leading to a proliferation of academic research into the efficacy of existing strategies – either over time or through back-testing of the investment methodology. Nearly two decades ago, prior academic research was synthesized into the widely utilized Fama-French three-factor asset pricing model.[10] All of these, as well as many other developments in modern finance (behavioral finance, interplay of financial capital and human capital, etc.), have led to the ability to test investment strategies for robustness and reliability. This has led to greater understanding of both the need, and the means, to conduct due diligence on both investment strategies and products. Hundreds of academic white papers now surface each year examining investment and portfolio management strategies and often revealing new insights which practitioners can seek to apply.

A.3. The Increased Knowledge Gap between Financial Advisors and Consumers. As the sophistication of our capital markets had increased, so has the knowledge gap[11] between individual

[6] In 1952, Professor Harry Markowitz, who won the Nobel Prize in Economics (1990), theorized that diversification reduces risk, and that assets should be evaluated and selected for inclusion not solely on the basis of their individual characteristics but rather by their effect on the investor's portfolio. It was demonstrated that an optimal portfolio could be constructed to maximize return for a given standard deviation.

[7] In 1966 Professor Eugene Fama, Sr. of the University of Chicago Graduate School of Business, utilizing extensive research on stock price patterns, developed the Efficient Markets Hypothesis (EMH), which generally asserts that prices reflect values and information accurately and quickly, and therefore it is difficult if not impossible to capture returns in excess of market returns without taking greater than market levels of risk. Various forms of the EMH exist today, and substantial confusion exists as to distinctions between collective investor rationality versus the efficacy of the EMH. Nevertheless, the EMH proponents possess substantial academic research backing either the semi-strong or weak forms of the EMH.

[8] The first studies of mutual funds (Jensen, 1965) and of institutional plans (A.G. Becker Corp., 1968) indicated active managers underperform indexes. A more recent study concludes: "For 1984-2006, when the CRSP database is relatively free of biases, mutual fund investors in aggregate get net returns that underperform CAPM, three-factor, and four-factor benchmarks by about the costs in expense ratios. Thus, if there are fund managers with enough skill to produce benchmark adjusted expected returns that cover costs, their tracks are hidden in the aggregate results by the performance of managers with insufficient skill." Fama, Eugene F. and French, Kenneth R., Luck Versus Skill in the Cross Section of Mutual Fund Returns (November 2009). Tuck School of Business Working Paper No. 2009-56 ; Chicago Booth School of Business Research Paper. Available at SSRN: http://ssrn.com/abstract=1356021.

[9] Center for Research in Securities Prices databases, maintained by the Univ. of Chicago Booth School of Business, which have over the years been expanded in terms of their number and historical coverage, and which have been subject to periodic revisions in efforts to enhance the reliability of the data and to remove survivorship bias.

[10] Fama, E.F. & K.R. French, The Cross-section of Expected Stock Returns, 47 *Journal of Finance* 427-486 (1982).

[11] The "knowledge gap" between financial advisors and individual investors has long been recognized. For example, the 1995 Tully Report noted: "As a general rule, RRs and their clients are separated by a wide gap of knowledge--knowledge of the technical and financial management aspects of investing. The pace of product innovation in the securities industry has only widened this gap. It is a rare client who truly understands the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many. This knowledge gap represents a potential source of client abuse, since uninformed investors have no basis for evaluating the merits of the advice they are given." Report of the Committee on Compensation Practices (April 10, 1995) (a.k.a., Tully Report, after its Chairman, Daniel P. Tully, Chairman and CEO, Merrill Lynch), available at http://www.sec.gov/news/studies/bkrcomp.txt. The suggested Tully Report reforms to overcome this financial gap included increased disclosures greater acceptance of responsibility by individual investors.

consumers and financial advisors. Investment theory continues to evolve, with new insights gained from academic research each year. In constructing an investment portfolio today, a financial advisor must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

A.4. Portfolio Management: Disintermediation and Re-intermediation. From the 1975 end to fixed commission rates on the major exchanges, to the increased use of of mutual funds and ETFs, to target date retirement funds, disintermediation has occurred with respect to several aspects of investment portfolio management. An ever-growing larger segment of the American public tries to invest "on their own" – or at least through the use of pooled investment vehicles which are not sold through the broker-dealer sales channel.

Disintermediation[12] has been a powerful force in many different industries over the past several decades. In the securities industry, perhaps the most dramatic impact of disintermediation has been in the use of alternative market mechanisms, which have reduced the role of market makers and driven down the cost of trading (brokerage commissions, bid-ask spreads, etc.).[13]

From the standpoint of consumers of investment products, as the internet has enabled the increased availability and exchange of information, calls for better and/or increased transparency have become more pronounced. Ease of comparison between similar products thereby results, and fees and costs are more and more heavily scrutinized in the selection process.

In turn, differential pricing with respect to the same product becomes problematic. While justifications exist for differential pricing from the standpoint of varying distribution costs, transparency reduces the viability of cross-subsidies between customers who are sold the same investment products.

Additionally, increased availability of information leads to new, more direct distribution channels, in which some intermediaries may be bypassed altogether. Firms which fail to adapt may lose their best, most profitable, and previously most loyal customers.

The pace of disintermediation is likely to accelerate in future years as technological advances (computer-aided personal investment and financial planning) and increased information availability (internet) and communication among investors (discussion forums, etc.) occurs. While disintermediation may be slowed by firms employing product formulation and marketing strategies which tout "exclusivity" of access to certain products, and/or coupling of limited access to other service offerings of the firm, such a

[12] For an early work exploring disintermediation in the financial services industry, *see* Freedman, Stephen R., Regulating the Modern Financial Firm: Implications of Disintermediation and Conglomeration (September 2000). St. Gallen Economics Working Paper 2000-21, observing: "Conglomeration across lines of business has been quite common under the European universal banking system, and will certainly take off in the US following the repeal of the Glass-Steagall Act in 1999 … Investor protection … should increasingly be addressed through the regulation of business conduct …." Available at SSRN: http://ssrn.com/abstract=253928.

[13] For an early analysis of this impact, *see* Weber, Bruce W., Trade Execution Costs and the Disintermediation of Trading in a Competing Dealer Market (July 1994). Information Systems Working Papers Series, available at http://ssrn.com/abstract=1284851. A summary of more recent techniques utilized in disintermediation in trade execution can be found in Ron A. Rhoades, Estimating the Total Fees and Costs of Stock Mutual Funds and ETFs (April 2009), a white paper available at www.JosephCapital.com, under "Resources."

strategy is likely to result in an investor backlash given the increased public criticisms of "proprietary products" and the lack of objectivity which may occur[14] when such products are recommended.[15]

At the same time, Re-intermediation has occurred and will continue to occur, as consumers have begun to migrate from sell-side product providers to buy-side purchaser's representatives for advice. Re-intermediation sometimes occurs when individual investors are "stung" by making the wrong moves when acting on their own (often the result of incomplete information or expertise, or due to emotional biases dictating improper investment decision-making).

Re-intermediation also occurs when the value proposition of the fiduciary financial planner – a "purchaser's representative" – is viewed by the consumer as justifying the costs of receiving objective financial planning advice. In such instances, if the consumer's perception of his or her needs so dictate, the individual investor may seek financial planning and/or investment advice from lower-fee providers, a task made easier through greater transparency in fee arrangements.[16]

Part of the challenge to Re-intermediation in the future will be the continued perception by many individual investors, often fostered by financial services firms and their advisors, that "financial planning" is wholly distinct from the provision of "investment portfolio advice." The offering of "financial plans" separate from investment portfolio management services, at firms both large and small, continues to foster the expectation of some consumers that individuals can pay a separate fee for a financial plan, yet then implement the financial plan "on their own" through direct access to investment product providers. While some consumers may be capable of the discipline required and possessing the time necessary to research and monitor investments, much evidence exists that the lack of ongoing competent professional advice results in diminished returns for individual investors who choose to "go it alone."[17] It remains to be seen

[14] Lack of objectivity is not confined to recommendations of proprietary over non-proprietary products. Many forms of compensation practices relating to mutual fund sales impair the delivery of objective advice and are likely to be attacked by competitors who do not receive material compensation from investment companies. Such practices include recommendations of proprietary funds over non-proprietary funds, preferred partner funds over non-preferred partner funds, funds which engage in revenue sharing over funds which do not, Class B shares over Class A shares, Class C shares over Class A shares, and funds that provide soft dollar compensation over funds which do not. While sales contests involving the awards of prizes (cash and non-cash compensation) and other differential compensation arrangements have been either banned or discouraged by regulators, other variable compensation practices remain, including but not limited to revenue sharing arrangements. *See* Serafeim, George, Directed Brokerage no More: The Effects of New Regulation in the Mutual Fund Industry (July 10, 2008) ("[E]vidence also indicates that brokers have begun compensating for lost revenues from directed brokerage commissions by implementing revenue sharing agreements. Although affected funds have lower inflows after the regulation, suggesting that brokers' bias is partly eliminated, revenue sharing agreements appear to be the new means of increasing fund inflows."). Available at SSRN: http://ssrn.com/abstract=1157917.

[15] Independent RIAs, sometimes aided by their custodians, often tout the objectivity of their advice and the fact that they eschew proprietary product sales. For example, the 2005 Charles Schwab Institutional marketing brochure provided to their RIAs for marketing, "Investing in More Objective Advice: A Guide to Working With an Independent Registered Investment Advisor," suggests investors who already work with a broker ask themselves this question: "Do I sometimes feel that my broker's recommendations for products, including ones from their own company, are not always in my best interest or may be motivated by commissions?"

[16] Through the Investment Adviser Registration Depository (IARD) system, several states already mandate the public-accessible filings of Form ADV, Part II narrative disclosure. Part II includes information about the service offerings and fees of registered investment advisers, as well as the increased savvy of consumers in obtaining internet-based data, will likely continue to accelerate fee competition among investment advisory firms. SEC-registered advisers may, but are not required to, file Part II with the IARD.

[17] DALBAR, Inc., Quantitative Analysis of Investor Behavior, March 2009 Advisor's Edition, observing: "Throughout the 15-year history of QAIB, which encompassed periods of unprecedented market upswings as well as last year's drop, the 'average investor' has continuously achieved 20-year results that have lagged the oft-quoted return statistics would

whether the acceleration in the move by some investors to self-directed investing, with financial planning advice provided separately, will be effectively countered by a more effective embrace by the financial services industry of the need for, and benefits of, integrated and holistic ongoing financial planning, of which investment advice is only one part.

A.5. Goals-Based Financial Planning: Both Needed and Desired by Clients. Given the complexity of the modern financial world, the fact is that we should no more expect the vast majority of individual consumers to be able to successfully navigate today's complex financial world than we would expect them to act as their own attorney or physician.

A.5.a. Financial Literacy Efforts, While Important, Just Don't Work. Many academics, as well as consumer advocates and state securities regulators,[18] have acknowledged the substantial limitations of financial literacy efforts given the high degree of complexity of investment products and financial advice. The extremely low level of financial literacy among Americans was recently reported on by Professor Lusardi:

> Over the past thirty years, individuals have had to become increasingly responsible for their own financial security following retirement. The shift from defined benefit (DB) to defined contribution (DC) plans has meant that workers today have to decide both how much they need to save for retirement and how to allocate pension wealth. Furthermore, financial instruments have become increasingly complex and individuals are presented with new and ever-more sophisticated financial products. Access to credit is easier than ever before and opportunities to borrow are plentiful. But are individuals well equipped to make financial decisions. In other words, do they possess adequate financial literacy to do so? This paper shows that most individuals cannot perform simple economic calculations and lack knowledge of basic financial concepts, such as the working of interest compounding, the difference between nominal and real values, and the basics of risk diversification. Knowledge of more complex concepts, such as the difference between bonds and stocks, the working of mutual funds, and basic asset pricing is even scarcer. Illiteracy is widespread among the general population ….
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> Given the current low levels of financial literacy, employers and the government should devise and encourage programs that simplify financial decision-making as well as provide sources of reliable financial advice.[19]

While financial literacy programs are often touted as the "cure" for enabling consumers to make better financial decisions, a more reasoned review of the academic evidence suggests the ineffectiveness of financial literacy education. As stated by Ian Hathaway and Sameer Khatiwada, writing for the Federal Reserve Bank of Cleveland:

> Conventional wisdom tells us that a more informed consumer is a better consumer. One could reasonably argue that when dealing with complex goods and services (such as those of a financial nature), consumer

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lead investors to believe are achievable. Why? There is one simple reason: When the going gets tough, investors panic … Market declines caused panic, and panic led to bad decisions. And bad decisions combined with declining markets resulted in exacerbated losses." I do not suggest that all financial planners also avoid the behavioral biases (loss aversion, narrow framing, herding, etc.) which so often doom individual investors; indeed, the failure of many

[18] As stated in the consumer-oriented brochure, "Cutting Through the Confusion": "While some people are comfortable handling their own investments, many are not. They find the idea of creating a plan for allocating their assets bewildering, choosing a mutual fund intimidating, and designing an investment portfolio to be one more thing for which they have neither the time nor the expertise. This is nothing to be embarrassed about. Investing can be confusing." "Cutting Through The Confusion," a brochure published by the "Coalition on Investor Education," which consists of the Consumer Federation of America, the North American Securities Administrators Association, the Investment Adviser Association, the Financial Planning Association, and the CFA Institute.

[19] Lusardi, Annamaria, Financial Literacy: An Essential Tool for Informed Consumer Choice? (July 2008). Paolo Baffi Centre Research Paper No. 2009-35. Available at SSRN: http://ssrn.com/abstract=1336389.

> knowledge is particularly important. Given the recent public policy debate about whether consumers are being taken advantage of by various financial services firms, financial education programs are likely to be one popular remedy. But, one must ask if financial literacy (i.e., a comprehension of particular financial products) allows those consumers with more of it to achieve better outcomes than those with less …
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> Taken together, the literature does not succeed in establishing the extent of the benefit provided by financial education programs, nor does it provide conclusive support that any benefit at all exists.[20]

A.5.b. Increased Recognition that Product Disclosures are Ineffective. Despite the 1995 Tully Report's assertions that consumers should bear the burden of reading and understanding disclosure documents, and that consumers should ask questions when they need more information,[21] much academic research has demonstrated the fallacy of the effectiveness of disclosures.[22] As stated by Professor Fisch:

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[20] Hathaway, Ian and Khatiwada, Sameer, Do Financial Education Programs Work? (April 1, 2008). FRB of Cleveland Working Paper No. 08-03. Available at SSRN: http://ssrn.com/abstract=1118485.

In another white paper critical of prior research into the effectiveness of financial literacy, Professor Willis wrote: "[Financial literacy education (FLE)] is widely believed to turn consumers into responsible and empowered market players, motivated and competent to handle their own credit, insurance, savings and investment matters by confidently navigating the marketplace. In this financially literate world, other forms of legal regulation of financial products are unnecessary and even counterproductive. This vision depends on the belief that FLE can not only improve financial behavior, but that it can do so to the degree necessary for consumers to protect and even increase their welfare in the modern financial marketplace … The demands of contemporary personal financial management are prodigious and varied … What degree of effectiveness should appropriately be claimed for the current model of financial literacy education? As yet, none …." Willis, Lauren E., Evidence and Ideology in Assessing the Effectiveness of Financial Literacy Education. U of Penn Law School, Public Law Research Paper No. 08-08; Loyola-LA Legal Studies Paper No. 2008-6; Available at SSRN: http://ssrn.com/abstract=1098270.

[21] Tully Report, *supra* n.11, stating in pertinent part: "Brokerage firms are not – and cannot be – teaching institutions for investors, but practices that narrow the knowledge gap between investors and RRs can only be viewed positively. Only one "best practice" was found in this area:

> MAKE SPECIAL EFFORTS TO INFORM INVESTORS OF THEIR RIGHTS AND RESPONSIBILITIES. All brokerage firms distribute such materials to their clients, as required by law. Typically, however, these are done in print so small that only the most diligent would wade through them. One firm interviewed provides each new account holder with a clear and thorough document explaining risk, return, and the role of the registered representative. The document provides a summary of services provided by the firm, trade and settlement arrangements, and procedures for resolving complaints. Further, the document spells out the client's responsibilities with respect to communicating objectives, and so forth. Other firms spell out alternative compensation arrangements which are fee-based rather than transaction-driven …

Investors have an important role to play in the alignment of interests described above. Intense competition has created a buyers' market for brokerage services, giving investors of the 1990s the power to demand AND RECEIVE high levels of professionalism and quality service.

Using their ability to direct business to organizations that serve them well, and to withhold it from those who serve them poorly, today's investors have more potential power over the behavior of brokers than any regulator or consumer watchdog. Investors' insistence on professionalism and quality service is the ultimate safeguard of their own best interests and, indirectly, the ultimate enforcer of high standards within the brokerage industry …

[Clients] must assume decision-making responsibility for their accounts. It is their responsibility to evaluate the advice of their brokers and to determine which actions will be taken. In many cases this means that clients must educate themselves in the basics of financial markets, the nature of risk, and other aspects of investing. Good decisions cannot be made in ignorance…." Tully Report, pp.15-18.

[22] For a general discussion of the ineffectiveness of disclosures in the context of waiving broad fiduciary duties of due care, loyalty, and good faith, *see* Rhoades, Managing Conflicts of Interest: The Limits of Disclosure and Informed Consent (2008), stating: "To accept the premise [advanced in the Tully Report] that investors are responsible for their own actions, it is necessary to conclude that investors are not only armed with adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them. Assuming, for the moment, that the disclosure is adequate (in writing, in 'plain English' to the extent possible, specific as to the material facts to be disclosed, and communicated to the investor in advance of any decision by the investor), the sole question then becomes the adequacy of

> The primary difficulty with disclosure as a regulatory response is that there is limited evidence that disclosure is effective in overcoming investor biases. … It is unclear … that intermediaries offer meaningful investor protection. Rather, there is continued evidence that broker-dealers, mutual fund operators, and the like are ineffective gatekeepers. Understanding the agency costs and other issues associated with investing through an intermediary may be more complex than investing directly in equities … once regulators move beyond disclosure into substantive efforts to constrain irrational behavior, regulation imposes substantial costs on the securities markets."[23]

Only recently has substantial thought been given to the ability of individual investors to achieve adequate understanding in order to make informed decisions. As stated by Professor Schwarcz:

> Analysis of the tension between investor understanding and complexity remains scant. During the debate over the original enactment of the federal securities laws, Congress did not focus on the ability of investors to understand disclosure of complex transactions. Although scholars assumed that ordinary investors would not have that ability, they anticipated that sophisticated market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors.[24]

A.5.c. Behavioral Bias Negate the Abilities of "Do-It-Yourself" Investors. As shown in DALBAR, Inc.'s 2009 "Quantitative Analysis of Investor Behavior", most individual investors underperform benchmark indices by a wide margin, far exceeding the average total fees and costs of pooled investment vehicles.[25] A growing body of academic research into the behavioral biases of investors reveals substantial obstacles individual investors must overcome in order to make informed decisions,[26] and reveal the inability of individual investors to contract for their own protections.[27]

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understanding of the disclosures which have been made." Available at http://www.fiduciarynow.com/ManagingConflictsofInterest.pdf.

[23] Jill E. Fisch, "Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst," 10 Lewis & Clark L. Rev. 57, 74-83 (2006).

[24] Steven L. Schwarcz, Rethinking The Disclosure Paradigm In A World Of Complexity, Univ.Ill.L.R. Vol. 2004, p.1, 7 (2004), *citing* "Disclosure To Investors: A Reappraisal Of Federal Administrative Policies Under The '33 and '34 Acts (The Wheat Report)," 52 (1969); *accord* William O. Douglas, "Protecting the Investor," 23 YALE REV. 521, 524 (1934).

[25] *Supra* n. 17.

[26] As stated by Professor Ripken: "[E]ven if we could purge disclosure documents of legaleze and make them easier to read, we are still faced with the problem of cognitive and behavioral biases and constraints that prevent the accurate processing of information and risk. As discussed previously, information overload, excessive confidence in one's own judgment, overoptimism, and confirmation biases can undermine the effectiveness of disclosure in communicating relevant information to investors. Disclosure may not protect investors if these cognitive biases inhibit them from rationally incorporating the disclosed information into their investment decisions. No matter how much we do to make disclosure more meaningful and accessible to investors, it will still be difficult for people to overcome their bounded rationality. The disclosure of more information alone cannot cure investors of the psychological constraints that may lead them to ignore or misuse the information. If investors are overloaded, more information may simply make matters worse by causing investors to be distracted and miss the most important aspects of the disclosure … The bottom line is that there is 'doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases' … While disclosure has its place in a well-functioning securities market, the direct, substantive regulation of conduct may be a more effective method of deterring fraudulent and unethical practices." Ripken, Susanna Kim, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation. Baylor Law Review, Vol. 58, No. 1, 2006; Chapman University Law Research Paper No. 2007-08. Available at SSRN: http://ssrn.com/abstract=936528.

[27] *See* Robert Prentice, Whither Securities Regulation Some Behavioral Observations Regarding Proposals for its Future, 51 Duke Law J. 1397 (March 2002). Professor Prentices summarizes: "Respected commentators have floated several proposals for startling reforms of America's seventy-year-old securities regulation scheme. Many involve substantial deregulation with a view toward allowing issuers and investors to contract privately for desired levels of disclosure and fraud protection. The behavioral literature explored in this Article cautions that in a deregulated securities world it is exceedingly optimistic to expect issuers voluntarily to disclose optimal levels of information, securities intermediaries

A.5.d. Financial Planning Increasingly Perceived as Essential. Proper financial planning is essential to encourage both an increase in household savings and in order to invest those funds more effectively. If people do not make careful, rational decisions about how to provide for their financial security over the course of their lifetimes, then the government will have to step in to save people from the consequences of their poor planning.

As evidence of the increased perception of the value of financial planning, in recent years qualified retirement plan sponsors have increasingly pressured investment solution providers to also provide increased individualized financial advice, taking into account all of the financial resources and liabilities of plan participants.[28]

A.6. Increased Disputes over Ownership of the Client Relationship. There has been a continued assertion by individual financial advisors, across all business models, that the clients are "theirs" and not the client of the firm. Courts have increasingly become hesitant to enforce non-compete agreements. Non-solicitation agreements, while generally enforced, are seldom valid as to any effort to ban general advertising in order to secure, by a departed advisor, re-engagement of the client. Rather than view the procurement of a client, and ownership of the client relationship, as a joint endeavor (with joint ownership resulting therefrom), financial services firms often cling to the older business model formulation, as an effort to preserve value. Financial services firms, whether they are structured as broker-dealers (BDs), registered investment advisers (RIAs), or insurance companies, are susceptible to significant risks of market share decline when their advisors depart. Ongoing efforts to recruit advisors by one firm, from another firm, continue; the protocol established for dealing with such departures is but a stop-gap measure. More recently, in the aftermath of shocks to many large financial services firms, some exceptional producers have fled the larger firms and joined, or started, their own independent BD and/or RIA firms.

A.7. The Appeal of the RIA Business Model: It's Not Just Different Regulatory Oversight. In a recent survey of registered representatives, 60% of the advisors surveyed find the idea of joining or starting an RIA appealing, and 49% say they'd consider it.[29] As reported recently by Registered Rep magazine:

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such as stock exchanges and stockbrokers to appropriately consider the interests of investors, or investors to be able to bargain efficiently for fraud protection." Available at http://www.law.duke.edu/shell/cite.pl?51+Duke+L.+J.+1397.

[28] *See* Kevin P. Condon, Ph.D., CFP®, The financial case for integrating directed advice programs into consumer-directed health plans, BenefitNews.com (July 1, 2006), stating: "As a group, 401(k) plan sponsors have realized, rather belatedly, that education initiatives, online financial calculators and automated advice engines are, by themselves insufficient to help many participants make sound 401(k)-related decisions. Far greater attention is now being paid to direct financial advice alternatives." New software programs, focusing on gap-based retirement planning, which enable inputs of not only qualified retirement plan investment assets but also other investments, home equity, and liabilities, will likely fulfill some of the demand for financial planning in the workplace, but their efficacy has yet to be studied comprehensively. A recent survey found that employers are beginning to offer access to telephone consultation services and personal meetings with a financial planning professional; in these cases, the employer often bears the full cost of formal retirement planning programs. Patricia A. Krajnak, CEBS, Sharon A. Burns, Ph.D., and Sally M. Natchek, CEBS, Retirement education in the workplace, Financial Services Review 17 (2008) 131–141,
available at http://www2.stetson.edu/fsr/abstracts/vol_17_num2_p131.pdf.

[29] Schwab Institutional survey, released Nov. 29, 2009, of 200 registered representatives respondents, who averaged 10 years of investment advisory experience and had an average of $84m in AUM. The survey also noted that less than half of the registered representatives (46%) believed their employer's brand helped them acquire or retain clients, and that 80% believed that if they left their current employer, their clients would follow them.

> [T]he wirehouses are slowly losing market share, and Cerulli projects their share of retail investor assets under management to fall to 40.7 percent in 2012 from 47 percent at the end of 2008. Meanwhile, the independent channel, which includes independent broker-dealers, registered investment advisor firms and dually-registered advisors, is expected to gain market share. The report predicts independent firms will nearly match wirehouses' market share footprint by 2012, with 39.3 percent of retail investor assets under management.[30]

It is often said that registered representatives give up their Series 7 registrations and join independent RIA firms in order to escape the dictates resulting from rules-based FINRA oversight. While there is some truth in the foregoing, it appears that the greater reason lies in the appeal of "being on the same side of the table" as the client.[31]

Regardless of RIA or BD affiliation, goals-based financial planning is an appealing career choice today. In a recent survey, financial planners reported deriving their greatest satisfaction from "Helping clients improve their lives."[32]

A.8. Demand for Talented Financial Planners Increases. The employment of personal financial advisors has been projected by the U.S. Department of Labor to grow by 41% over the subsequent decade (following a 2006 baseline), much faster than the average for all other occupations.[33]

Why this growth? Primarily because there has been a greater recognition of the need for personal financial planners to deal with the complexities of managing today's modern financial life. Yet the question must be posed as to why the growth in demand is for personal financial planners in particular, rather than in the services of related specialists (such as attorneys, CPAs, life insurance agents, etc.). The answer lies in the fact that the financial planner, consciously or unconsciously, is a generalist, and offers clients the possibility of economies of scope in the consumption of financial services and products. Benefits can result from the coordinative function of advisors, as to identifying planning needs of the client, prioritizing such needs, and overseeing their fulfillment in a timely manner. A financial planner can offer the role of "quarterback" – and can add value by screening out poorly qualified or unethical specialist advisors, and monitoring the performance of their services, thereby reducing a client's search and monitoring transaction costs.[34]

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[30] Halah Touryalai, Survey Says: Wall Street Advisors Going…Wait For It…Independent! Registered Rep magazine (Sept. 11, 2009), *citing* Cerulli report entitled "Advisor Migration: The Changing Landscape of Retail Distribution."

[31] Anecdotal evidence supports this conclusion, from discussions this author has had with numerous advisors who have migrated to the independent RIA business model. As related to Schwab Institutional by John Burns: ""The RIA model was the only option that let me serve my clients' best interests." Indeed, this author began his own independent RIA firm only after surveying eight different business models and determining that the independent RIA firm model was likely to be the best, from the standpoint of providing a broader array of service and product offerings.

[32] College for Financial Planning, 2009 Survey of Trends in the Financial Planning Industry. Available at http://www.cffpinfo.com/pdfs/2009SOT.pdf

[33] DOL Bureau of Labor Statistics, Occupational Outlook Handbook, 2008-09 Edition, further noting that: "Growing numbers of advisors will be needed to assist the millions of workers expected to retire in the next 10 years. As more members of the large baby boom generation reach their peak years of retirement savings, personal investments are expected to increase and more people will seek the help of experts. Many companies also have replaced traditional pension plans with retirement savings programs, so more individuals are managing their own retirements than in the past, creating jobs for advisors. In addition, people are living longer and must plan to finance longer retirements."
Available at http://www.bls.gov/oco/pdf/ocos259.pdf.

[34] *See* Kenneth Black, Jr., Contrad S. Ciccotello, and Harold D. Skipper, Jr., Issues in Comprehensive Personal Financial Planning, 11 Financial Services Review 1 (2002), available at http://www2.stetson.edu/fsr/abstracts/vol_11_num1_p1.pdf

Despite growing demand for financial planning services, evidence exists that the supply of financial planners is not keeping pace:

> Cerulli estimates that there were over 298,000 financial advisers practicing in the United States at the end of 2007. However, this number has decreased slightly from the 301,000 practicing advisers reported on the 2004 survey. The industry has been challenged to hire and train new advisers as consumer expectations have risen and the sophistication of services that advisers need to provide has only grown. This has created a number of changes in how the financial advisory industry must operate. First, the adviser population is rapidly aging, and there exists a dearth of new talent to replace these advisers. Second, advisers are in greater need of education and training than ever before to address the complex financial needs of consumers. Finally, advisers are increasingly forming team practices to allow them to specialize and provide more sophisticated services.[35]

With the average financial advisor being an age 55 white male,[36] and the demand for financial planning services continuing to grow, greater demand will likely exist with respect to the very limited pool of experienced financial advisors – those ages 35-50 in particular. Who will provide these experienced financial planners? The large financial services firm of today has become, to a significant degree, as the training ground for new entrants to the financial services industry. Also, larger independent RIA firms are increasingly entering the fray for new talent, recruiting graduates with personal financial planning, finance degrees, and CFP® certifications. Yet it often takes years for a new financial planner to become experienced enough to provide holistic advice and master the intricacies and complexities of integrated wealth management (as well as gaining the credentials and demonstrated experience so as to enable the financial planner to attract and retain the desired type of client).

Recruitment of "second career" individuals is likely to slow. This is in large part due to the high educational and experience requirements[37] necessary to become and compete as a successful Certified Financial Planner™. Even with certification, significant additional training is often required to enable financial advisors to be able to provide the comprehensive advice desired by clients, as well as enabling the advisor to secure and maintain client relationships through both "up" and "down" markets.

Recruitment of experienced talent from related industries will likely possess mixed results going forward. Efforts to recruit CPAs into the financial planning community will likely slow, as many CPAs have already entered the practice of personal financial planning over the past decade and the nationwide shortage of experienced CPAs continues to provide opportunities for advancement in auditing, tax, and other forms of consulting engagements. Recruitment of estate planning attorneys may be increasingly possible, but these efforts will likely be hampered by the decrease in the number of new estate planning attorneys following estate tax equivalent exemption increases adopted in 2001 legislation. Additionally,

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[35] College for Financial Planning, 2009 Survey of Trends in the Financial Planning Industry, noting also that: "Advisers are increasingly moving to independent channels. Over half of respondents to the 2009 survey work in an independent advisory channel (independent broker/dealer, dual registration, independent RIA). There is a clear secular trend toward adviser independence, but there will always remain a place for the employee adviser operating in more structured distribution channels." Available at http://www.cffpinfo.com/pdfs/2009SOT.pdf.

[36] Comments of Deanna Katz, Chairman, Evensky & Katz; Associate Professor, Texas Tech University, at the Tiburon Advisors CEO Summit XVII, November 27, 2009.

[37] A bachelor's degree (or higher), or its equivalent, in any discipline, from an accredited college or university is required to attain CFP® certification. In addition, applicants must pass the CFP® Certification Examination, a 10-hour exam testing their ability to apply financial planning knowledge to client situations. Also, at least three years of qualifying full-time work experience are required for Certified Financial Planner™ certification. A background check is also required, and applicants must agree to abide by CFP Board's Code of Ethics and Professional Responsibility and Financial Planning Practice Standards.

the most successful estate planning attorneys – often those most likely to become top producers as financial planners – often possess little financial incentive to undertake the transition.

A.9. The CFP® Certification Becomes Most Attractive to Potential Clients. From the standpoint of consumers, the Certified Financial Planner™ certification has become the most widely recognized[38] standard for the identification of financial planning expertise. In contrast, the more specialized Chartered Financial Analyst (CFA) charter, focused largely on a fundamental knowledge of investment principals, which has been around since 1963 (and which was ranked by the *Economist* as the gold standard among investment analysis designations), has been important to many securities firms in their recruitment of investment analysts; however, the CFA charter does not in and of itself attract clients, as most advisers who hold the CFA charter have confirmed.[39] Other designations, such as Chartered Financial Consultant (ChFC), Chartered Life Underwriter (CLU), and Personal Financial Specialist (PFS) have likewise failed to win widespread consumer acceptance.

A.10. Broader Application of Fiduciary Standards has Occurred. Fiduciary standards of conduct for those in advisory relationships based upon trust and confidence have long existed under the law. The Investment Advisers Act of 1940 simply resulted in the incorporation of existing common law fiduciary standards of conduct into federal law.[40] As large financial services firms have migrated to provide more

[38] *See Ibanez v. Fl Dep't of Business & Professional Regulation, 512 U.S. 136, 114 S.Ct. 2084, 129 L.Ed.2d 118 (1994)*, in which the U.S. Supreme Court stated: "'Certified Financial Planner' and 'CFP' are well-established, protected federal trademarks that have been described as 'the most recognized designation[s] in the planning field ….'" The U.S. Supreme Court cited Financial Planners: Report of Staff of United States Securities and Exchange Commission to the House Committee on Energy and Commerce's Subcommittee on Telecommunications and Finance 53 (1988), reprinted in Financial Planners and Investment Advisors, Hearing before the Subcommittee on Consumer Affairs of the Senate Committee on Banking, Housing and Urban Affairs, 100th Cong., 2d Sess., 78 (1988).

As stated on Wikipedia.org: "One of the oldest, best-known financial planning certification trademarks is the CERTIFIED FINANCIAL PLANNER certification, which has gained global recognition because of its active standard setting activities and worldwide presence. CFP certification was first introduced in the United States in the early 1970s to meet the need of the consumers. CFP Board, based in Washington, D.C. owns the CFP marks within the United States. The CFP marks are owned outside of the United States by Financial Planning Standards Board …."

As stated by the CFP Board of Standards itself: "Why has the CERTIFIED FINANCIAL PLANNER™ certification become so sought after by consumers and the financial planners who serve them? The answer is simple. The public is looking for a planner who has demonstrated a commitment to competency, and financial professionals want an established certification that sets them apart in a globally expanding financial planning profession. CFP Board research shows consumers increasingly rely on credentials when selecting a financial adviser."

[39] Cynthia Harrington, Icing the Cake, Bloomberg Wealth Manager.

[40] As stated by the U.S. Supreme Court: "Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries … Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes." *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

The Congress has continuously incorporated the common law of fiduciary duty into numerous federal statutes by simply using the words "fiduciary duty"- *see, e.g.,* §36(b), Investment Company Act, and ERISA. The Supreme Court has repeatedly held that "where Congress uses terms that have settled meaning under common law ... Congress means to incorporate the established meanings of these terms." *NLRB v. Amax Coal Co*., 53 U.S. 322, 101 S.Ct. 2789, 69 L.Ed.2d 672 (U.S.1981) (adopting *Meinhard's* fiduciary standard).

The existence of a "federal fiduciary standard" under the Investment Advisers Act of 1940 does not mean that deference is not provided to the scope of fiduciary duties as they exist under state common law. *See U.S. v. Brennan*, 938 F.Supp. 1111 (E.D.N.Y., 1996) ("Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law. *See, e.g., Varity v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996); *F.D.I.C. v. Wright*, 87 B.R. 1011 (D.S.D. 1988) (bankruptcy).") *Id*. at 1119.

comprehensive and/or ongoing services to individual clients, their activities have increasingly been held to be subject to a fiduciary standard of conduct under a "best interests" standard – either through the application of the Advisers Act or state common law.[41] Moreover, the emergence of ERISA[42] in 1974 and the application of its "sole interests" standard[43] have further complicated the legal environment for

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[41] Under state common law, fiduciary status arises from those relationships which, on their particular facts, are appropriately categorized as fiduciary in nature. A variety of circumstances may indicate that a fiduciary relationship exists, as opposed to an arms-length relationship. Such circumstances, or indicia or evidential factors, include influence, placement of trust, vulnerability or dependency, substantial disparity in knowledge, the ability to exert influence, and placement of confidence. Another factor may lie in the ability of the fiduciary, by virtue of his or her position or authority, to derive profits at the expense of his or her client.

The development of the branch of fiduciary relationships arising out of relationships based on trust and confidence accelerated during the 20th Century and continues today, in response to the increased complexity of our modern world. Increased amounts of specialization are required in modern society, and this in turn leads to greater reliance on others in order to obtain greater affluence. As stated by Professor Frankel, "Courts, legislatures, and administrative agencies increasingly draw on fiduciary law to answer problems caused by these social changes." Tamar Frankel, *Fiduciary Law,* 71 Calif. L. Rev. 795, 796 (1983).

Many state courts, applying state common law to relationships based upon trust and confidence, have held that the relationship is or may constitute a fiduciary relationship between the financial advisor and/or investment adviser and the client. *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007) ("Obviously, when a person such as Hutton is acting as a financial advisor, that role extends well beyond a simple arms'-length business transaction. An unsophisticated investor is necessarily entrusting his funds to one who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his investor/entrustor. The relationship goes well beyond a traditional arms'-length business transaction that provides 'mutual benefit' for both parties."). *See also U.S. v. Williams*, 441 F.3d 716, 724 (9th Cir. 2006); *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 4430 (NY 6/2/2005) (NY, 2005); *Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 2005); *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385, 414 (S.D.N.Y., 2005) (the customer "relied upon superior knowledge. Asset Alliance allegedly was plaintiff's investment advisor and committed to 'monitor the status and performance of [Beacon Hill and Bristol] at least once a month and [to] promptly inform Sanpaolo if, for any reason, it believes that [Beacon Hill or Bristol] should be de-selected.' These allegations are sufficient to plead a fiduciary relationship."); *Mathias v. Rosser*, 2002 OH 2531 (OHCA, 2002) ("[T]he evidence established that Rosser was a licensed stockbroker and held himself out as a financial advisor, and that plaintiff was an unsophisticated investor who sought investment advice from Rosser precisely because of his alleged expertise as a broker and investment advisor. Further, Rosser testified that plaintiff had relied upon his experience, knowledge, and expertise in seeking his advice. Therefore, we conclude that plaintiff presented sufficient evidence to establish that she and Rosser were in a fiduciary relationship."); *Cunningham vs. PLI Life Insurance Company*, 42 F.Supp.2d 872 (1990); *MidAmerica Federal Savings and Loan Ass'n v. Shearson / American Express Inc.*, 886 F.2d 1249 (10th Cir. 1989) (The court found a fiduciary relationship under Oklahoma law between a broker and his client in circumstances where the broker held himself out as having superior knowledge and expertise and the client reasonably placed his confidence in the broker.); *Koehler v. Pulvers,* 614 F. Supp. 829 (USDC, Cal, 1985).

It should be noted that neither federal nor state securities laws generally preempt common law claims based upon breach of fiduciary duty (except under special circumstances, such as ERISA accounts and under SLUSA). This is because the securities statutes were modeled after the common law actions of fraud and deceit. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-215, 96 S.Ct. 1375, 1381-1391, 47 L.Ed.2d 668 (1976) (review of legislative history); *see also* Securities Regulation, 69 Am.Jur.2d Sec. 1 *et seq.*

It should be noted that all agents, including brokers and investment advisers, are, by definition, fiduciaries under common law. However, the scope of those fiduciary duties (care, loyalty, good faith and disclosure) dependent on the powers and responsibilities assumed. For example, a broker-dealer firm accepts responsibility as an "agent" of the customer for the proper execution of the brokerage transaction. In connection with the scope of that agency, the broker-dealer and its RRs owe "limited fiduciary duties" or "quasi-fiduciary duties" to the customer.

[42] Employee Retirement Income Security Act of 1974 (ERISA) (Pub.L. 93-406, 88 Stat. 829, enacted September 2, 1974).

[43] ERISA imposes a duty to prudently manage the retirement fund's assets for the sole and exclusive interest of the participants and beneficiaries, as set forth in Section 404(a) of ERISA, 29 U.S.C. §1104(a). ERISA's stricter application of the fiduciary standard was summarized by Professor Laby: "ERISA contains many nonnegotiable provisions, which demonstrate the mandatory nature of that particular legislative scheme. ERISA's exclusive benefit rule provides that an ERISA fiduciary shall discharge his duties 'solely in the interest' of plan participants and for the 'exclusive purpose' of

financial services firms who seek to avoid any application of the broad fiduciary duties of due care, loyalty, and utmost good faith. Currently, many financial advisors (and their firms), regardless of size, accept fiduciary responsibility for ERISA-covered plans – yet often without possessing the necessary expertise, resources, and controls over risk arising from the application of ERISA's stricter fiduciary standards.[44]

A.11. Increased Regulation of Financial Planning is Likely to Occur. In recent years, financial planners have submitted to "voluntary regulation" under the auspices of several industry organizations, including the CFP Board of Standards, Inc., the Financial Planning Association, and the National Association of Personal Financial Advisors, each of which requires adherence to certain ethical and/or practice standards.

> "If men were angels, no government would be necessary."
> *James Madison*

The SEC has wrestled with the application of the Advisers Act to financial planning activities, and its various rulings and pronouncements on this issue have been diverse and often contradictory. Currently in Congress, there exists strong opposition to application of the Advisers Act to financial planning activities. Proposals to permit the proposed new Consumer Financial Planning Agency to regulate aspects of financial planning have likewise met industry opposition.

In the author's view, such opposition is problematic for financial services firms. Barring the adoption of express federal preemption, which is highly unlikely in the current legislative environment, efforts in Washington to prevent the regulation of financial planning by either the SEC or the CFPA, it is highly likely that the states will move to adopt regulation of financial planning activities – regardless of how the financial planner is otherwise regulated over overseen.

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providing them with benefits. Another provision clarifies that plan assets 'shall never inure' to the employer. ERISA departs from the common law of trusts by voiding any provision purporting to 'relieve a fiduciary from responsibility or liability.'" Laby, Arthur B., The Fiduciary Obligation as the Adoption of Ends. Buffalo Law Review, Vol. 56, No. 1, 2008. Available at SSRN: http://ssrn.com/abstract=1124722. The effect of the Pension Protection Act of 2006's amendments to ERISA, as it pertains to the provision of investment advice, remain the subject of Department of Labor rulemaking (*see http://www.dol.gov/federalregister/HtmlDisplay.aspx?DocId=23318&AgencyId=8&DocumentType=2*, withdrawing Jan. 21, 2009 "Final Rule" designed to implement an exemption to ERISA's prohibited transaction rules). According to the EBSA, the agency received a number of comments that raised concerns about the potential for investment adviser self-dealing as a result of these provisions. EBSA noted comments which claimed that the rule does not contain strong enough safeguards to protect the interests of plan participants and beneficiaries from potential conflicts of interest. The EBSA concluded that given these and other legal and policy concerns raised, the Department is justified in withdrawing its final rule, and intends to propose new regulations on the statutory prohibited transaction exemption under ERISA shortly. ERISA's fiduciary standards are also likely to see further modification by Act of Congress; currently under consideration by the House Ways and Means Committee is The 401(k) Fair Disclosure and Pension Security Act of 2009 (H.R. 2989), which combines provisions of two other bills that were approved by the House Education and Labor's Subcommittee on Health, Employment, Pensions and Labor on June 17, 2009: the 401(k) Fair Disclosure for Retirement Security Act (H.R. 1984) sponsored by Rep. George Miller (D-CA), and the Conflicted Advice Prohibition Act (H.R. 1988) sponsored by Rep. Robert Andrews (D-NJ).

[44] Center for Due Diligence, Evaluating ERISA Plan Advisors, Part 1 (Nov. 10, 2009), stating that: "ERISA fiduciary standards, the highest standards known to law, are already higher than all existing and proposed standards applicable to the BD community" and also noting that: "As the retirement plans component of their business grows, advisors are forced to evaluate the structure of their practice. They must also determine the type of entity that allows them to provide competitive services that are in the best interest of their clients. This step requires advisors to evaluate the pros and cons of Broker/Dealer association, establishing their own Registered Investment Advisor (RIA) or joining an independent firm." http://thecfdd.com/files/insights/EvaluatingERISAPlanAdv.pdf.

A.12. Smaller Firms Often Lack Resources Needed to Compete. Smaller financial advisory firms are often successful due to the sheer personality of their advisors, and their ability to build relationships based upon trust and confidence. Despite this, small RIA firms, in particular, have been challenged by ever-increasing compliance burdens, such as the required annual risk assessment and compliance review. Increased focus by securities regulators at both the federal and state levels will likely occur on the methods and analysis utilized to conduct due diligence. Developments in technology have led to better opportunities to provide services to clients, yet acquisition of many technologies in a cost-affordable manner may require certain economies of scale. As independent investment advisory firms move from small ensembles to larger firm environments, increased resources are required to address advisor training, recruitment, and brand identification. Some smaller RIA firms have met these challenges through informal or formal alliances with other firms, through outsourcing of certain back office functions, and through building advisory teams. Yet most registered investment advisers remain unable to secure, for their clients, the benefits which could be provided through the resources of a larger financial services firm, as will be explored in the next section.

> **"Every institution is called upon to renew or reform itself. Without that it becomes either irrelevant or an impediment. Constructive changes in an institution must come thoughtfully and deliberately and with awareness of consequences."**
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> - SEC Commissioner Richard B. Smith, Remarks Before the 23rd National Conference of the American Society of Corporate Secretaries, Inc., June 1969

B. WHAT LARGE FINANCIAL SERVICES FIRMS CAN DO TO PROSPER: FIDUCIARY TRANSFORMATION.

B.1. Regardless of Congressional Action, Will Continue. While many in the broker-dealer lobby view RIA firm support of fiduciary standards of conduct (generally, and as to their application to the advisory activities of broker-dealers) as self-serving, in reality the reverse is true. Efforts by SIFMA and its member firms to curtail the application of fiduciary standards to the investment advisory and financial planning activities of broker-dealer firms may well prove successful in Congress (and subsequently at the SEC). However, if SIFMA is successful, then nearly every independent registered investment adviser will silently breathe a sigh of relief. Indeed, it is in the self-interest of RIA firms that they don't face robust competition in the delivery of objective investment and financial planning advice.[45] Currently broker-dealer firms are not viewed as the primary competition by RIA firm leadership, and instead are viewed as a tremendous source of potential clients.

Moreover, and regardless of the outcome of pending legislation in Congress, it is highly likely that *bona fide* fiduciary standards of conduct will be applied to investment advisory and financial planning activities. This may occur through the application of existing state common law fiduciary standards - unless expressly preempted by federal legislation, which appears unlikely. Additionally, efforts which have slowed down the regulation of financial planning at the federal level will likely lead to increased regulation of financial planning by the states, over time, especially if Congress and/or the SEC adopt the view that the Advisors Act does not apply to financial planning activities.

In essence, disintermediation in financial services, and Re-intermediation through the increased utilization of registered investment advisers, may be slowed by future legislative and/or regulatory action. However,

[45] One might call into question the lobbying efforts of the IAA, CFP Board, FPA, and NAPFA, among others, to preserve the existing fiduciary standard of conduct found in the Advisers Act and apply this standard to the activities of broker-dealer firms, when their members might be adversely affected through renewed competition. Many members of these organizations are somewhat altruistic, in that they view the provision of investment and financial planning advice under a bona fide fiduciary standard of conduct as good for both Americans and the economic future of America itself. Yet other members recognize that should financial planning rise to the level of a true profession, under the guise of a professional regulatory organization (such as that seen for attorneys), the fiduciary standard of conduct will be preserved and peer review made possible to better enforce fiduciary standards. Additionally, once financial planning is always provided under a non-waivable bona fide fiduciary standard of conduct, with objective and competent financial advice being its hallmarks, consumer demand for financial planning services will continue to rise. Professions are self-regulated by the professionals themselves and not subject to oversight by commercial interests (which are often not aligned fully with the necessity of appropriate fiduciary standards, and hence would seek to weaken them). Professional regulation has, historically, led to preservation and enhancement of standards of conduct over time, as professionals recognize that high standards increase demand for professional services and raise the status of the profession, generally.

in the end, the "fiduciary transformation" of the retail securities industry can only be slowed, not stopped. Over time, and often spurred on by market declines and/or adverse news affecting broker dealer firm reputations, registered representatives (especially the more successful ones) will continue to migrate over to the registered investment adviser business model (especially so in moving to firms in which conflicts of interest are substantially removed). The traditional product-sales-driven business model will continue to lose market share to the fiduciary advisor business model.

The brokerage model will never disappear completely, nor should it; if consumers desire to work with a product salesperson, in an arms-length relationship (which is clearly denoted to not be an advisory relationship, and no advisory services are rendered), then such consumers should possess such choice. But the financial press, as well as consumers themselves, will continue to refer to, and seek out, objective advice.

B.2. Realize that Fiduciary Culture Begins at the Top. The embrace of a *bona fide* fiduciary standard of conduct, if it is to be successfully implemented, begins at the highest echelons of the financial services firm – its CEO, executive team, and even its Board of Directors. It must be recognized that a fiduciary culture, once adopted by top leadership, then must permeate each and every decision affecting the firm – its organization at every level, its mission statement, each existing and new client services offering, and indeed each and every operational aspect of the financial services firm.

B.3. Achieve a Thorough Understanding of the Fiduciary Principle. One cannot embrace what one does not understand. Contrary to the assertions by many in the securities industry – lobbyists and securities law attorneys – fiduciary duties incorporate the duty of disclosure, but undertaking disclosure is but one aspect of compliance with the fiduciary standard of conduct. Disclosure must be affirmatively undertaken of all material facts in a manner which achieves client understanding, and which leads to the informed consent of the client. Even then, any proposed transaction must be fair and reasonable to the client. Moreover, informed consent is doubtful if the client is being asked to consent to a transaction which would cause the client harm and provide a pecuniary benefit for the advisor, for it is the rare client that undertakes a gratuitous transfer to his or her advisory firm.

A concise statement of the fiduciary duties of investment advisers, based on observations culled from reported cases and decisions, was recently published in Advisor Perspectives.[46]

A more detailed outline which summarizes the fiduciary duties of investment advisers and financial planners can be found in the author's outline, *Understanding the Fiduciary Standard of Conduct for Investment Advisers and Financial Planners: A Summary of Key Principles*, included as the Attachment to this outline.

Acting in a fiduciary capacity means realizing that certain business practices should be avoided. The greater the conflicts of interest between the financial services firm and the client, in either quantity or quality or both, the greater the erosion of trust and confidence between the firm and its client. At some point, the presence of substantial or numerous conflicts of interest may well make it impossible to maintain a fiduciary relationship. Additionally, the presence of substantial conflicts of interest increases the probability of taking undue advantage of the client by advisors of the firm, creating increased potential for litigation and risk to the firm's reputation.

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[46] Ron A. Rhoades, JD, CFP®, I Am A Fiduciary Advisor, Advisor Perspectives, November 3, 2009, available at http://www.advisorperspectives.com/newsletters09/pdfs/I_am_a_Fiduciary_Financial_Advisor.pdf.

B.4. Focus on the Client Service Relationship. The embrace of the fiduciary principle, and its effective implementation and permeation at every level of an organization, results in a client-centric financial services firm. The phrase "client-centric" should not be merely that – a statement of what is desired to occur. Rather, each and every client service offering must be examined from the point of view of both an unsophisticated client and that of an educated, thoroughly knowledgeable client. Questions which might be asked of the firms' service offerings include:

- Is each service provided needed and desired by the client, and helpful in securing a client's financial future?
- Are there financial planning services which are not being provided, but which most clients would desire as part of the service offering if they knew such services were possible?
- Are there other parts of the client service offering which, although perhaps desired by the client, fail to result in substantially adding to the value of the services and advice received by the client?
- Are the points of contact planned each year, for each type of client service offering, sufficient to maintain a relationship of trust and confidence between the advisor(s) and client?
- Is the education of the client sufficient so as to better ensure that the client "sticks with the plan" through both up and down markets?[47]
- Is the client service offering customizable to reflect the varying degrees of sophistication and client understanding by the client?[48]

B.5. Increase Due Diligence: Investment Strategies Should Pass Examination Under *Daubert/Frye* Expert Examination Standards. General fiduciary principles impose the obligation on an investment adviser to exercise due care in the development of the investment strategy and in the selection of specific investment products (or managers) for her or his client. In Exhibit A hereto, the application of the *Daubert* and *Frye* standards (as to the admissibility of certain expert testimony in federal or state courts) is discussed as the appropriate standard under which an investment strategy is tested.

However, fiduciary law does not prohibit the utilization of novel or untested investment strategies, nor those based wholly upon qualitative judgment and therefore not susceptible to back-testing or confirmation by academic research. However, in such situations, the inherently speculative nature of such novel or untested investment strategies must be clearly and affirmatively disclosed to the client, along with any special or unique risks which may be present, as well as other appropriate disclosures.

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[47] There are many elements of a fiduciary financial planner's value proposition. However, if a client departs from the financial services firm during a down market, and flees the stock market, this will largely negate the value added through risk reduction strategies, tax-efficient portfolio management, cost-efficiencies achieved through investment product due diligence, application of academic research to investment strategy design, orienting investment and financial decisions toward the focused identification and achievement of a client's lifetime financial goals, etc. During the late 2008 through early 2009 stock market decline, the author's firm lost very few clients (far less than 5% of total clients and/or total AUM), but each loss of a client – especially since those clients often fled the equity markets – was viewed as a personal failure to properly educate instill within those client the discipline required for long-term investment success.

[48] It is common for financial planners / investment advisers to spend less time with clients who demand less. Often this is counter-productive, and can result in increased risk to the financial services firm. Applying the fiduciary duty of disclosure of material facts, coupled with the need to ensure client understanding, it is imperative that greater time be spent in educating the less sophisticated client as to the investment strategies utilized and various aspects of their implementation. The natural tendency of individual financial advisors to spend less time with clients who demand less explanation must be effectively countered through firm service standards, required documentation of client communications, and compliance oversight.

Additionally, firms which adopt a fiduciary culture will not promote investment strategies merely because they possess "sex appeal" and are likely to lead to a greater number of clients and/or greater level of managed assets. Investment strategy review, testing, and selection should be driven by investment research and compliance dictates, not the marketing arm of a financial services firm which seeks to act in its clients' best interests at all time.

B.6. Investment Product Due Diligence. There are a large variety of investment products. Each type of investment product requires its own due diligence methodology. Investment product due diligence should "lift the hood" to more closely examine all of the attributes and characteristics of the investment product, as well as compliance by the investment managers with their own fiduciary duties and applicable laws and regulation.

Given the expertise required, centralized due diligence on investment product selection is likely to be a necessity in each and every financial services firm.

What investment strategies would I offer, in a financial services firm? I would begin with four core strategies which might be suitable for the vast majority of the clients of a fiduciary firm:

1) Strategic asset allocation, utilizing mutual funds from Dimensional Funds Advisors.
2) Tactical asset allocation, employing exchange-traded funds, and based upon relative valuations of various asset classes (taking into account, with respect to international stocks, fluctuations in currency exchange rates). Any tactical asset allocation strategies adopted should be back-tested, with adequate safeguards against data mining, in order to confirm a high degree of success for the proposed strategy. Note, however, that the use of such strategies in taxable accounts would be disfavored, as they would likely result in realization of capital gains, both short-term and long-term, over time.
3) Strategic asset allocation with ETFs, together with the selective use of options to hedge against short-term (2 years or less) stock market downturns. This type of strategy has its inherent costs, and limits to upside potential, but also possesses substantial protection against major stock market declines. This strategy might be suitable for a client in the decumulation phase of their financial lives, where a high degree of volatility poses greater personal risks.
4) Separate account management stressing tax-efficient investing is a valid strategy for many clients, provided risk reduction is afforded through broad diversification (as a means of eliminating the statistical disadvantage suffered by many 40-stock portfolios – in terms of the likelihood of underperformance of the majority of such portfolios as to their longer-term terminal values). Cost efficiencies can be secured for clients by the large financial services firm through bunching of individual security trades and strategies designed to minimize trading costs. Stressing low portfolio turnover further reduces transaction costs, and may well permit greater tax efficiency.

Additional investment strategies could then be added, based upon proposals received from in-house or outside strategists. Each strategy recommended would be submitted to the rigors of back-testing (if possible) and due diligence examination to ascertain any unique risks, hidden costs, etc.

B.7. Adopt Level Compensation Methodologies. Contrary to belief by some, the fiduciary standard of conduct does not compel fee-only (AUM, flat fee, and/or hourly fee-based) compensation. Commission-based compensation is perfectly acceptable, and may be more appropriate for certain service offerings (such as involving the laddering of a municipal bond portfolio). The problem with any method of compensation is when it may vary based upon the recommendations provided to the client. In such instances, the magnifying glass of 20/20 hindsight is often applied (albeit often incorrectly) by a trier of fact in a subsequent dispute, and efforts to justify higher fees for one recommendation, as opposed to another, are extremely vexing.

> Question: Is the use of the term "fee-based" inherently misleading as to individual investors, since more accurately the terminology should be "fee-and-commission based"?

Hence, efforts should exist to eliminate situations leading to variable compensation where possible.

All those providing investment advice possess conflicts of interest resulting from possible variable compensation. These should be identified, affirmatively disclosed, and properly managed. For example, the author's fee-only RIA firm's Form ADV, Part II possesses the following disclosures of potential conflicts of interest which may result in the firm's level of compensation varying:

> *Proper Management of Conflicts of Interest Relating to the Fees We Receive from You.* The vast majority of our clients pay Joseph fees based upon a percentage of the assets we advise upon. This is a very common form of compensation for registered investment advisory firms and avoids the multiple inherent conflicts of interest associated with commission-based compensation (does not accept commission-based compensation of any nature, nor does Joseph accept 12b-1 fees). Asset-advised-upon percentage method of compensation can still at times lead to conflicts of interest between our firm and our client as to the advice we provide. For example, conflicts of interest may arise relating to the following financial decisions in life: incur or pay down debt; gift funds to charities or to individuals; purchases of a (larger) home or cars or other non-investment assets; the purchase of a lifetime immediate annuity; expenditures of funds for travel or other activities; investment in private equity investments (private real estate ventures, closely held businesses, etc.), and the amount of funds to place in non-managed cash reserve accounts. We have adopted internal policies to properly manage these and other potential conflicts of interest. Our goal is that our advice to you remains at all times in your best interests, disregarding any impact of the decision to be undertaken upon our firm.

Do all investment advisers have a similar form of disclosure in their Form ADV, Part II? Moreover, to ensure client understanding, do they discuss the conflict of interest with the client, when it arises in a specific context? Is that discussion documented in notes to the file by the advisor?

B.8. Portfolio and Other Reports: Clients Expect More. In addition to forthcoming law requiring the tracking of cost basis by custodians, clients expect more in this age of technology. Forward-thinking financial services firms will realize that client access to their portfolio information – when desired, in the format desired, and providing all of the information desired – is essential. Customization of reporting capabilities is essential, especially since many clients react favorably to charts and graphs, while others prefer the detail provided in tabular formulations of data. Reporting capabilities might include:

(1) Online availability at all times, including real-time market valuation.

(2) Performance reports with up-to-date assessments, provided each day following.

(3) Realized gains and losses, year-to-date, in taxable accounts.

(4) Unrealized gains and losses, year-to-date, in all accounts.

(5) Consolidated reporting, including assets held at other custodians.

(6) Portfolio rebalancing reports.

(7) Non-financial asset listings, such as the client's primary residence, closely held business interests, etc., and real-time updated listings of liabilities.

(8) Copies of key documents available in a secure online data vault, including beneficiary designations on accounts, investment policy statements, historical reports and/or analysis, tax returns, estate planning documents – with certain of these documents available to the client's other professional advisors as permitted by the client.

The application of technology to reporting capabilities is essential, as is the focused design of client reports with the aid of expert form designers and focus groups.

Advisors should be trained in how to present report options to clients, and in aiding clients to select the package of reports they desire to receive, in the manner they chose to receive it, and at the times they desire to receive same (or access same).

B.9. Understand that Financial Planning and Investments are Inextricably Linked.

People want and need financial advice. In essence, they desire a "financial coach," especially when major financial decisions are present. Such decisions are often about investments, or may impact the client's investment policy. And, increasingly, investment decisions possess ramifications in many aspects of planning.

For example, take the purchase of a variable annuity which invests in stock fund subaccounts for a client who is 60 years of age. This decision certainly affects the client's other investments, as the stock fund subaccounts may be taken into account in terms of viewing the client's entire portfolio. If the variable annuity provides a guarantee of value upon its annuitization (during the lifetime of the client), this may reduce the risks of volatility for the client, which in turn may lead to a change in the client's asset allocation / investment policy. The deferral of income inside the annuity provides the benefits inherent with tax-deferred income – avoidance of current taxation leading to greater funds to invest in succeeding years. The tax-deferred income might be utilized at a time when the client has major health care expenses (such as those resulting from the need for custodial care). However, withdrawals in later years may occur when the client is either in a lower or a higher marginal income tax bracket, with respect to ordinary income. Still, marginal tax rates may be much higher on the accumulated income since long-term capital gain treatment (and, for 2010, qualified dividend income treatment) are foregone, as are foreign tax credits if the subaccount invests in foreign stock funds.

> The "two hats" special rule, under which the SEC proposed (in Sept. 2007) that a brokerage account and an investment advisory account could be maintained for the same client, at the same time - in essence permitting "two hats" and "switching of hats" – is based upon an interpretation by the SEC of the phrase "solely incidental" (in defining the extent of the broker-dealer exclusion) which challenges the inherent truth that "words have meaning."
>
> Should the Advisers Act not be amended by Congress, and if the "Special Rule" is finalized by the SEC, look for a judicial challenge to the "two hats" rule.
>
> Under fiduciary law, fiduciary status applies to the entirety of the relationship between the advisor and the client. Moreover, fiduciary duties are "sticky" – they cannot be easily cast off.

While the variable annuity's beneficiary designation may result in probate avoidance, non-careful preparation of the beneficiary designation may result in unintended heirs receiving funds. In addition, certain individual heirs and irrevocable trusts named as beneficiary may end up paying higher combined federal / state / local marginal tax rates than the annuitant / owner would have paid; rarely is deferral of income taxes into the future, to pay taxes at a higher tax rate, a good thing. If the client is charitably inclined, naming a qualified charity as a beneficiary of the variable annuity may secure greater growth over the long term, as to end-of-lifetime bequests, while preserving access to the annuity's funds in case of a lifetime need.

The presence of the variable annuity may alter the tax diversification strategy of the overall portfolio as well, including when withdrawals should be timed from both qualified and non-qualified accounts so as to minimize the taxation of social security retirement benefits, avoid paying higher Medicare Part B premiums, or avoid higher marginal tax rates. In some states, variable annuities possess protection from claims of general creditors. These and many other considerations may come into play in determining whether a variable annuity is a proper choice for a client, from the standpoint of investor-specific due diligence, as well as general investment product due diligence.

Clients both want and desire an advisor who views all of the planning and investment needs holistically. Investment decisions usually interrelate with financial, tax, estate, and risk management planning for a client. In addition, since any investment decision will no doubt refer back to, or at least reflect, the financial plan (formal or informal, comprehensive or modular) of the client, it is extremely difficult to view financial planning as distinct from investment advice.

B.11. Lobby for the Redesign of 12b-1 Fees (Or - The Next Scandal?) .

One of the most contentious issues facing the SEC currently is that of 12b-1 fees. The SEC has indicated that it will address 12b-1 "reform" in some fashion in the future, but little hint has occurred as to how this may unfold.

In reality, in many contexts, 12b-1 fees are investment advisory fees "in drag." They are utilized to compensate registered representatives and their broker-dealer firms for services of an investment advisory nature.[49] If 12b-1 fees remain, absent Congressional legislation in the near term look for a judicial challenge to the use of 12b-1 fees to pay for advisory services. Dual registration (RIA/BD) would solve the issue of improper use of 12b-1 fees, provided every registered representative who is compensated by means of 12b-1 fee payments is registered as an investment adviser representative. Any conflicts of interest arising from the dual registrant's receipt of 12b-1 fees would be solved by crediting any and all 12b-1 fees received against the advisory fees charged to the client.

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[49] The anti-fraud provision of the Advisers Act, 15 U.S.C. § 80b–6, Prohibited transactions by investment advisers, which forms the basis on which fiduciary duties have been applied to investment advisers, states: "It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, *directly or indirectly*—…." (*Emphasis added.*) Broker-dealers who receive "special compensation" - generally, anything other than a commission at the time of a product sale or upon the deposit of funds into the product, appear to fall outside of the broker-dealer exclusion from the Advisers Act. *See Philadelphia Suburban Water Co. v. Pennsylvania Public Utility Commission*, 2002 PA 3603 (PACW, 2002) ("'Indirectly' signifies the doing by an obscure circuitous method something which is prohibited from being done directly, and includes all methods of doing the things prohibited except the direct one. *Farmers' State Bank v. Mincher* (Tex. Civ. App.) 267 S.W. 996. *State v. Pielsticker*, 225 N.W. 51, 52 (Neb. 1929). In *Amicable Life Insurance Co. v. O'Reilly*, 97 S.W. 2d 246, 249 (Tex. Civ. App. 1936), the Texas Supreme Court noted that 'indirectly' cannot be treated as surplusage; this word must be given its meaning in the adjudicated case.")

If 12b-1 fees were not used to pay for some aspect of ongoing advice, 12b-1 fees (of the 1% annually variety, at least) – which often never disappear – would result, in many instances, in unreasonable compensation to the broker-dealer firm. In this regard, Class C mutual fund shares may well be the focus of the next "scandal" – with very similar issues existing as were present in the Class B mutual fund sales scandal.

Whatever direction Congress, the SEC, and/or the courts proceed with regard to the complex issues involving the propriety of 12b-1 fees (only a few of which issues have been touched on above), this author would hope that should monumental change occur, that more than adequate time – a few years – is provided to undertake any transition away from 12b-1 fees, should such become necessary. Many dedicated registered representatives have staked their livelihoods on the receipt of 12b-1 fees, believing that such fees more closely aligned their interests with those of their customers; it would be unfair to see their quest for fair treatment of their customers lead to a dismantling, overnight, of their primary source of practice income.

E.12. The Sale of Proprietary Products: Adopt Practices which Minimize the Conflict and Meet the Due Diligence Obligation. The sale of proprietary mutual funds and other proprietary investment products represents one of the greatest challenges, as to reconciling current business practices with fiduciary law.

Pooled investment vehicles, such as mutual funds, provide a means to serve those who do not possess the resources to engage separate account managers, and it affords the individual investor the opportunity to secure diversification benefits at lower costs. The conceptual problem arises in that the placement of an investor's cash into a mutual fund is perceived not just as part and parcel of investment management services provided by the personal financial advisor himself or herself, but rather results in the purchase of an investment product. Due diligence requires a comparative analysis of available investment products.

As a practical matter, conflicts of interest inevitably occur when recommending proprietary funds. Having clients invest in proprietary funds brings a number of not-so-incidental benefits to the investment adviser or its affiliates, including but not limited to securing the critical mass to keep a fund open and/or attract other investors and resulting higher net worth of the parent company as more assets under management are secured in the funds themselves. While often all of the management fee paid by a fund shareholder to the fund's investment adviser is credited back against investment advisory fees (at least in the fiduciary bank trust department environment), many other forms of compensation may result. For example, it appears that many proprietary mutual funds possess higher administrative costs than many of their peers; administrative fees often result in payments to other affiliates, and are seldom credited against investment advisory fees paid. Affiliated funds may also pay soft dollar compensation and other brokerage commissions to affiliate broker-dealers.

In the face of such conflicts of interest, how can investment advisers properly manage the conflicts? The first way would be to structure the fund's operations in such a fashion as to minimize any and all payments to affiliated service providers and/or affiliated broker-dealers. Additionally, due diligence must be undertaken by the investment adviser which demonstrates no harm to the investor is likely to result from the investment in a proprietary product, as opposed to a similar non-proprietary product. Given the fact that, at least with respect to active management strategies, it can take several decades to demonstrate the success of the fund manager is due to skill as opposed to statistical aberration, this can be a very high hurdle. Yet the burden of proof of adequate due diligence falls on the investment adviser when disputes

arise over the validity of the advice provided. It is highly unlikely that a common practice used by bank trust departments – that of selecting only those proprietary funds for clients which outperformed over the near term the other (non-proprietary) funds available – will survive attack by expert testimony. Much more due diligence is required other than just looking at historical short-term performance.

E.13. Principal Trades: Set Up a Secure Chinese Wall.

If the large financial services firm feels compelled to act as a dealer and sell to or purchase from investment advisory clients, realize the difficulties that result. Every decision the dealer makes to sell out of its own portfolio is accompanied at the same time by a recommendation of the same firm to the client to purchase the very same security. Since a fiduciary must undertake disclosure of all material facts, this includes the reason the firm has chosen to sell, the profit the firm will have made from the transaction, and the lack of any better alternative for the client. As to the latter requirement, given the very large bid-ask spreads typically seen, even over the course of one business day, in corporate and municipal bonds (even those which are among the most actively traded), ensuring that the client is not harmed by the principal transaction becomes problematic.

Moreover, the undertaking of principal trading creates the risk of rogue decision-makers in the large financial services firm. Compensation incentives are based upon trader's profitability, and a firm's trader (out of, or into, its own inventory) may choose not to reveal all material facts to the firm's retail advisors (and their clients) – such as when they quickly dump securities in expectation of adverse news (or worse, following the receipt of news or conclusion of analyses).

Are the risks to the financial services firm from principal trading practices worth the profit that results? Are these risks worth the erosion of client trust which necessarily results from this major conflict of interest?

One solution which could, and this author would argue should, be adopted is to undertake a Chinese wall in the financial services firm between the investment adviser client trading desk and the dealer's trading desk. The investment adviser trading desk would be shown what issues were available at any time, but would not know whether the trade would occur on an agency or principal basis.

A better solution is to utilize the aggregate purchasing power which a large financial services firm would possess to secure improvement in execution (price improvement) on behalf of its investment advisory clients. Aggregating orders into million-dollar bond purchases will substantially lower the transaction costs, especially in comparison with bond purchases of less than $100,000 denominations. Smaller registered investment adviser firms simply cannot compete against such a service offering, unless they band together with other firms to establish a joint fixed income trading desk (as some firms have done, but often at considerable cost to the adviser, and/or incremental cost to the clients thereby negating much of the purchasing power advantages otherwise secured).

E.14. Provide Ongoing Continuing Education of Quality and Quantity to Your Financial Planners.

The world changes far too quickly in the world of financial planning, tax planning, risk management planning, estate planning and investments for financial planners to not keep pace through continuing education. Even the sales-oriented financial planner must learn to identify financial planning issues, and be aware of new opportunities which emerge. Larger financial services firms can employ their resources, including both access to technology and access to quality educational content providers, to provide ongoing education to their financial planners.

One idea is for a large financial services firm to mandate 60 or more hours of continuing education each year, for each and every one of its personal financial advisors. Much of this can be accomplished through 1-hour continuing education (CE) conducted, via webinars, nearly each week a year. Attending the sessions could be made mandatory, with webinars posted and made available online for a period of time for "make-up" sessions.

While webinars leverage technology and enable the cost-efficient delivery of CE, nothing re-energizes most advisors than providing for their attendance at a seminar. The remaining 12-16 hours of CE could be provided through a 2-day gathering of the firm's financial planners, either nationally or regionally. Emphasis of such a gathering could focus on client relationship building, marketing, and client counseling skills. Motivational speakers could be brought in. Reinvigorate your sales force, each and every year (if not more often), and ensure that they understand and remain motivated by the firm's mission.

The requirement of such education – twice the hours required each year to maintain the CFP® certification – could be a real marketing advantage for the firm's advisors. Each quarter a different focus of the CE could be undertaken (interspersed with other topics), so as to provide a Certificate of Completion for the advisor – to add to the advisor's C.V. and further aide in credibility enhancement.

E.15. Centralize Financial Planning and Portfolio Management. Realize that, even with a CFP® credential in hand, your "Business Developers" (*i.e.*, top sales force) are unlikely to possess all the knowledge that their clients require. In addition, there will be others hired by the firm who possess relationship management skills, along with technical expertise, but who are not very good in developing new business.

The solution is not to make persons into which they are not; this causes undue stress on team members over time and is likely to lead to substantial attrition. Rather, fit the position to the person's capacities and interests. For example, some experienced financial planners will possess all of the skills required – technical knowledge and ability, as well as the ability to secure new clients. Those individuals may operate with a minimum of support (but, nevertheless, oversight). Even then, persons performing two roles may be counseled as to which role is likely to be more profitable for them, personally, over the long term.

More likely, the best "business developers" will lack the technical expertise, and desire / aptitude, to prepare financial plans and render financial planning and/or investment advice with a high degree of skill and knowledge. Teaming such business developers with a support team can enable all to blossom, especially if the team is structured so as to enable the business developer to hand off client relationships over time to other team members (while retaining rewards from securing such business), in order that the business developer can go after new clients.

For quality control purposes, consideration should be given to centralization of financial planning functions in the firm – or at least centralize the oversight of the "technical" team members. Business developers, while they may "lead" a team, will seldom possess the ability to adequately supervise the technical staff. Adequate compliance procedures, and routine oversight of the financial advice which is provided, can better ensure that the quality of the advice lives up to the high standards which the firm should adopt (and, in so doing, lessen liability risks).

Portfolio management, even in terms of watching for certain deviations from strategic asset allocation targets, can be aided through the application of technology. Tax-savvy trading staff should be employed,

and trained, in how to best reduce the long-term tax drag resulting from trading decisions, client cash requirements, and the deployment of cash inflows. Model portfolios can be utilized to provide standardized investment policies to fit a particular client's risk attributes. However, practices to discourage include the employment of model portfolios on a wholesale basis in a fashion which does not consider the particular ways of minimizing the tax drag on that particular client's tax portfolio returns.

In order to secure an adequate work force as the demand for financial planning services grows, close affiliation should be established with many of the universities which are now churning out the next generation of financial planners.

E.16. Don't Shy Away from Providing Tax Advice to Individual Investors.

Financial planning and investment decisions are often driven by tax concerns. It's not what your clients make, it's what they keep that matters.

Given the vast import of taxes in the net returns of individual investors, arguably it is impossible for a fiduciary financial advisor to disclaim the provision of tax advice in connection with the construction and proper management of a taxable client's investment portfolio. There are limits to the extent a fiduciary can circumscribe his or her duties by seeking to define a more limited "scope of the engagement."

When new clients come to this financial planner's firm from the large financial services firms, virtually every portfolio seen is not structured tax-efficiently. Usually little or no attention is given to correct asset placement, the use of tax-efficient investment vehicles (and the avoidance of tax-inefficient ones), the avoidance of short-term capital gains, and the harvesting of capital losses. Unless all financial planners become better at structuring and managing their clients' portfolios with a view toward long-term tax minimization, then both regulators and plaintiff's attorneys are likely to have a field day.

E.17. Promote Your Firm's *Truly Objective* Advice to the Press. Right now, I – "Small Firm" – have the national press largely in my pocket. While I don't have the marketing dollars the "Large Firms" possess to build and maintain a national brand and to secure ongoing exposure, I don't need it. Each and every week articles appear in the press advising "Big Firm's" brokerage customers to seek out a truly independent advisor – especially those who possess a level of competency indicated by attainment of the CFP® certification.

Firms which adopt a true fiduciary mindset can then advertise the result – adherence to *bona fide* fiduciary standards of conduct – as a powerful marketing tool. More importantly, members of the press, when informed of the path the large financial services firm has taken – will steer clients to that firm's door.

E.18. Increased Liability? As CCO of my firm, the increased potential liability that my firm, and advisors, possess to our clients as a result of our acceptance of fiduciary status, is so far down on my list of concerns that it rarely crosses my mind. The reason is simple – once conflicts of interest are removed, due diligence is undertaken, and care is taken in the provision of financial and investment advice (as well as properly documenting the advice provided), there is very little for clients to complain about.

E.19. Change (Partially) Ownership of the Client Relationship. The forward-thinking financial services firm will realize that both the firm and its advisors contribute to the acquisition of each client and the maintenance of that relationship. Hence, why don't they share in the "ownership" of the client relationship?

While every firm should continue to seek non-solicitation agreements, you may agree in advance with each advisor that should they depart the firm, and should the client follow the advisor, the advisor will compensate the firm by buying out the firm's interest in that client relationship over time. Likewise, if the advisor departs, the firm will assist in selling the advisor's client relationships to another advisor of the firm (to be paid out over time).

Some form of shared ownership of the client relationship will likely dramatically change your financial advisor's perspective of working "for" the large financial services firm, and will fulfill for them the entrepreneurial desires which many of them possess. Yet, many other changes in the structure of the firm and how it provides services to clients will also aid in advisor recruitment and retention efforts:

- Attract and retain advisors by providing a platform they feel comfortable working under – free of the conflicts of interests which cause them distress in dealing with clients.
- Retain advisors through appropriate deferred compensation arrangements, which encourage long-last relationships between the firm and its clients, and the firm and its advisors.
- Attract and retain advisors by offering comprehensive back-office support – portfolio monitoring and trading support team, due diligence on investment strategies and products, compliance, financial plan development and presentment, ongoing financial and tax advice available to respond to ongoing client needs, ongoing education of the advisors, rewards for achievements of additional educational program milestones, etc.
- Attract and retain advisors by establishing a firm business model which is sustainable over the long term; such a business model, designed for affirmative increase in market share, rather than defensively in an effort to preserve market share, will create the excitement and atmosphere which attract more advisors, leading to larger growth of the firm and increased stock values over time.

C. CLOSING THOUGHTS. Smaller RIA firms have experienced significant growth in the number of new clients, even through the recent stock market declines. From the standpoint of many independent, fee-only RIAs, the larger broker-dealer firms today are not seen as the competition, but rather as fertile ground for "easy picking."[50]

Recent months have seen, in large part due to the unhinging of the glue of many deferred compensation arrangements tied to the value of stock in the financial services firms, an exodus of registered representatives from broker-dealer firms. However, other reasons exist for the flight of top sales and relationship manager talent. Many financial advisors flee to the independent BD and/or RIA model because they would prefer to work in an environment which possesses reduced conflicts of interest.

[50] At Joseph Capital Management, LLC, our "competition" consists of: (1) bank trust departments, which tout their fiduciary business model (even though they often fail to execute it well); (2) Vanguard; and (3) other independent RIA firms. We lose very few potential clients to larger BD firms, and we possess a higher closing ratio for prospective clients to our firm when they are presently served by larger BD firms.

Legislation emerging from Congress, and rule-making efforts at the SEC, may fail to embrace a *bona fide* fiduciary standard of conduct for all those who provide investment advice and may even lower the existing fiduciary standard applicable to RIAs. It is likely that Congress will also fail to subject financial planning to regulation at the national level.

Challenges will remain for large financial services firms. This results from the application of broad fiduciary duties under state common law (which are unlikely to be preempted by this Congress). Additionally, the past decade has seen the re-emergence of the states as a bastion of investor protection. Lack of federal regulation of financial planning will likely spur the states to fill the void through state-specific regulatory schemes over the provision of financial advice. While legislative and regulatory efforts may slow down disintermediation, it won't stop the fundamental underlying forces which effect change – the demands of both clients and advisors that a fiduciary business model be adopted.

Paradigm shifts are often difficult to accept. The large financial services firm of today should possess a long-term strategic plan to adapt. Forward thinking leadership will embrace the *bona fide* fiduciary standard of conduct, which will in turn necessitate a re-design of the firm's operational structures and client service offerings. With their significant resources and through efficiencies of scale, those larger financial services firms which react most quickly, and which execute well, in such an endeavor, will prosper. Moreover, this "fiduciary transformation" results in a "win-win-win" scenario:

- A huge "win" for the firm's clients, as they receive better investment and financial planning advice and are far more likely to follow a long-term plan to accomplish their lifetime financial goals;
- A significant "win" for the firm's advisors, who thrive professionally, receive high levels of satisfaction from their relationships with clients built upon trust and confidence, and who are vastly appreciative of the expert support they receive as they build and preserve "their" practices; and
- An enormous "win" for the firm itself, as it grows market share through a more attractive offering to prospective clients, retains clients over the very long term through trusted relationships, and retains advisors by providing an environment for them to both prosper and enjoy their professional lives.

ATTACHMENT:

UNDERSTANDING THE FIDUCIARY STANDARD OF CONDUCT FOR INVESTMENT ADVISERS AND FINANCIAL PLANNERS: A SUMMARY OF KEY PRINCIPLES

by Ron A. Rhoades, JD, CFP®[51]

October 18, 2009, as revised Dec. 1, 2009

In the investment adviser and financial planning communities, there has long existed confusion over what the "fiduciary standard" requires. This confusion has been exacerbated by often-inconsistent rule-making and/or no-action letters by the SEC. Additionally, advocacy efforts from a few organizations have long sought to minimize the fiduciary standard of conduct – either as to its application, the specific requirements resulting from its application, or both. This memorandum explores the "fiduciary standard of conduct" applicable to investment advisers and, by extension, also to financial planners. The purpose of this memorandum is to provide a greater understanding of the fiduciary standard of conduct, as an aide to those involved in policy-making efforts at the federal and/or state levels, by providing a *summary* explanation of the fiduciary standard of conduct as it currently exists under the Advisers Act and state common law. In addition, I provide a copy of a letter signed by seven university professors, expressing concerns regarding language in proposed legislation which could be construed as resulting in a non-fiduciary standard of conduct for investment advisers.

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EX: OCT. 16, 2009 LETTER TO CONGRESS, FROM UNIVERSITY PROFESSORS

[51] The author submits this memorandum *personally* and not on behalf of any organization or firm to which the author may belong or be associated with. Ron may be reached by e-mail at rrhoades@josephcapital.com, or by phone at (352) 746-4460.

INTRODUCTION.

Reasons for the Application of Fiduciary Standards. Why are fiduciary standards of conduct imposed? Why are arms-length relationships not embraced, and why does the law restrain conduct by fiduciaries (and their ability to contract around broad fiduciary duties)? Understanding the *rationale* for imposition of the fiduciary standard of conduct is essential to understanding the fiduciary standard itself. This rationale is summarized in the end notes to the Letter to Congress (found in Exhibit A to this memorandum).

Application of these Concepts to Financial Planners. Since the Advisers Act is based upon state common law, and since either the Advisers Act (depending upon its construction by regulators), state statutes, and/or state common law (or all three) applies the fiduciary standard found in the Advisers Act to personal financial planning activities, this material may be of interest to those interested in the standards to financial planners.

Impact of Organizational Ethics Codes, Etc. Organizational ethics codes and/or codes of conduct may either adopt higher or lower standards. This does not generally modify the requirements imposed by law. Although organizational standards do not create a separate cause of action under fiduciary law, these standards may be utilized, in some instances, as evidence of the proper standard of care in a breach of fiduciary duty action. However, the existence of lower organizational standards are likely to have far less impact upon an investment adviser's or financial planner's fiduciary duties of loyalty and utmost good faith; courts would unlikely accept a lower standard of conduct simply because an association's standards of conduct do not rise to the level required by applicable law.

The Greater Risks Posed To Investment Advisers and Personal Financial Advisors in Today's Regulatory Environment. The past year has seen a substantial erosion of trust in our financial institutions. High-profile Ponzi schemes involving financial services intermediaries both large and small have called into question the capability of the existing regulatory regime for the retail securities industry. Near-term impacts include:

- Embarrassing scandals have led to the typical reaction by regulators - examiners of securities firms have stated that they are more likely to refer violations of an investment adviser's fiduciary duties for enforcement proceedings;
- Disgruntled clients of financial advisors and their attorneys are increasingly successful during arbitration hearings with broker-dealer firms in obtaining the application of fiduciary duties, as they seek to recover losses from often-inappropriate or conflicted investment recommendations; and
- Congress is likely to address, through new legislation, both the control of financial system systemic risks, as well as the diverse, piecemeal regulatory scheme which governs the furnishing of investment products and services to individual Americans.

All of these developments pose regulatory and reputational risks for investment advisers and personal financial advisors as they seek to understand and comply with their fiduciary duties.

A. CONFUSION OVER THE FIDUCIARY STANDARD OF CONDUCT EXISTS. There appears to exist a fundamental lack of agreement over just what the fiduciary standard of conduct actually requires under the Advisers Act. A related issue is what the phrase "best interests" means. The fact that there exists confusion over these points, some seven decades after the enactment of the Advisers Act, is not unexpected, given recent developments.

Over the past two decades, the SEC has, in its rule-making efforts, generally de-emphasized (but not overturned, formally)[52] its prior rulings and various court decisions which applied the Advisers Act and its fiduciary standard of

[52] For example, the SEC's promulgation of the "Temporary Rule" in 2007 with regard to expanded relief from principal trading made no specific mention, in the rule itself or the associated release, of the multitude of very specific requirements imposed on investment advisers when engaged in principal transactions with their clients. An elaboration of these requirements can be found in several decisions, including *Arleen Hughes* (1949), *Geman* (2003).

conduct. The SEC, no doubt under pressure (and many would assert, "regulatory capture" by the broker-dealer, investment banking, and investment company communities), has begun to view the Advisers Act as imposing a "disclosure" requirement, with consent of the client being all that is necessary.

In addition, the standards of conduct provided by various investment adviser / financial planner trade associations may or may not reflect *bona fide* fiduciary standards of conduct, and may not incorporate all of the requirements imposed by fiduciary law.

What matters to the individual investment adviser and financial planner is *what the law requires*, and what actions can be undertaken to ensure compliance with the fiduciary standards of conduct imposed by law.

The SEC's views (even if unclear) as to the nature of fiduciary standard of conduct may be authoritative as to the application of the (federal) Advisers Act, but even these views are capable of being overturned by the courts. And, since the state common law of fraud is not expressly preempted by the Advisers Act (although "implied preemption" may exist in certain compelling circumstances), the state common law application of fiduciary duties to the activities of investment advisers and financial planners must also be considered.

This memorandum seeks to summarize the fiduciary standard of conduct for investment advisers and financial planners, by reference to decisions arising under the Advisers Act, as well as references to some state common law decisions.

B. UNDERSTANDING THE INVESTMENT ADVISERS' ACT FIDUCIARY STANDARD OF CONDUCT, GENERALLY. The fiduciary standard of conduct is a tough standard that should not be diminished merely to accommodate someone's business model.

1. **A "Best Interests" Standard, Generally.** The Advisers' Act fiduciary standard of conduct is generally described as a "best interests" fiduciary standard of conduct. The Advisers Act has always adopted the

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The SEC's proposed "Two Hats" rule (Sept. 2007), based upon strained interpretation of the phrase "solely incidental" in reference to the investment advisory activities of broker-dealers and the application of the broker-dealer exclusion from the Advisors Act's requirements, flies in the face of substantial legal precedent that fiduciary status is applied to the adviser in all aspects of its relationship with the client, not just to specific accounts under a "check-the-box" approach. Many dually registered firms appear to be following this Proposed Rule in their existing business practices – which the author suggests is undertaken at their own peril, given the likelihood that the Proposed Rule, if adopted by the SEC, would be judicially challenged, and given the application of state common law to investment adviser activities.

Moreover, SEC application of the anti-fraud rules (i.e., fiduciary duties) to financial planning activities has been remarkably inconsistent over the years. At first, the SEC held the view that marketing investment advisory services or financial planning services as a means to effect the sale of securities may well violate the anti-fraud provisions of Section 206 of the Advisers Act. *See Elmer D. Robinson*, SEC No-Action Letter (Jan. 6, 1986); *Nathan & Lewis*, SEC No-Action Letter (Apr. 4, 1988). [However, a broker-dealer that employs terms such as "financial planner" merely as a device to induce the sale of securities might violate the antifraud provisions of the Securities Act of 1933 and the Exchange Act. *Cf. In re Haight & Co., Inc*., Securities Exchange Act Release No. 9082 (Feb. 19, 1971) (Broker-dealer defrauded its customers in the offer and sale of securities by holding itself out as a financial planner that would give comprehensive and expert planning advice and choose the best investments for its clients from all available securities, when in fact it was not an expert in planning and made its decisions based on the receipt of commissions and upon its inventory of securities.)]"

However, as noted in FN 153 of the 2005 IA Release (Merrill Lynch Rule), the SEC stated: "Our staff has previously expressed the view that advice provided in connection with financial planning is not solely incidental to brokerage. *See, e.g., Townsend and Associates*, SEC Staff No-Action Letter (Sept. 21, 1994) (advice is not incidental that is provided "as part of an overall financial plan that addresses the financial situation of a customer and formulates a financial plan."). *See also Investment Management & Research, Inc*., SEC Staff No-Action Letter (Jan. 27, 1977). It is also consistent with views expressed in two of the leading treatises on investment advisers. See Thomas P. Lemke & Gerald T. Lins, REGULATION OF INVESTMENT ADVISERS §1:20 (2004); INVESTMENT ADVISER REGULATION, supra note 150 at §2:5:1. It may, however, be inconsistent with statements made in a few of our staff's other letters. See, e.g., *Nathan & Lewis Securities*, SEC Staff No-Action Letter (Mar. 3, 1988) ("Nathan & Lewis No-Action Letter"); *Elmer D. Robinson*, SEC Staff No-Action Letter (Dec. 6, 1985)."

"best interests" standard[53] found in the Investment Advisers Act of 1940, which is a codification of state common law.

2. **Not a "Sole Interests" Standard.** The Advisers Act does NOT impose a "sole interests" standard. Under a "sole interests" standard, any form of self-dealing is essentially prohibited.[54]

3. **The Tri-parte Fiduciary Standard.** We can derive from the case law and reported administrative decisions applicable to investment advisers and financial planners, as well as general principles of fiduciary law, a listing of some of the specific principles or duties arising from the fiduciary standard of conduct. In this regard, in the United States we frequently refer to a triad of broad fiduciary duties – due care, loyalty, and utmost good faith. While useful as a clear and succinct statement of the law, these tri-parte general duties or principles still often fail to provide adequate guidance to advisors and those who regulate them. In an attempt to fill this void, following is the author's further elicitation of the fiduciary duties of advisors, presented in summary fashion, which this author has derived from various reported decisions and rulings:

   a. **Status as a Fiduciary.** An advisor is a fiduciary (and a trusted source of objective professional advice) with respect to the client, and shall at all times during the course of the relationship[55] (during which any advice is provided by the adviser to the client), owe to such client broad fiduciary duties of due care, loyalty, and utmost good faith.

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[53] As to the "best interests" standard being present under the Advisers Act, *see S.E.C. v. Moran*, 922 F.Supp. 867, 895-6 (S.D.N.Y., 1996) ("the SEC alleges that by allocating Liberty stock to his personal and family accounts and requiring his clients to pay a higher price for the stock the next day, Moran Sr. and Moran Asset placed their own interests ahead of their clients thereby violating the fiduciary duty owed to those clients … Section 206 of the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17, 100 S.Ct. 242, 246, 62 L.Ed.2d 146 (1979); *Burks v. Lasker*, 441 U.S. 471, 482 n. 10, 99 S.Ct. 1831, 1839 n. 10, 60 L.Ed.2d 404 (1979); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 n. 11, 97 S.Ct. 1292, 1300 n. 11, 51 L.Ed.2d 480 (1977); *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 191-92, 84 S.Ct. 275, 282-83, 11 L.Ed.2d 237 (1963) … [T]he court interprets Section 206 to establish a fiduciary duty which in addition to applying to misrepresentations and omission, also requires the investment advisor to act in the best interests of its clients. *See e.g., SEC v. Capital Gains Bureau*, 375 U.S. at 195, 84 S.Ct. at 284-85 ('Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes.') …."

[54] A more elaborate explanation of the difference between the "sole interests" standard and "best interests" standard can be found in Professor John Langbein's article: "The sole interest rule prohibits the trustee from "plac[ing] himself in a position where his personal interest . . . conflicts or possibly may conflict with" the interests of the beneficiary. The rule applies not only to cases in which a trustee misappropriates trust property, but also to cases in which no such thing has happened—that is, to cases in which the trust "incurred no loss" or in which "actual benefit accrued to the trust" from a transaction with a conflicted trustee. The conclusive presumption of invalidity under the sole interest rule has acquired a distinctive name: the "no further inquiry" rule. What that label emphasizes, as the official comment to the Uniform Trust Code of 2000 explains, is that "transactions involving trust property entered into by a trustee for the trustee's own personal account [are] voidable without further proof." Courts invalidate a conflicted transaction without regard to its merits—"not because there is fraud, but because there may be fraud." "[E]quity deems it better to . . . strike down all disloyal acts, rather than to attempt to separate the harmless and the harmful by permitting the trustee to justify his representation of two interests … I compare the trust law duty of loyalty with the law of corporations, which originally shared the trust law sole interest rule but abandoned it in favor of a regime that undertakes to regulate rather than prohibit conflicts … I recommend (in Section II.C) reformulating the trust law duty of loyalty in light of these developments. I would generalize the principle now embodied in the exclusions and exceptions, which is that the trustee must act in the beneficiary's best interest, but not necessarily in the beneficiary's sole interest. Overlaps of interest that are consistent with the best interest of the beneficiary should be allowed. What is needed to cure the overbreadth of the sole interest rule is actually quite a modest fix: reducing from conclusive to rebuttable the force of the presumption of invalidity that now attaches to a conflicted transaction." Langbein, John H., Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?. Yale Law Journal, Vol. 114, p. 929 (2005), available at SSRN: http://ssrn.com/abstract=696801

[55] Generally, "[t]he duties of a broker in a fiduciary status are not at an end when a transaction is completed; they include a continuing duty to keep abreast of financial information that may affect the customer's portfolio and to act on the basis of that information." *Paine, Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508, 515-6 (Colo., 1986).

b. **Duty of Due Care.** An advisor shall act with due care. In connection therewith (and not by way of limitation):

  i. An advisor possesses a fiduciary duty to the client to exercise with good judgment, knowledge, and due diligence[56] as to the investment strategies, the investment products,[57] and the matching of those strategies to meet the needs and objectives of the client,[58] and with that degree of care ordinarily possessed and exercised in similar situations by a competent professional properly practicing in his or her field.

  ii. An advisor shall maintain the confidentiality of client information in accordance with applicable law and the agreement with the client.

c. **Duty of Loyalty.** An advisor shall abide by his, her or its fiduciary duty of loyalty to the client at all times during the course of the relationship with the client. In connection therewith (and not by way of limitation):

  i. The advisor shall at all times place and maintain his or her or its client's best interests[59] first and paramount to those of the advisor; [60]

  ii. The advisor shall not, through either false statement nor through omission,[61] mislead his or her or its clients;

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[56] "The broker or advisor implicitly represents to the client that he or she has an adequate basis for the opinions or advice being provided." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006), *citing Hanly v. S.E.C.,* 415 F.2d 589, 596-97 (2d Cir. 1969); *Univ. Hill Found. v. Goldman*, 422 F. Supp. 879, 893 (S.D.N.Y. 1976).

[57] While the duty of due diligence is a high one, it is not without boundaries. For example, "ERISA imposes the highest standard of conduct known to law on fiduciaries of employee pension plans. *Reich v. Valley National Bank of Arizona*, 837 F.Supp. 1259, 1273 (S.D.N.Y.1993), *quoting Donovan v. Bierwirth*, 680 F.2d 263 (2nd Cir.1982); Kuper v. Iovenko, 66 F.3d 1447, 1453 (6th Cir.1988). However, this is not equivalent to a standard of absolute liability, as ERISA fiduciaries are only required to exercise prudence, not prescience or omniscience. *Frahm v. Equitable Life Assurance Society of the United States*, 137 F.3d 955, 960 (7th Cir.1998); *DeBruyne v. Equitable Life Assurance Society of the United States*, 920 F.2d 457, 465 (7th Cir.1990)." *Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818, 863 (C.D. Ill., 2004).

Another case "addressed, in the context of determining liability under federal securities laws, whether an investment advisor has a duty to investigate the accuracy of statements made in an offering memorandum not prepared by itself and which its client relies upon in making an investment. The court declined to impose such a duty "when there is nothing that is obviously suspicious about those statements." *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385, 413 (S.D.N.Y., 2005), *citing Gabriel Capital, L.P. v. Natwest Finance, Incorporated*, 137 F.Supp.2d 251, 262 (S.D.N.Y.2000). ("An investment advisor is retained to suggest appropriate investments for its clients, but is not required to assume the role of accountant or private investigator and conduct a thorough investigation of the accuracy of the facts contained in the documents that it analyzes for the purpose of recommending an investment."). *Id.* at 263. Of course, if a representation is made that the accuracy of documents will be verified, then such a duty of due diligence, voluntarily assumed by the investment adviser, will likely exist. *See Fraternity Fund* at p.415 ("Here, however, Asset Alliance allegedly represented to Sanpaolo that it 'ensure[d] that the portfolios' marks are consistent with market values.' By making this representation, Asset Alliance took on a duty to review and check Beacon Hill's prices.").

[58] "[T]he broker handling a discretionary account becomes the fiduciary of his customer in a broad sense. Such a broker, while not needing prior authorization for each transaction, must … manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history." Leib v. Merrill Lynch, Pierce, Fenner & Smith, 461 F.Supp. 951,3 (E.D. Mich., 1978).

[59] In contrast to the "best interests" standard traditionally imposed upon investment advisers and financial planners under the Investment Advisers Act of 1940 and state common law, ERISA (at least prior to amendments made by the Pension Protection Act of 2006) imposed a "sole interests" standard. *See Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818 (C.D. Ill., 2004) ("Under the section 404(a) duty of loyalty, ERISA fiduciaries must act 'solely in the interest of plan participants and beneficiaries' … for the 'exclusive purpose' of providing benefits to them."). *Id.* at 863.

[60] "An essential feature and consequence of a fiduciary relationship is that the fiduciary becomes bound to act in the interests of her beneficiary and not of herself." *In re Prudential Ins. Co. of America Sales Prac.,* 975 F.Supp. 584, 616 (D.N.J., 1996).

iii. The advisor shall affirmatively provide full and fair disclosure of all material facts[62] to his or her or its client prior to a client's decision[63] on a recommended course of action,[64] including but not limited to: (1) all fees and costs[65] associated with any investment, securities and insurance products recommended to a client, expressed with specificity for the particular transaction contemplated; and (2) all of the material benefits, fees and any other material compensation paid to the advisor (and additionally those benefits, fees and other material compensation paid to the advisor representative) or to any firm or person with whom he or she or it may be affiliated, expressed with specificity for the particular transaction which is contemplated.

iv. The advisor is under an affirmative obligation to reasonably avoid conflicts of interest[66] which would impair the independent and objective advice rendered to the client. As to any remaining conflicts of interest which are not reasonably avoided, the advisor shall undertake full and affirmative disclosure of such conflict of interest[67] and shall ensure

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[61] "[We] think the better reading of section 206 is that it prohibits failures to disclose material information, not just affirmative frauds. This reading is consistent with the fiduciary status of investment advisers in relation to their clients ... and it is also more likely to fulfill Congress's general policy of promoting 'full disclosure' in the securities industry." *S.E.C. v. Washington Inv. Network*, 475 F.3d 392 (D.C. Cir., 2007), *citing SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180 at 191-2, and at 186, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

[62] "Courts have imposed on a fiduciary an affirmative duty of `utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation `to employ reasonable care to avoid misleading' his customers*." SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

[63] "When a stock broker or financial advisor is providing financial or investment advice, he or she … is required to disclose facts that are material to the client's decision-making." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

[64] As the Commission said here, 'when a firm has a fiduciary relationship with a customer, it may not execute principal trades with that customer absent full disclosure of its principal capacity, as well as all other information that bears on the desirability of the transaction from the customer's perspective.'… Other authorities are in agreement. For example, the general rule is that an agent charged by his principal with buying or selling an asset may not effect the transaction on his own account without full disclosure which 'must include not only the fact that the agent is acting on his own account, but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction, from the viewpoint of the principal.'" *Geman v. S.E.C.,* 334 F.3d 1183, 1189 (10th Cir., 2003), quoting *Arst v. Stifel, Nicolaus & Co*., 86 F.3d 973, 979 (10th Cir.1996) (applying Kansas law) (quoting RESTATEMENT (SECOND) OF AGENCY § 390 cmt. a (1958)).

[65] Disclosure of just the "disclosed fees" and costs of a pooled investment vehicle is inadequate, in the view of this author, given the substantial impact of transaction costs and opportunity costs within many mutual funds and other pooled investment vehicles, and the non-inclusion of these costs in a fund's stated "annual expense ratio." *See* Ron A. Rhoades, JD, CFP®, Estimating the Total Costs of Stock Mutual Funds (April 22, 2009), available at http://www.josephcapital.com/Resources.html. "[W]e decline to find that providing a client with a prospectus is a complete defense, as a matter of law, to state claims that the stock broker or investment advisor misrepresented facts or failed to disclose facts material to his or her client's investment decisions." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

[66] "[T]he Committee Reports indicate a desire to ... eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.' The [IAA] thus reflects a ... congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-2 (1963). "The IAA arose from a consensus between industry and the SEC that 'investment advisers could not 'completely perform their basic function — furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments — unless all conflicts of interest between the investment counsel and the client were removed.'" *Financial Planning Association v. Securities and Exchange Commission*, No. 04-1242 (D.C. Cir. 3/30/2007) (D.C. Cir., 2007) *citing SEC vs. Capital Gains* at 187.

[67] "The overall statutory scheme of the IAA addresses the problems identified to Congress in two principal ways: First, by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined, *see Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17 (1979), and second, by requiring full disclosure of all conflicts of interest." *Financial Planning Association v. Securities and Exchange Commission,* No. 04-1242 at p.17 (D.C. Cir. 3/30/2007) (D.C. Cir., 2007). The existence of "federal fiduciary standard" under the Investment Advisers Act of 1940 does not mean that deference is not

the intelligent, independent and informed consent[68] of his or her or its client is obtained with regard thereto. In any event, the proposed arrangement remains should be prudently managed in order that the client's best interests are preserved[69] and that the proposed arrangement is substantively fair to the client.

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provided to the scope of fiduciary duties as they exist under state common law. *See U.S. v. Brennan*, 938 F.Supp. 1111 (E.D.N.Y., 1996) ("Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law. *See, e.g., Varity v. Howe*, ___ U.S. ___, ___, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996); *F.D.I.C. v. Wright*, 87 B.R. 1011 (D.S.D. 1988) (bankruptcy).") *Id.* at 1119.

[68] The fiduciary duty to avoid conflicts of interest, and the necessity to obtain the informed consent of the client as to conflicts of interest not avoided, were well known in the early history of the Advisers Act. In an address entitled "The SEC and the Broker-Dealer" by Louis Loss, Chief Counsel, Trading and Exchange Division, U.S. Securities and Exchange Commission on March 16, 1948, before the Stock Brokers' Associates of Chicago, the fiduciary duties arising under the Advisers Act, as applied in the *Arleen Hughes* release, were elaborated upon:

> The doctrine of that case, in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to *make a scrupulously full disclosure of every element of its adverse interest in, the transaction*.
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> In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. *He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses*. This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law 'acts not on the possibility, that, in some cases the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.' Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine 'has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.''
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> *This time-honored dogma applies equally to any person who is in a fiduciary relation toward another*, whether he be a trustee, an executor or administrator of an estate, a lawyer acting on behalf of a client, an employee acting on behalf of an employer, an officer or director acting on behalf of a corporation, *an investment adviser* or any sort of business adviser for that matter, or a broker. The law has always looked with such suspicion upon a fiduciary's dealing for his own account with his client or beneficiary that it permits the client or beneficiary at any time to set aside the transaction without proving any actual abuse or damage. What the recent Hughes case does is to say that such conduct, in addition 'to laying the basis for a private lawsuit, amounts to a violation of the fraud provisions under the securities laws: This proposition, as a matter of fact, is found in a number of earlier Commission opinions. *The significance of the recent Hughes opinion in this respect is that it elaborates the doctrine and spells, out in detail exactly what disclosure is required when a dealer who has put himself in a fiduciary position chooses to sell his own securities to a client or buys the client's securities in his own name …*
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> *The nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases use of the term 'principal' itself may suffice. In others, a more detailed explanation will be required. In all cases, however, the burden is on the firm which acts as fiduciary to make certain that the client understands that the firm is selling its own securities …*

[*Emphasis added*.]

[69] *See, generally, Pan Am Corp. v. Delta Air Lines, Inc*., 175 B.R. 438 (Bankr. S.D.N.Y., 1994) ("The [fiduciary] relationship requires that [the fiduciary must not] exert influence or pressure upon the other or take selfish advantage of the trust in such a way as to benefit himself or prejudice the [client]. A breach of fiduciary duty has occurred when influence has been acquired and abused and when confidence has been reposed and retained.")

d. **Utmost Good Faith.** An advisor shall act with utmost good faith[70] toward his, her or its client. Not by way of limitation thereof, an advisor shall not act recklessly nor with conscious disregard of the client's interests.

4. **The "One" Fiduciary Standard under the Common Law.** Under state common law, there exists only one fiduciary standard of conduct governing the activities of investment advisers and financial planners.

   a. *Some Statutes Modify the Common Law Fiduciary Standard.* This common law fiduciary standard may be modified by statute, such as the Advisers Act or ERISA (or, within the limits of agency authority and discretion, through administrative regulations applying statutes).

   b. *Fiduciary Standards of Conduct Constantly Evolve.* Additionally, the "one fiduciary standard" is not static – it evolves as the business practices of financial planners and investment advisers evolve to fit the nature of the relationship between the parties.[71]

   c. *The Fiduciary Standard Should NOT Be Legislative Defined.* This author concurs with the position by learned commentators that "the *overarching* fiduciary standard"[72] should not be "defined" further by legislation setting forth specific fiduciary duties. This is because fiduciary duties must evolve over time to meet the ever-changing business practices of advisors and fraudulent conduct successfully circumscribed.[73] Any attempt to "define" the fiduciary standard of conduct would effectively negate the ability of courts of equity to react to the ever-changing field of investment and financial planning advice.[74]

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[70] "When a stock broker or financial advisor is providing financial or investment advice, he or she is required to exercise the utmost good faith, loyalty, and honesty toward the client." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

[71] "The content of common-law fraud has not remained static as the courts below seem to have assumed. It has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue." *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180, ___ (1963).

[72] *See* July 14, 2009 letter to Chairman Barney Frank and Ranking Member Spencer Baucus, House Committee on Financial Services, from the CFP Board of Standards, Inc., Consumer Federation of America, Financial Planning Association, Fund Democracy, Investment Adviser Association, North American Securities Administrators Association, and National Association of Personal Financial Advisors, available at http://www.consumerfed.org/pdfs/group_fiduciary_duty_letter_july_2009.pdf.

[73] *See Stonemets v. Head*, 248 Mo. 243, 154 SW 108 (1913), in which Judge Lamb or the Missouri Supreme Court stated:

> Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition. Messieurs, the fraud-feasors, would like nothing half so well as for courts to say they would go thus far, and no further in its pursuit.

See also Justice Douglas in *Pepper v. Litton*, 308 U.S. 295, 311 (1939), wherein he stated:

> He who is in such a fiduciary position cannot serve himself first and his cestuis second … He cannot use his power for his personal advantage and to the detriment of [the cestuis], no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis , Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation … Otherwise, the fiduciary duties … would go for naught: exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart.

[74] Because fraud is by its very nature boundless, the one fiduciary standard of conduct applicable to investment advisers should not be subjected to attempts to "define" them legislatively, by means of any particular definition. *See* speech entitled "Diversiform Dishonesty" by Edward H. Cashion, Counsel to the Corporation Finance Division, U.S. Securities and Exchange Commission, on November 17, 1945 to the National Association of Securities Commissioners, where in reference to Section 36 of the Investment Company Act of 1940, Mr. Cashion stated:

> Like fraud, abuse of trust is not a fact but a conclusion to be drawn from facts. *The terms 'gross abuse of trust' or 'gross misconduct' should not be limited by any hard and fast definition.* Both constitute fraud in it general sense" … the interpretation of gross misconduct and gross abuse of trust as used in Section 36 will depend not only upon relevant

C. THE FIDUCIARY DUTY OF LOYALTY.

1. **The Fiduciary Duty of Loyalty, Generally.** It is the principle of the fiduciary duty of loyalty which makes fiduciary duties so demanding upon the fiduciary. Although expressed as an obligation or duty of loyalty, the fiduciary duty of loyalty essentially imposes an inhibition or disability upon the fiduciary. It requires the fiduciary to refrain from certain acts, in exclusion of the interests of the fiduciary himself. Under English law, from which American law is derived, the broad fiduciary duty of loyalty includes these three separate rules:

    a. *The "No Conflict" Rule:* A fiduciary must not place itself in a position where its own interests conflict with those of its client.

    b. *The "No Profit" Rule:* A fiduciary must not profit from its position at the expense of the client. This aspect of the fiduciary duty of loyalty is often considered a prohibition against self-dealing. Under the heading, "Duty of Loyalty," the Second Restatement of Trusts states that the fiduciary "is under a duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do. Similarly, the Second Restatement of Agency provides that the duty of loyalty entails a duty not to make a profit on transactions conducted for the principal or deal with the principal as an adverse party.

    c. *The "Undivided Loyalty" Rule:* A fiduciary owes undivided loyalty to its client and therefore must not place itself in a position where his or her duty toward one client conflicts with a duty that it owes to another client.

2. **The Duty of Loyalty: The General Requirement of Disclosure of All Material Facts.** A salient feature of fiduciary law is that the fiduciary is under a legal obligation of enhanced disclosure to the client (or beneficiary, or representative thereof). Generally, "fiduciary law protects the [client] by obligating the fiduciary to disclose all material facts, requiring an intelligent, independent consent from the [client], a substantively fair arrangement, or both."

    a. *The Advisers Act Requirement to Disclose Material Facts and to Avoid Misleading Clients.* Investment advisers are fiduciaries and possess an affirmative duty to "provide full and fair disclosure of all material facts" as well as an affirmative obligation to "employ reasonable care to avoid misleading" clients. Engaging in transactions with clients without making required disclosures of material facts is a violation of Section 206 of the Advisers Act.

    b. *What is a Material Fact?* Generally, a material fact is "anything which might affect the (client's) decision whether or how to act."

    c. *Disclosures Must Be Timely Given.* "[D]isclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent."

3. **The Fiduciary's Duty to Disclose Conflicts of Interest.**

    a. *What is a Conflict of Interest?* A "conflict of interest" generally refers to any activity or relationship in which an investment adviser's interests compete with the interests of its clients. More broadly, "a conflict of interest arises in any situation in which an interest interferes, or has the potential to interfere, with a person, organization or institution's ability to act in accordance with the interest of another party, assuming that the person, organization or institution has a (legal, conventional or fiduciary) obligation to do so."

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common law principles but also upon the declaration of policy as set forth in the Act … I believe that any substantial deviation from that codification of the fiduciary obligations imposed upon directors and officers of investment companies, ipso facto, constitutes gross misconduct and gross abuse of trust. [*Emphasis added*.]

b. *A Conflict of Interest is Always a Material Fact*. Due to the risks posed by a conflict of interest, the presence of a (material) conflict of interest is always a material fact which must be disclosed in fiduciary relationships by the fiduciary.

c. *Unavoidable Conflicts of Interest are Still Conflicts.* Unavoidable and systematic conflicts of interest are still conflicts of interest and must be treated as such. The fact that the financial advisor or investment adviser is not to blame for finding herself in a conflict of interest situation, or that the conflict of interest is incapable of being avoided, does not mean that the conflict of interest is not a material fact requiring, at the minimum, disclosure.

d. *The Compensation of the Financial Planner is Always a Source of Conflicts, and Must be Fully Disclosed.* "Compensation is inherent in any commercial transaction; it is simultaneously a source of conflicts of interests and a possible means of reducing these conflicts by creating the proper incentives." At the inception of the fiduciary relationship, the financial advisor and client bargain as to the type and amount of compensation the client is to pay for the fiduciary's services. Even in this process, full disclosure of the compensation methodology and amounts (or at least good faith estimates of same) is required.

e. *"Casual Disclosure" vs. "Full Disclosure" and Obtaining Informed Consent.*

(1) *The Scope of the Fiduciary Obligation of Disclosure.* The fiduciary duty of disclosure extends not just to the existence of a conflict, nor when a profit may be made by the fiduciary on a proposed transaction, but also mandates disclosure of "all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal. This includes, in the case of sales to him by the principal, not only the price which can be obtained but also all facts affecting the desirability of sale … and all other matters which a disinterested and skillful agent advising the principal would think reasonably relevant." Stated differently, "'any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,' is expressly made unlawful. These quoted words as they appear in the statute can only mean that Congress forbid not only the telling of purposeful falsity but also the telling of half-truths and the failure to tell the 'whole truth.' These statutory words were obviously designed to protect the investing public as a whole whether the individual investors be suspicious or unsuspecting."

(2) *"Casual Disclosure" is Insufficient.* The duty of disclosure is not satisfied merely by "casual disclosure," such as "there may be facts which may be of interest to you" or "I may possess a conflict of interest." As stated by Justice Cardoza: "If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity of reservation, in all its stark significance …."

(3) *Disclosure Must Be Affirmatively Made.* Additionally, the duty to disclose is an affirmative one, and the failure to disclose by an investment adviser is a violation of the Advisers Act. *The fiduciary is required to ensure that the disclosure is received by the client*; the "access equals delivery" approach adopted by the SEC in connection with the delivery of a full prospectus to a consumer would not likely qualify as an appropriate disclosure by a fiduciary financial advisor to her or his client. As stated in an early case applying the Advisers Act: "It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge material facts to the ones whose interests she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure. The statutes and rules discussed above make it unlawful to omit to state material facts irrespective of alleged (or proven) willingness or readiness to supply that which has been omitted."

D. UNDERSTANDING THE FIDUCIARY DUTY OF LOYALTY WHEN A CONFLICT OF INTEREST IS PRESENT.

1. **"Disclosure" and "Consent" Alone are Insufficient.** Advocates of the "new federal fiduciary standard" have implied that "disclosure" of a conflict of interest, followed by the "consent" of the client to proceed with the transaction, is all that is required of the fiduciary. This view takes into account only the disclosure-based regime of either the Securities Act of 1933 or the Securities Exchange Act of 1934[75] - which contemplate an arms-length relationship[76] between the issuer or broker and customer.

   In contrast, the Advisors Act requires much more of those in fiduciary relationships with their clients. In the presence of a conflict of interest, fiduciary law protects the client by obligating the fiduciary to: (1) *affirmatively disclose all material facts* to the client; (2) ensure *client understanding* of the transaction, the conflict of interest which exists, and their ramifications; (3) obtain an *intelligent, independent and informed consent* from the client; and (4) ensure that the proposed transaction, even with client consent, remains *a substantively fair arrangement* for the client. The remainder of this memorandum provides authority for each of the foregoing requirements of the "best interests" standard.

5. **Full Disclosure of All Material Facts Required.** "Courts have imposed on a fiduciary an affirmative duty of `utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation `to employ reasonable care to avoid misleading' his customers*." SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

6. **A "Material Fact" is Anything Which May Affect Client's Decision.** "When a stock broker or financial advisor is providing financial or investment advice, he or she … is required to disclose facts that are material to the client's decision-making." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006). A material fact is "anything which might affect the (client's) decision whether or how to act." *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 227 Va. 441 (Va., 1984). An example of the type of disclosure, when a conflict of interest is present, is revealed in a recent decision arising under the Advisers Act: "[W]hen a firm has a fiduciary relationship with a customer, it may not execute principal trades with that customer absent full disclosure of its principal capacity, *as well as all other information that bears on the desirability of the transaction from the customer's perspective*.'… Other authorities are in agreement. For example, the general rule is that an agent charged by his principal with buying or selling an asset may not effect the transaction on his own account without full disclosure which 'must include not only the fact that the agent is acting on his own account, but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction, from the viewpoint of the principal.'" *Geman v. S.E.C.,* 334 F.3d 1183, 1189 (10th Cir., 2003), quoting *Arst v. Stifel, Nicolaus & Co*., 86 F.3d 973, 979 (10th Cir.1996) (applying Kansas law) (quoting RESTATEMENT (SECOND) OF AGENCY § 390 cmt. a (1958)).

7. **Disclosure Must "Bare the Truth … in All Its Stark Significance"; Disclosure that "A Conflict Exists" is Insufficient.** As stated by Justice Cardoza: "If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity of reservation, in all its stark significance …." *Wendt v. Fischer*, 243 N.Y. 439, 154 N.E. 303 (1926).

   See also In re Src Holding Corp., 364 B.R. 1 (D. Minn., 2007): "The fact that the client knows of a conflict is not enough to satisfy the attorney's duty of full disclosure. *Florida Ins. Guar. Ass'n Inc. v. Carey Canada, Inc*., 749 F.Supp. 255, 259 (S.D.Fla.1990) ("Consent can only come after consultation — which the rule contemplates as full disclosure.... [I]t is not sufficient that both parties be informed of the fact that the lawyer is undertaking to represent both of them, but he must explain to them the nature of the conflict of

[75] "[T]he duty of full disclosure was imposed as a matter of general common law long before the passage of the Securities Exchange Act." *In the Matter of Arleen W. Hughes*, SEC Release No. 4048 (February 18, 1948).

[76] The distinction between arms-length relationships and fiduciary relationships is illustrated in a chart found in the Professors' letter (see exhibit).

interest in such detail so that they can understand the reasons why it may be desirable for each to [withhold consent].") (*quoting Unified Sewerage Agency, Etc. v. Jeko, Inc*., 646 F.2d 1339, 1345-46 (9th Cir.1981)); *see also British Airways, PLC v. Port Authority of N.Y. and N.J*., 862 F.Supp. 889, 900 (E.D.N.Y.1994) (stating that the burden is on the client's attorney to fully inform and obtain consent from the client); *Kabi Pharmacia AB v. Alcon Surgical, Inc*., 803 F.Supp. 957, 963 (D.Del.1992) (stating that evidence of the client's constructive knowledge of a conflict would not be sufficient to satisfy the attorney's consultation duty); *Manoir-Electroalloys Corp. v. Amalloy Corp*., 711 F.Supp. 188, 195 (D.N.J.1989) ("Constructive notice of the pertinent facts is not sufficient."). A client is not responsible for recognizing the conflict and stating its lack of consent in order to avoid waiver. *Manoir-Electroalloys*, 711 F.Supp. at 195. The lawyer bears the duty to recognize the legal significance of his or her actions in entering a conflicted situation and fully share that legal significance with clients."

8. **Disclosure Must be Timely.** Disclosure must be timely provided. "[D]isclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent." *In the Matter of Arleeen W. Hughes*, SEC Release No. 4048 (February 17, 1948), *affirmed* 174 F.2d 969 (D.C. Cir. 1949).

9. **Disclosure Must be Affirmatively Made.** The duty to disclose is an affirmative one, and the failure to disclose by an investment adviser is a violation of the Advisers Act. The fiduciary is required to ensure that the disclosure is received by the client; the "access equals delivery" approach undertaken with regard to disclosures required by the SEC under the '33 and '34 Acts would not qualify as an appropriate disclosure by a fiduciary financial advisor to her or his client. As stated in an early case applying the Advisers Act:

> It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge material facts to the ones whose interests she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure. *The statutes and rules discussed above make it unlawful to omit to state material facts irrespective of alleged (or proven) willingness or readiness to supply that which has been omitted.*

   Hughes v. SEC, 174 F.2d 969 (D.C. Cir., 1949). [*Emphasis added*.]

10. **The Extent of Disclosure Necessarily Varies with the Sophistication of the Client; Burden is on Adviser to Ensure "Client Understanding" of the Disclosure.** The fiduciary duty to avoid conflicts of interest, and the necessity to obtain the informed consent of the client as to conflicts of interest not avoided, were well known in the early history of the Advisers Act. In an address entitled "The SEC and the Broker-Dealer" by Louis Loss, Chief Counsel, Trading and Exchange Division, U.S. Securities and Exchange Commission on March 16, 1948, before the Stock Brokers' Associates of Chicago, the fiduciary duties arising under the Advisers Act, as applied in the *Arleen Hughes* release, were elaborated upon:

> The doctrine of that case, in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to *make a scrupulously full disclosure of every element of its adverse interest in the transaction*.
>
> In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. *He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses*. This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law 'acts not on the possibility, that, in some cases

the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.' Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine 'has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.'

This time-honored dogma applies equally to any person who is in a fiduciary relation toward another, whether he be a trustee, an executor or administrator of an estate, a lawyer acting on behalf of a client, an employee acting on behalf of an employer, an officer or director acting on behalf of a corporation, *an investment adviser* or any sort of business adviser for that matter, or a broker. The law has always looked with such suspicion upon a fiduciary's dealing for his own account with his client or beneficiary that it permits the client or beneficiary at any time to set aside the transaction without proving any actual abuse or damage. What the recent Hughes case does is to say that such conduct, in addition 'to laying the basis for a private lawsuit, amounts to a violation of the fraud provisions under the securities laws: This proposition, as a matter of fact, is found in a number of earlier Commission opinions. *The significance of the recent Hughes opinion in this respect is that it elaborates the doctrine and spells, out in detail exactly what disclosure is required when a dealer who has put himself in a fiduciary position chooses to sell his own securities to a client or buys the client's securities in his own name …*

The nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases use of the term 'principal' itself may suffice. In others, a more detailed explanation will be required. In all cases, however, the burden is on the firm which acts as fiduciary to make certain that the client understands that the firm is selling its own securities …

Id. [*Emphasis added*.]

11. **The Consent must be "Intelligent, Independent and Informed."** Generally, "fiduciary law protects the [client] by obligating the fiduciary to disclose all material facts, requiring an *intelligent, independent consent* from the [client], a substantively fair arrangement, or both."[77] [*Emphasis added*.]

    In a recent white paper, Professor Frankel reminded us that "blanket" waivers of fiduciary duties are seldom appropriate: "[F]iduciary rules cannot be avoided if the entrustors are incapable *of independent and informed consent*. The entrustors' consent is subject to a number of conditions. The fiduciaries must disclose the details of the proposed transactions to the clients-entrustors. The information should enable the entrustors to protect themselves in the bargain and deal with their fiduciaries. Therefore, consent to future unspecified transactions is uninformed and should not be binding. Nor are the clients -- entrustors' consents to highly unfavorable conflict of interest transactions always binding. The terms of the transactions may indicate possible fraud or misleading disclosure. Clients' consents may be more doubtful and would require more evidence of entrustors' *independence* when the fiduciaries are experts, and the non-expert entrustors are unlikely to *form informed and rational decisions*." [*Empahsis added.*][78]

12. **Informed Consent must not be Induced; Even with Informed Consent the Transaction Must Remain "in All Respects Fair and Reasonable."** The purpose of the fiduciary duty of disclosure is arming the client with sufficient information to undertake an informed decision, when the client is called upon to do so. In the context of conflicts of interest which may exist between the fiduciary and the client, the purpose of full and affirmative disclosure of material facts by a fiduciary financial planner is also to obtain the client's informed consent to proceeding with a recommendation or transaction. Indeed, under traditional notions of fiduciary law, conflicts of interest must be avoided absent the informed consent of the client.

[77] Frankel, Tamar, Fiduciary Law, 71 Calif. L. Rev. 795 (1983).

[78] Frankel, Tamar, "Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers" (August 10, 2009). Boston Univ. School of Law Working Paper No. 09-36. Available at SSRN: http://ssrn.com/abstract=1446750.

However, "informed consent" does not exist if full disclosure of all facts is not undertaken, if the consent is induced, or if the transaction does not remain fair and reasonable to the client. As one court stated:

> One of the most stringent precepts in the law is that a fiduciary shall not engage in self-dealing and when he is so charged, his actions will be scrutinized most carefully. When a fiduciary engages in self-dealing, there is inevitably a conflict of interest: as fiduciary he is bound to secure the greatest advantage for the beneficiaries; yet to do so might work to his personal disadvantage. Because of the conflict inherent in such transaction, it is voidable by the beneficiaries unless they have consented. Even then, it is voidable if the fiduciary fails to disclose material facts which he knew or should have known, if he <u>used the influence of his position to induce</u> the consent <u>or if the transaction was not in all respects fair and reasonable</u>.

Birnbaum v. Birnbaum, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986).

The informed consent of the client to proceed with a transaction recommended by a fiduciary advisor in the presence of a conflict of interest would rarely be given by an informed client if the conflict of interest were not managed to keep the best interests of the client paramount at all times; clients rarely undertake gratuitous transfers to their financial advisors. Hence, courts appear to often find that there was not full disclosure, or that it was not affirmatively undertaken, or that the terms of the transaction were not fair, where the voluntary nature of the consent, or the understanding by the client of the material facts, is suspect. Such cases often arise in the context of the attorney-client relationship. *See, e.g. Schenk v. Hill, Lent & Troescher*, 530 N.Y.S.2d 486, 487 (N.Y. Sup. Ct. 1988) (a lawyer hired to sue another lawyer for malpractice was himself a potential defendant in the same action, and obtained client consent to waive the conflict of interest. In disqualifying the lawyer, the court said: "[T]he consent obtained in this case does not reflect a full understanding of the legal rights being waived … [T]he unsophisticated client, relying upon the confidential relationship with his lawyer, may not be regarded as able to understand the ramifications of the conflict, however much explained to him."); *Wade v. Clemmons*, 377 N.Y.S.2d 415, 419 (N.Y. Sup. Ct. 1975) (striking down contingent fee because client would have refused to agree to settlement offer yielding fee if properly advised).

<u>E. EXPLORING THE FIDUCIARY DUTY OF DUE CARE.</u> "Because fiduciaries have far greater expertise than the entrustors, fiduciaries must use their skills in performing their services well and attentively."[79] "Fiduciaries may not purport to give advice without sufficient knowledge."[80] While the "duty of care" is generally considered to be the "lesser" fiduciary duty (in contrast to the fiduciary duty of loyalty), recent developments have triggered a more careful examination of the fiduciary duty of due care, and in particular the due diligence required of an adviser.

1. **<u>The Fiduciary Duty of Due Care is Relational.</u>** The fiduciary duty of due care is not unlike the duty of care seen in general tort law (such as that seen in the law of negligence), in that it sets forth a standard of conduct of a "reasonable person." Yet, just as the duty of care owed by a professional for negligence is higher than that of an ordinary person, the investment adviser's duty of care is relational. The care exercised by an investment adviser is measured objectively against the activities a prudent investment adviser would have exercised in the same circumstances.

2. **<u>So What Is The Standard of Care for an Advisor?</u>** In *Erlich v. First National Bank of Princeton*,[81] a 1984 decision applying New Jersey law, the court went to great lengths in describing the duties of the bank which had provided a nondiscretionary "custodian management account" for a customer, in which the account manager gave advice "to the customer on purchases and sales and the customer makes the final decisions." The court held the bank and its employees to be fiduciaries on the basis that they "held themselves out to be professional investment advisers, stating in the Bank's brochures that 'we bring considerable experience to bear and the specialized knowledge we have gained in ... the management of money.... We are highly trained in the techniques of investment.'" In denying to enforce an exculpatory clause in the agreement

[79] Frankel, Tamar, "Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers" (August 10, 2009). Boston Univ. School of Law Working Paper No. 09-36. Available at SSRN: http://ssrn.com/abstract=1446750.

[80] *<u>Id.</u>*

[81] 208 N.J.Super. 264, 505 A.2d 220 (N.J.Super.L., 1984).

with the customer which would have relieved the bank of all liability for “recommendations made in good faith nor for failure to make recommendations”, the court addressed the duties of the bank (which it held acted as an investment adviser and was therefore acting in a professional capacity) in detail and explored the bank’s duty of due care:

> It is clear that the term 'professional services' is no longer limited to the traditional professions such as law and medicine." [Citation omitted.] … The essence of a professional service is that it involves 'specialized knowledge, labor or skill and the labor or skill is predominantly mental or intellectual, rather than physical or manual.' [Citation omitted.] Unlike doctors and lawyers, who are self-regulated, investment advisers who hold themselves out to the public as having special knowledge and skill are not self-regulated. This distinction does not justify a holding that they may contractually exculpate themselves from negligent advice. To allow investment advisers to exculpate themselves from the mischief caused by their breach of duty would violate the public policy of this State … professional must exercise that degree of care, knowledge and skill ordinarily possessed and exercised in similar situations by the average member of the profession practicing in his field [citations omitted] … Industry custom and practice are commonly looked to for illumination of the appropriate standard of care in a negligence case. *Fantini v. Alexander*, 172 N.J.Super. 105, 108, 410 A.2d 1190 (App.Div.1980); RESTATEMENT, TORTS 2d, § 299A at 73 (1965). The Bank offered plaintiff professional investment advisory services. This was not merely a brokerage account. It is therefore the degree of care, knowledge and skill expected of professional investment advisers to which we must look for the standard of care.
>
> There is a dearth of case law on this issue, but I find that *the obligation of the investment manager to give prudent advice is the standard of care to be applied* in this case. *This is a higher standard of care* than that found in the "Know Your Customer" and "Suitability" rules. Prudent advice includes: (1) knowing the customer, his assets, and objectives; (2) diversifying investments; (3) engaging in objective analysis as the basis for purchase and sale recommendations and (4) making the account productive. See Bines, THE LAW OF INVESTMENT MANAGEMENT (1979), Ch. 6 *passim*. The investment manager is not a guarantor; he has no crystal ball with which to predict with perfect certainty the behavior of a particular stock in the market. When judging the actions of the manager with the benefit of hindsight, incorrect advice is easy to detect. We hasten to point out, however, that incorrect advice is not necessarily negligent advice … *The duty to give prudent advice obligates the investment manager to carefully assess the customer's circumstances, both at the outset and during the term of the account*. The customer's age, health, family obligations, assets and income stream (both current and prospective) should be evaluated to determine his ability to absorb losses in the event an investment is unsuccessful … *The obligation to give prudent investment advice imports the duty to make such recommendations as a prudent investor would act on ‘for his own account, having in view both safety and income, in the light of the principal's means and purposes.’* RESTATEMENT, AGENCY 2d, § 425(b) (1958). *The prudence of the investment advice must be judged by objective standards. A manager's personal beliefs are largely irrelevant when measuring his conduct against the conduct of a prudent, objective adviser …The accepted standard of professional performance is that which has ‘substantial support as proper practice by the profession.’* Alternate courses of conduct engaged in by the few do not establish the standard. *Schueler v. Strelinger*, 43 N.J. 330, 346, 204 A.2d 577 (1964) … *The Bank … owed plaintiff the duty to act with skill and care in accordance with industry practice, and to advise an investment strategy that, under the circumstances, was prudent*. [*Emphasis added.*]

3. **The Standard of Care is Always Evolving.** Advisors are therefore expected to adhere to an “expert” standard of care, but even this test applied is not static. The knowledge and expertise required of an advisor, and the process undertaken and judgment required, evolves over time. As investment advisers’ knowledge regarding investment management and its delivery improves, and better techniques and practices become widely accepted, investment advisers must continually adapt their practices to meet the “prudent expert” test applied to investment advisers. Moreover, as new risks to investors become known, measures to guard against those risks must be addressed appropriately by the investment adviser.

4. **Procedural Due Diligence, Generally.** The main evaluation of an investment adviser’s adherence to the duty of due care is undertaken by examining the process the fiduciary undertakes in performing her or his functions and not the outcome achieved. Indeed, the very word “care” connotes a process. One associates caring with a condition, state of mind, manner of mental attention, a feeling, regard, or liking for something. How else may one determine whether an investment adviser who regularly achieves below average returns, or an attorney who loses most cases, has performed her or his duty of care? It is only

through evaluating the steps the fiduciary took while doing her or his job, and not whether they resulted in success, that one may judge whether the fiduciary has breached her or his duty.

5. **Substantive Due Diligence, Generally.** While many commentators focus on the "process" underlying decisions involving an investment adviser's duty of due care, adherence to the duty of care involves both process and substance. That is, in reviewing the conduct of an investment adviser in adherence to the adviser's fiduciary duty of due care, a court or arbitrator or examiner would likely review the method by which the decision was made by the investment adviser (procedural due care) as well as the substance of the transaction or advice given (substantive due care). Substantive due care pertains to the standard of care and the standard of culpability for the imposition of liability for a breach of the duty of care. In plain English, the question must be asked: "Was good judgment undertaken by the investment adviser at each step of the process undertaken?" (This assumes that the process undertaken met the fiduciary duty of due care.)

   However, courts and securities examiners recognize that it is simply not possible for a investment adviser to be aware of every piece of relevant information before making a decision on behalf of the client, nor can a fiduciary guarantee that the best (with 20/20 hindsight) judgment will be made in all cases. Due to the difficulty of evaluating the behavior of fiduciaries, most often the reviewer of the conduct of a fiduciary turn to an analysis not of the advice that was given but rather to the process by which the advice was derived. Nevertheless, while adherence to a proper process is also necessary, at each step along the process the investment adviser is required to act prudently with the care of the prudent investment adviser. In other words, the investment adviser must at all times exercise good judgment, applying his or her education, skills, and expertise to the financial planning or investment issue before the investment adviser. Simply following a prudent process is not enough if prudent good judgment, and the investment adviser's requisite knowledge, expertise and experience, is not applied as well.

6. **Effect of Association Codes / Standards as Evidence of the Standard of Care.** Generally, it is clear that an association's "Code of Ethics" or its "Rules of Professional Conduct" do not establish an independent cause of action. Additionally, ethics rules, even when mandatory on professionals pursuant to law, do not establish standards of care unless such as intended "by language that is clear, unambiguous, and peremptory." [82] However, ethics codes can be utilized as evidence of the standard of care. While ethics codes do not define standards for civil liability, the standards stated in a code of ethics or rules of professional conduct are not irrelevant in determining the standard of care in certain actions for malpractice. The code of ethics may provide guidance in ascertaining the professional's obligations to their clients under various circumstances, and conduct which violates the code of ethics may also constitute a breach of the standard of care due a client. Hence, in a civil action charging malpractice or negligence, the standard of care is the particular duty owed the client under the circumstances of the representation, which

[82] *Peck v. Meda-Care Ambulance Corp*., 457 N.W.2d 538, 542 (Wis.Ct.App.1990). In an earlier Montana Supreme Court decision the consumer argued that a publication of the American Institute of Architects (AIA), "The Architects' Handbook of Professional Practice" (AIA Handbook) should have been admitted into evidence as controlling authority to establish the architects' standard of care. The trial court allowed the AIA Handbook book into evidence. On appeal, the Montana Supreme Court acknowledged that, "The [AIA] handbook describes the standard of practice for architects in the United States." The consumer desired a ruling a ruling that any deviation from the standards set forth in that AIA Handbook should be deemed outright negligence, without any further proof (a legal theory known as "negligence per se"), as occurs with deviations from statutory requirements. The Montana Supreme Court would not go that far, however, and instead ruled that: "While violation of a statute may be classed as negligence per se, violation of other regulations is not generally classed as negligence per se. More precisely on point, absent specific statutory incorporation, the provisions of a national code are only evidence of negligence, not conclusive proof thereof." *Taylor, Thon, Thompson & Peterson v. Cannaday*, 230 Mont. 151, 749 P.2d 63, 65 (Mont. 1988). *See also Elledge v. Richland/Lexington School Dist*., 534 S.E.2d 289 (S.C. Ct. App., 2000), stating: "Evidence of industry standards, customs, and practices is 'often highly probative when defining a standard of care.' 57A *Am. Jur. 2d* Negligence 185 (1999) ... ('[E]vidence of custom within a particular industry, group, or organization is admissible as bearing on the standard of care in determining negligence.' (*quoting Muncie Aviation Corp. v. Party Doll Fleet, Inc*., 519 F.2d 1178, 1180 (5th Cir. 1975))); *Brown v. Clark Equip. Co*., 618 P.2d 267, 276 (Haw. 1980) (finding safety data, codes or standards promulgated by voluntary industry organizations 'admissible as evidence on the issue of negligence' and 'as an alternative to or utilized to buttress expert testimony')."

may or may not be the standard contemplated by the applicable ethics rules. In an examination by securities regulators, the use of association codes and standards of conduct are also relevant in assessing compliance by the investment adviser with her or his fiduciary standard of due care.

7. **Due Diligence: The Fiduciary's Selection and Monitoring of Investment Strategies and Products, Generally.** General fiduciary principles impose the obligation on an investment adviser to exercise due care in the development of their investment strategy, and in the selection of specific investment products (or managers) for her or his client. Moreover, should the investment adviser possess the obligation to the client to monitor the investment strategy or product, the adviser should undertake periodic and/or alert-based monitoring mechanisms and possess and execute a strategy for periodic due diligence of the strategy or product.

   a. *The Need to Test Any Investment Strategy.* It is not enough to adhere to an investment strategy which has not been tested and/or scrutinized by the investment adviser. Instead, securities examiners should expect that the investment adviser's Investment Committee records will reflect a scientific analysis of the investment strategy recommended by the adviser to his or her clients, or reliance upon a scientific analysis undertaken by others with respect to the overall strategy or particular aspects of it. But how is an investment strategy to be "tested"? And what standards for such testing should securities examiners require of investment advisers? This section explores the standards for evaluation of expert testimony, and how those standards can be applied in testing (by an examiner) of the investment adviser's own due diligence efforts.

   b. *Daubert Supplies a Standard for Expert Testimony.* The admission of expert testimony is governed by Fed. R. Evid. 702, which states:

      > If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

      In addition, expert testimony must be both relevant and reliable to be admitted. *Daubert v. Merrell Dow Pharms*., Inc., 509 U.S. 579, 589, 113 S. Ct. 2786 (1993). It may be based upon the personal knowledge or experience of the expert. *See Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 150, 119 S. Ct. 1167 (1999). The key to evaluating expert testimony that is based on the expert's personal experience is determining whether the expert employs "the same level of intellectual rigor that characterizes the practice of an expert in the relevant field." *Kumho*, 526 U.S. at 152, 119 S. Ct. 1167.

      The U.S. Supreme Court in the *Daubert* decision adopted the proposition that scientific methodology should be "based on generating hypotheses and testing them to see if they can be falsified…" The Court stated that the "generated" hypotheses should be supported by an articulation of credible principles. There must be more than the mere standing of the proponent backing up the expert testimony.

      The *Daubert* case involved the determination of the standard for admitting expert testimony in federal courts. The standard that the Court articulated is now referred to as the *Daubert* standard. Under the *Daubert* standard, a judge in federal court now makes a threshold determination regarding whether certain scientific knowledge would indeed assist the trier of fact (the jury, or in a jury's absence, the judge). "This entails a preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology properly can be applied to the facts in issue." This preliminary assessment can turn on whether something has been tested, whether an idea has been subjected to scientific peer review or published in scientific journals, the rate of error involved in the technique, and even general acceptance, among other things. It focuses on methodology and principles, not the ultimate conclusions generated.

The *Daubert* decision was heralded by many observers as one of the most important Supreme Court decisions of the last century imparting crucial legal reforms to reduce the volume of what has disparagingly been labeled "junk science" in the court room. While its application to expert testimony in federal courts is undisputed, some state courts continue to choose to apply the *Frye* standard,[83] which holds that expert opinion based on a scientific technique is admissible only if the technique is generally accepted as reliable in the relevant scientific community. According to one state court, *Frye*'s general acceptance standard "is more likely to yield uniform, objective, and predictable results among the courts, than is the application of the *Daubert* standard, which calls for a balancing of several factors," including hypothesis testing, error rate, peer review and general acceptance. *Grady v. Frito-Lay, Inc*., 2003 Pa. LEXIS 2590 (December 31, 2003). Some state courts also apply a hybrid standard.[84] In terms of practical application, while the focus of the inquiry has changed from *Frye* to *Daubert*, the result rarely does. Accordingly, the *Daubert* standard is occasionally referred to as "Frye in drag."

c. *Investment Adviser Examinations: The Relevance of the Daubert, Frye, or Hybrid Expert Testimony Admission Standards to the Standards Applicable to an Investment Adviser's Due Diligence.* In the context of securities administrator examinations of investment advisers, examiners seek to ascertain if an investment adviser is fulfilling his or her fiduciary duties to his or her clients. Securities examiners should therefore require the investment adviser to describe how he or she meets the fiduciary duty of due care, with regard to due diligence in the selection of investment strategy, the recommendation of specific investments, and ensuring that the investments fit the client's particular situation and needs.

d. *Investment Advisers Must Provide Justification for Their Decisions.* The implicit duty for every fiduciary is to insure that the process utilized by him or her will clear the same threshold analysis a court would employ in evaluating whether expert testimony on the same point would be permitted.

e. *Due Diligence in Manager Selection.* Should the investment adviser choose outside investment managers (including investment advisers to mutual funds) to manage all or a discrete part of a client's portfolio, the investment adviser must use his or her own expertise (or retain third-party experts for this purpose) to ensure that the investment manager can reasonably be expected to provide high-quality investment management services. To the extent that the scope of the investment adviser's engagement extends to monitoring investment products previously selected, such monitoring should occur on a reasonable basis and actions should be taken to replace investment managers which do not meet the quality standards.

f. *Delegation of Due Diligence is Permitted*. Fiduciaries without expertise in the development and evaluation of investment strategies, and/or the selection of investment managers and investment products, should be encouraged to seek expert help.

g. *Investment Manager or Product Selection: Duty to Consider Fees and Expenses*. Investment advisers possess the obligation to determine that the fees and expenses of the investment products selected are reasonable under the circumstances.

h. *Disclosure of Fees and Costs to the Client is Also Required.* In addition, investment advisers possess, as part of their duty of loyalty when undertaking a recommendation of an investment product to a client, to

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[83] (For a listing of the standards for admission of expert testimony used in each state, *see* http://www.ncsconline.org/wc/courtopics/StateLinks.asp?id=126&topic=TortCa)

[84] Tennessee law now appears to incorporate at least seven "non-exclusive" factors for determining the admissibility of an expert's testimony: (1) whether scientific evidence has been tested and the methodology with which it has been tested; (2) whether the evidence has been subjected to peer review or publication; (3) whether a potential rate of error is known; (4) whether, as formerly required by Frye, the evidence is generally accepted in the scientific community; (5) whether the expert's research in the field has been conducted independent of litigation; (6) the expert's qualifications for testifying on the subject at issue (this factor is particularly important when the expert's personal experience is an essential part of his or her methodology or analysis); and (7) the connection between the expert's knowledge and the basis for the expert's opinion. This factor enables the courts to make sure that no analytical gap exists between the expert's knowledge and the basis for his or her opinion. *See* J*ohnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

disclose all material facts regarding the investment product to the client. Without this information, the client cannot undertake an informed decision. Should the investment adviser be acting in a purely discretionary capacity, the investment adviser must possess this information before undertaking the purchase of the investment product, and should ensure that the material information about the investment product is subsequently provided to the client within a reasonable time thereafter.

i. *"Total Fees and Costs" Should be Discerned.* All fees and costs, both direct and indirect, should be discerned (or at least estimated) and disclosed. Many advisors are unaware of the many "hidden" fees and costs of pooled investment vehicles.[85] Not only should advisers attempt to discern these fees and costs, as part of their due diligence process, but they should seek to disclose them in a timely manner to their clients.

j. *Does the Advisor Possess the Duty of Due Care to Undertake Tax Planning in Connection with the Delivery of Investment Advice to the Individual Client?* It can be argued that, given the material impact of taxes on the investment returns of a client, an advisor must consider the application of strategies designed to minimize the long-term tax impact upon the client.

Tax planning may relate to the investment products chosen for taxable accounts, the use of non-qualified tax-deferred investment vehicles (or their non-use, as they often are tax-inefficient in the long term), the financial advice to contribute to certain types of retirement plan accounts, Roth IRA contributions and conversions, and decumulation planning (involving such factors as marginal tax rates of the client both now and in the future, effect on taxation of social security benefits, effect on Medicare premiums, etc.)

Will an investment adviser always possess the duty to an individual investor to seek lower-tax-drag alternatives when investing in taxable accounts? Probably not, for there may be some investors who, due to their specific circumstances (large amount of capital loss carryforwards, and/or low marginal income tax brackets) for whom certain taxable distributions from an investment portfolio would not materially impact the individual investor's long-term returns.

Attempts to limit the scope of the engagement, so as to preclude consideration of tax consequences by the fiduciary advisor, are likely to be ineffective. (See discussion in subsequent section of this memorandum, as to waivers of fiduciary duties and scope of engagement issues). This is because, in order to disclaim any responsibility to consider taxes as part of investment portfolio design and management, a complete explanation of the limits imposed must be undertaken by the client, together with an explanation of the ramifications of non-consideration of taxes. This must be affirmatively made. It is likely that only with informed consent of the client can the duty to consider taxes be negated, and individual clients who are truly "informed" would rarely provide such informed consent.

These, and other issues in fiduciary law as applied to investment advisers and financial planning, deserve greater exploration through additional legal research and analysis, and also through efforts of professionals to provide "best practices" to members of their profession.

F. EXPLORING THE FIDUCIARY DUTY OF UTMOST GOOD FAITH. Perhaps the least understood of the tri-parte fiduciary duties is the duty of "utmost good faith." In part, this is because some courts view this duty as part of the other two fiduciary duties of due care and loyalty, while others view it as a stand-alone duty. In part, this is because the fiduciary duty of utmost good faith is seen as a "gap-filler" – and utilized by courts as a means of achieving equity in circumstances where the other two fiduciary duties don't appear to fit the particular circumstances of the case.

1. **Generally, the Good Faith Obligation Applies to All Contracts.** The duty of "good faith" existing between parties to a contract is nothing new.[86] Duties of "good faith" are implied in every contract and enable

[85] *See* Rhoades, "Estimating the Total Fees and Costs of Stock Mutual Funds and ETFs" (April 22, 2009), available at http://fpcompliance.com/EstimatingTotalFeesCostsofStockMutualFunds042009.pdf.

[86] *See* Chapter 2 for a general discussion of arms-length (contractual) relationships and the duty of good faith implied in every contract; *see also Teachers Ins. & Annuity Ass'n of America v. Butler*, 626 F.Supp. 1229, 1231-2 (S.D.N.Y., 1986) ("a duty of fair dealing and good faith is implied in every contract. As this Court has said: 'Where the parties are under a duty to perform that is definite and certain the courts will enforce a duty of good faith, including good faith negotiation, in order that a party not

courts to "fill in gaps" by providing "the term most suitable to the agreement in question."[87] The contractual obligation of good faith constitutes a "gap filler" term in a contract, in the sense that the doctrine is utilized by courts to resolve specific issues relating to contractual disputes, where the contract between the parties is silent on whether the conduct of a party complained of is prohibited.[88] In resolving contractual disputes, judges must ascertain what the parties would have intended, had they contracted as to the specific matter in dispute. Such "gap-filling" occurs in the context of commercial contracts only when the parties "have failed to express [the good faith obligations] because they are too obvious to need expression."[89]

2. **Fiduciary Relationships: "Utmost" Good Faith, Generally.** Yet in the context of the fiduciary relationship, the duty of good faith is perceived to be so strong it is referred to as "utmost good faith" and a separate duty by some courts from the duties of due care and loyalty.[90] Utmost good faith has been defined as the "most abundant good faith; absolute and perfect candor or openness and honesty; the absence of any concealment or deception, however slight. A phrase used to express the perfect good faith, concealing nothing, with which a contract must be made …."[91]

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escape from the obligation he has contracted to perform.'); *see also Original Great American Chocolate Chip Cookie Co., Inc. v. River Valley Cookies, Ltd*., 970 F.2d 273 (C.A.7 (Ill.), 1992), in which Judge Posner stated: 'There is no blanket duty of good faith; nor is reasonableness the test of good faith. Contract law does not require parties to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother's keeper. That philosophy may animate the law of fiduciary obligations but parties to a contract are not each other's fiduciaries … Contract law imposes a duty, not to 'be reasonable,' but to avoid taking advantage of gaps in a contract in order to exploit the vulnerabilities that arise when contractual performance is sequential rather than simultaneous … Suppose A hires B to paint his portrait to his satisfaction, and B paints it and A in fact is satisfied but says he is not in the hope of chivvying down the agreed-upon price because the portrait may be unsaleable to anyone else. This … would be bad faith, not because any provision of the contract was unreasonable and had to be reformed but because a provision had been invoked dishonestly to achieve a purpose contrary to that for which the contract had been made. The same would be true here, we may assume, if the Sigels had through their efforts built the Aurora cookie store into an immensely successful franchise and the Cookie Company had tried to appropriate the value they had created by canceling the franchise on a pretext: three (or four, or five, or for that matter a dozen) utterly trivial violations of the contract that the company would have overlooked but for its desire to take advantage of the Sigels' vulnerable position.' *Id. at 280* (citations omitted).")

[87] Pargendler, Mariana, "Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered," Tulane Law Review, Vol. 82, 2008, at p.2, available at SSRN: http://ssrn.com/abstract=1008400.

[88] *Id,* in which Professor Pargendler states: "good faith serves as a doctrinal rubric for a 'tailored' gap-filling provision. The most universal formulation of the doctrine of good faith states that a party cannot act to prevent the other from obtaining the fruits of the contract. The lack of a more precise definition for the duty of good faith provides the ideal framework for courts to fill the gaps with a case-specific hypothetical bargain method. Some restrictions imposed on the doctrine of good faith, such as the notion that the doctrine does not create an independent duty divorced from the specific clauses of the contract, reinforce the claim that good faith operates to provide the most appropriate gap-filling provisions taking into account the precise characteristics of the deal in question." Yet, the good faith doctrine requires in every contract 'honesty in fact.'" *Id.* at pp 4-5. As further stated by Professor Pargendler: "A second and related prong of the doctrine of contractual good faith prohibits bad faith or malicious advantage-taking in contract performance (i.e., it requires, in the wording of the UCC, that the parties behave with "honesty in fact", also known as the rule of "pure heart and empty head"). The requirement of honesty in fact can be understood as a corollary of the gap-filling character of good faith; however, its more universal application is due to the plausible assumption that no one would agree to being taken advantage of maliciously. Unlike other contractual duties derived from good faith, which vary according to the express terms and characteristics of the deal in question, the requirement of honesty in fact applies to every contract as a floor to the parties' bargained for duties." *Id* at p.19.

[89] *Id.* at p.28.

[90] *See In re Enivid. Inc*., 345 B.R. 426 (Bankr.Mass., 2006) ("Several Delaware cases have examined whether good faith is an independent fiduciary duty or a component of the traditional fiduciary duties of care and loyalty under Delaware law. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (De1.1993) … (referring to the duty of good faith as a separate duty within the triad of duties of good faith, loyalty and due care); *but see In re Gaylord Container Corp. S'holder, Litig*., 753 A.2d 462, 475-76, n. 41 (Del.Ch.2000) (referring to good faith as a subsidiary requirement of the duty of loyalty).")

[91] BLACK'S LAW DICTIONARY 1520 (6th ed. 1990).

3. **Good Faith Requires "Honesty."** The fiduciary's duty of utmost good faith requires both subjective and objective honesty. As to the fiduciary's subjective honesty, the fiduciary must sincerely believe that his conduct is in the best interests his or her client, that any statements or representations made as a fiduciary to the client are truthful, and that the fiduciary's conduct is within the realm of decent behavior. Beyond the personal belief of the fiduciary in the rightness of his or her actions, the fiduciary's adherence to his or her good faith obligation is not judged solely by reference to the fiduciary's belief that his or her actions were compliant or non-compliant with the duty of good faith. Instead, the fiduciary's compliance with his or her duty of good faith are judged objectively – by the views of others (judges, juries, or arbitrators) – with a view as to whether the fiduciary should have made inquiry to discern certain facts[92] and whether a fiduciary's actions would have been compliant when judged by disinterested observers.[93]

4. **Utmost Good Faith as a "Gap-Filler."** The fiduciary duty of good faith is also a "gap-filler." In the context of the directors of a corporation and the duty of good faith owed by such directors, Professor Lowenstein observed:

> The notion of a 'subjective intent' or a 'conscious disregard' forces one to examine the director's motivation, in contrast to the fiduciary duty of care, which looks to process undertaken by directors to inform themselves, or the fiduciary duty of loyalty, which looks to the relationship of the director to the transaction under scrutiny. These demarcations are not, however, bright and independent of one another. While the duties of due care and loyalty encompass many affirmative obligations as well as prohibited conduct, the traditional duties of care and loyalty do not cover all types of improper conduct by a fiduciary. Into this gap steps the

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[92] *See In re Cannon*, 230 B.R. 546 (Bankr. W.D. Tenn., 1999), addressing good faith in the context of transfers by a debtor to a creditor and 11 U.S.C. §548(c); ("Good faith is to be measured objectively, rather than subjectively … Courts have found mere failure to inquire in the face of unusual circumstances to be sufficient. In *M & L Business Machine*, 84 F.3d 1330 (10th Circuit, 1996), the Tenth Circuit upheld the bankruptcy court's findings that payments to a Ponzi scheme investor were not made in good faith. The court of appeals concluded that a reasonably prudent investor in the defendant's position should have known of the debtor's fraudulent intent and impending insolvency based on the extraordinary rate of returns promised, the use of postdated checks, and implausible explanations as to how the debtor could pay such high rates. In addressing the standard of good faith, the court noted that the Bankruptcy Code does not define the term 'good faith' and, citing *Collier*, that '[t]he unpredictable circumstances in which the courts may find its presence or absence render any definition of `good faith' inadequate, if not unwise.' 84 F.3d at 1335. The Tenth Circuit further stated: 'Nevertheless, contrary to Mr. McKay's contention `good faith' has frequently been construed to include an objective component.' After noting that `[g]ood faith is an intangible and abstract quantity with no technical meaning,' *Black's Law Dictionary* states that the term includes not only *`honest belief, and absence of malice and the absence of design to defraud or to seek an unconscionable advantage' but also `freedom from knowledge of circumstances which ought to put the holder on inquiry.' Black's Law Dictionary* at 693 (6th ed.1990) (*emphasis supplied*). Prominent bankruptcy scholars agree: `[t]he presence of any circumstances placing the transferee on inquiry as to the financial condition of the transferor may be a contributing factor in depriving the former of any claimed good faith unless investigation actually disclosed no reason to suspect financial embarrassment.' 4 *Collier on Bankruptcy, supra*, § 548.07 at 548-73. M & L Business Machine, 84 F.3d at 1335-36.") *In re Cannon* at 592-3.

[93] Melvin A. Eisenberg, "The Duty of Good Faith in Corporate Law," 31 DEL. J. CORP. L. 1, 23 (2006) ("Good faith in law ... is not to be measured always by a man's own standard of right, but by that which the law has adopted and prescribed as a standard for the observance of all men in their dealings with each other. Indeed, in law generally, the objective elements of good faith dominate the subjective element."). As Professor Deborah De Mott puts it, in discussing the fiduciary duties of corporate directors: "Wholly apart from these practical issues of proof, a standard for good faith that looks solely to directors' motives ignores the function to be served by the standard. As applied to directors' decisions, a standard of good faith tests directors' fidelity to the interests they may appropriately consider or serve. Subjective motivation and sincere belief are, at best, imprecise surrogates to measure fidelity. Directors, like other people, are capable of deceiving themselves about the point and effect of their actions. Sincere self-deception is not responsive to the obligation to which directors, as fiduciaries, are subject. Fiduciary norms are stringent: they prohibit the fiduciary from creating interests in conflict with interests of the beneficiary protected by the relationship, and they deny a fiduciary the profit derived from a breach of duty even when the breach caused no demonstrable injury to the beneficiary. One explanation for this stringency is the persistent capacity of decisionmakers for sincere self-deception when self interest is at stake." Deborah DeMott, "Puzzles and Parables: Defining Good Faith in the MBO Context," 25 WAKE FOREST L. REV. 15, 22-23 (1990).

duty of good faith, offering to the courts another means of finding a breach of the broad fiduciary duties possessed by financial planners and other fiduciaries.[94]

The fact that a breach of the duty of good faith can support an independent action, not dependent upon any breach of the other fiduciary duties of due care and loyalty, is well known in fiduciary law (but not always accepted in every fiduciary law context[95]). For example, a financial planner may act recklessly, supplying advice to a client which is cavalierly given and not based upon adequate knowledge or analysis. Suppose that (and fortunately for the sake of the financial planner, the advice results in a favorable outcome for the client). Since there is no harm which has been done, nor any personal profit derived by the fiduciary, an action for the breach of the duty of due care or the duty of loyalty is unlikely to afford any remedy. Yet, courts may well find the fiduciary financial planner's conduct a breach of the duty of good faith, as a "reckless and indifferent" act with respect to the client.[96]

[94] Mark Lowenstein, "The Diverging Meaning of Good Faith," Colorado Law School Legal Studies Research Paper Series No. 08-28 (2008), p.8, available at SSRN: at: http://ssrn.com/abstract=1285135.

[95] "[T]he Delaware Supreme Court announced in *Stone v. Ritter* that good faith was not an independent fiduciary duty and that the failure to act in good faith "is not conduct that results, ipso facto, in the direct imposition of fiduciary liability." Rather, the Stone Court characterized the duty to act in good faith as a "subsidiary element, i.e., a condition, of the fundamental duty of loyalty" despite previously having referred to good faith as one of the "triad" duties of care, loyalty and good faith." Lowenstein*, supra* n.___, at pp.8-9, *citing Stone ex. rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369 (Del. 2006).

[96] Most courts have adopted the definition of recklessness first set forth by the Seventh Circuit Court of Appeals in the case of *Sundstrand Corporation v. Sun Chemical Corporation*, 553 F.2d 1033, 1045 (7th Cir. 1977): "Reckless conduct may be defined as … highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care … which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." The distinction between negligent and reckless conduct is an important one, as reckless conduct can support an application of the harsher remedies available when scienter must be demonstrated. *See also In re Enivid. Inc*., 345 B.R. 426 (Bankr.Mass., 2006) [holding that a separate claim existed for breach of the duty of good faith by directors and officers in approaching the operation of the corporation with a level of indifference or egregiousness that amounted to bad faith., and stating: "Several Delaware cases have examined whether good faith is an independent fiduciary duty or a component of the traditional fiduciary duties of care and loyalty under Delaware law. *See Cede & Co. v. Technicolor, Inc*., 634 A.2d 345, 361 (De1.1993) … (referring to the duty of good faith as a separate duty within the triad of duties of good faith, loyalty and due care); *but see In re Gaylord Container Corp. S'holder, Litig*., 753 A.2d 462, 475-76, n. 41 (Del.Ch.2000) (referring to good faith as a subsidiary requirement of the duty of loyalty)."]

EXHIBIT: OCTOBER 16, 2009 LETTER TO CONGRESS, FROM UNIVERSITY PROFESSORS ET. AL.

October 16, 2009

Honorable Christopher Dodd
Chairman

Honorable Richard Shelby
Ranking Member

Senate Committee on Banking
Washington, DC 20510

Honorable Barney Frank
Chairman

Honorable Spencer Baucus
Ranking Member

House Financial Services Committee
Washington, DC 20515

Re: Section 103 of the Discussion Draft, Investor Protection Act of 2009

Dear Chairman Dodd, Ranking Member Shelby, Chairman Frank and Ranking Member Bachus:

We write in our capacities as members of the academic, legal, compliance, and registered investment adviser communities, to express our strong support for preserving the current fiduciary standard of conduct found in the Investment Advisers Act of 1940. We express our deep concern over proposals advanced by some participants in the securities industry which would create a far lower standard for firms and individuals who provide investment advice.

In order to correct misunderstandings as the nature and effect of various proposals, and to facilitate a greater understanding of the fiduciary standard of conduct, we offer the following observations:

1. The Proposed Legislation Would Result in a Lowering of Standards of Conduct Upon Those Who Provide Investment Advice. The highest standard under the law[i] – the fiduciary standard of conduct – currently applies under the Investment Advisers Act of 1940[ii] and the common law[iii] of the various states to those who provide investment and financial advice. The proposed legislation[iv] would result in a lower standard of conduct for investment advisers, and hence less protection for all Americans who desire and who receive financial and investment advice, by adopting an arms-length standard of conduct for investment advisers in place of the fiduciary standard of conduct, as explained herein.
2. "Personalized Investment Advice" Includes Advice Provided to "Non-Retail" Clients. The Advisers Act is applied to all advisers' clients, whether "retail"[v] or otherwise. The argument that that only "personalized investment advice" to "individual investors" was intended to be covered by the Advisers Act is mistaken. The term "personalized" used in connection with the phrase "investment advice" refers not to the nature of the client, but rather to the activities of the investment adviser.[vi] There exists no justification for narrowing the scope of the Advisers Act by excluding non-retail clients, such as endowment funds, government entities, pension funds, trustees, and many others, from the protections afforded by the fiduciary standard of conduct.
3. There Exists Only One Fiduciary Standard of Conduct for Investment Advisers; It is Uniformly Applied. When the fiduciary standard of conduct is applied to financial advisors and investment advisers, wheth*er such s*tandard is imposed by the Advisers Act or state common law, it has been applied *uniformly* by the courts to financial advisors and investment advisers. There are not "51 different standards," as has been suggested by some advocates of a "new federal fiduciary standard" (which is not a fiduciary standard at all). Only one fiduciary standard of conduct exists under the law for investment advisers and financial advisors; [vii] there is no need to modify this one standard. Even if such uniform standards did not already exist, legislation which instead applies the currently existing one fiduciary standard of conduct to all providers of financial and investment advice would cure the very complaints of those who mistakenly give the impression that "51 different standards" exist. Furthermore, this uniform standard has been established and refined in years of interpretation by the courts and the regulators. A new "unified standard" will erase the rich history of the current law.

4. The Fiduciary Standard of Conduct Must Remain Flexible to Address Fraud. It has long been acknowledged under the law that fiduciary duties must adapt in order that fraudulent conduct, which is always changing, be successfully prohibited and published.[viii] Any attempt to further "define" the fiduciary standard of conduct through legislation could effectively negate the ability of courts of equity to react to the ever-changing field of investment and financial planning advice and to new schemes cooked up by fraudsters.[ix]

5. The "New Federal Fiduciary Standard" as Proposed is *Not* A Fiduciary Standard of Conduct; How Fiduciaries Deal with Conflicts of Interest. Advocates of a "new federal fiduciary standard" have implied that "disclosure" of a conflict of interest, followed by the "consent" of the client to proceed with the transaction, is all that is required of the fiduciary. This view takes into account only the disclosure-based regime of either the Securities Act of 1933 or the Securities Exchange Act of 1934 which contemplate an arms-length relationship[x] between the issuer or broker and customer. In contrast, the Advisors Act requires much more of those in fiduciary relationships with their clients. In the presence of a conflict of interest, fiduciary law protects the client by obligating the fiduciary to: (1) *affirmatively disclose all material facts* to the client; (2) ensure *client understanding* of the transaction, the conflict of interest which exists, and their ramifications; (3) obtain an *intelligent, independent and informed consent* from the client; and (4) ensure that the proposed transaction, even with client consent, remains *a substantively fair arrangement* for the client.[xi]

6. Consumer Choice Remains; Investors Will Retain Access to a Broad Array of Products. The issue of "consumer choice" is a red herring.[xii] The same investment product choices will remain for Americans. The issues are the standard of conduct for those who offer investment and financial advice, and the representations and inferences[xiii] made by providers with regard to their duties toward the client. The fiduciary standard of conduct possesses real teeth, as it imposes affirmative obligations of loyalty, utmost good faith and due care on the advisor, which duties continue throughout the life of the relationship. It is not, and should not become, a check-the-box standard that only periodically applies, as individual investors rarely possess the knowledge necessary to negotiate for the standard of conduct which the advisor should provide.[xiv]

7. Commission-Based Compensation Is Not Prohibited Under the Advisers Act; Third-Party Compensation Arrangements Create Difficulties, But These Should Be Resolved Through Best Practices, Not Legislation. Commission-based compensation is not specifically prohibited under the current Advisers Act; there is no need to specify in legislation that commission-based compensation is permitted, and inclusion of such a paragraph could inadvertently be construed as permitted self-dealing, a lowering of the fiduciary standard. Commission-based compensation leads to conflicts of interest which must be affirmatively disclosed and properly managed, as discussed above. The even more difficult problem a fiduciary faces is when *variable compensation* is present. In this regard, the securities industry could adopt the approach of agreed-to-in-advance *level compensation* as a "best practice." Those who seek to provide investment advice should adapt to the higher standard of conduct imposed upon investment and financial advisors; the law should not be revised to accommodate the sales practices of Wall Street's broker-dealer firms operating under the guise of unbiased advice.[xv]

8. The *Bona Fide* Fiduciary Standard of Conduct is Essential for Americans, and America Itself. Strong practical and public policy reasons exist for the imposition of the true fiduciary standard of conduct upon investment advisers and financial advisors.[xvi] The increased complexities of today's modern capital markets and the difficult decisions today's Americans face in preparing for their own financial futures provide an even greater rationale for the fiduciary standard of conduct established in the Advisers Act.[xvii]

9. The Proposed Legislation Which Would *Lower* Standards of Conduct for Investment Advisers and Financial Advisors, Following a Global Economic Crisis Caused In Large Part by Broker-Dealer Firms, Would Undermine the Investors' Trust in Our Capital Markets. Restoring individual investor's trust in our capital markets system is essential. It would be ironic indeed if the economic crisis is used by lobbyists,

who represent the very same firms whose risk-taking led in substantial part to the current recession. It would be tragic if they succeed in convincing Congress to lower the standards of conduct for providers of investment advice to our fellow Americans, instead of tightening the standards.

10. If a New Standard of Conduct is to be Adopted, Don't Call it a "Fiduciary Standard." Fiduciary standards are applicable to many who are in positions of trust and confidence. The lowering of a "fiduciary standard" as to one fiduciary actor could result in a slippery slope, in which the fiduciary standards of conducts are subsequently lowered for attorneys, trustees, ERISA plan sponsors and advisors, and many other forms of fiduciaries. Congress should not proceed down this path of enacting "particular exceptions" which would "denigrate" the one fiduciary standard of conduct.[xviii]

11. Harmonization" Should Not Lower Standards of Conduct. It has been recognized that brokers have recently changed their business practices to act and look more like advisers, and to refer to themselves using terminology which denotes an advisor-client fiduciary relationship based upon trust and confidence. In contrast, the business practices of investment advisers have not generally changed in the nearly seven decades since the Advisers Act of 1940 was adopted. The proposed "harmonization" seeks to make investment advisers look more like brokers,[xix] and transforms the current fiduciary relationship between investment advisers and their clients into a contractual arms-length relationship. This proposed standard matches the far lower past suitability standard, but is advanced under the guise of a new "federal fiduciary standard." This attempt at "harmonization" has no foundation in investor protection.[xx]

Conclusion. As Congress works to restore the vitality of the U.S. economy, renew investor confidence, and address failures of and weaknesses in, the current regulatory framework, the undersigned express our strong support of the proposal in the Obama Administration's white paper on financial regulatory reform to require that "broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers."

Federal investor protection laws since 1933 have been largely developed by Congress to strengthen, supplement and enhance co-existing state laws for the protection of investors and not to deny investors the common law protections they already possess. The Investor Protection Act of 2009, as proposed in the "Discussion Draft" dated Oct. 1, 2009, would – to the extent it would take away the common law protections applicable to fiduciaries – place investors in a lower caste or subclass; such investors would be denied the protections afforded by common law to all other beneficiaries of fiduciary duties. If this should become Congressional policy, it would contradict and undermine the Congressional policy which led to federal securities regulation in the first place.

We urge Congress to revise the draft of the Investor Protection Act of 2009 to: (1) unambiguously provide for the fiduciary standard of conduct, as developed over centuries of common law and applied with remarkable consistency by civil, probate and other courts across this great nation to those brokers who choose to offer investment advice, whether to individuals or entities; and (2) ensure that the fiduciary duty which already exists under the Advisers Act is not undermined or weakened in any way. Such an approach will enhance investor protection, reduce investor confusion, and promote regulatory fairness and efficiency by establishing the same fiduciary duty for all investment professionals who provide investment and financial advice.

Our fellow Americans deserve no less.

Sincerely,

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Donald B. Trone, President, Foundation for Fiduciary Studies

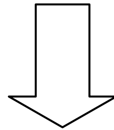
Denise Wilcox, CFP®, AIF®, Financial Solutions, Henderson, NV

Exhibit A in the Letter to Congress:
The Distinction: Arms-Length (Broker) vs. Fiduciary (Adviser) Relationships

ARMS-LENGTH SALES RELATIONSHIPS

PRODUCT MANUFACTURERS, SECURITIES ISSUERS, SECURITIES DEALERS

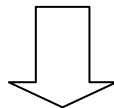
Providers of mutual funds, ETFs, annuities, life insurance products, stocks, bonds, hedge funds, and other financial products



REPRESENTATIVE OF MANUFACTURERS / ISSUERS (BROKERAGE FIRM / REGISTERED REPRESENTATIVE / LIFE INSURANCE BROKERS AND AGENTS)

Providers / distributors of mutual funds, ETFs, annuities, life insurance products, stocks, bonds, hedge funds, and other financial products

Securities brokers and dealers receive commissions and other forms of compensation (payment for shelf space, soft dollar compensation) paid by product manufacturers



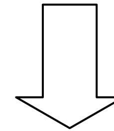
CUSTOMER

Entitled to rely on the "good faith" of the broker, dealer, or seller, enhanced by the requirement that any product sold be "suitable" to the customer's needs (which relates mainly to product-specific risks, not to the fees, costs, or tax consequences of the product)

FIDUCIARY ADVISORY RELATIONSHIPS

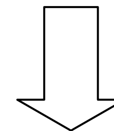
CLIENT

Seeks out a trusted advisor for guidance. Requires expert advice to navigate the complexities of the modern financial world.



REPRESENTATIVE of CLIENT (PURCHASER): INVESTMENT ADVISER / FINANCIAL ADVISOR

Bound to represent the best interests of the client at all times. Possessing broad fiduciary duties of due care, loyalty, and utmost good faith toward the client.



PRODUCT MANUFACTURERS / ISSUERS / SECURITIES DEALERS

Investment product / securities providers.

Increased competition to develop products and more choices, due to presence of knowledgeable advisors acting as representatives of the purchaser.

[i] The fiduciary standard of conduct is consistently described by the courts as the "highest standard of duty imposed by law." *See, generally Black's Law Dictionary* 523 (7th ed. 1999) ("A duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another."); *also see F.D.I.C. v. Stahl*, 854 F.Supp. 1565, 1571 (S.D. Fla., 1994) ("Fiduciary duty, the highest standard of duty implied by law, is the duty to act for someone else's benefit, while subordinating one's personal interest to that of the other person); *and see Perez v. Pappas*, 98 Wash.2d 835, 659 P.2d 475, 479 (1983) ("Under Washington law, it is well established that 'the attorney-client relationship is a fiduciary one as a matter of law and thus the attorney owes the highest duty to the client.'"), *cited by Bertelsen v. Harris*, 537 F.3d 1047 (9th Cir., 2008).

[ii] As stated by the U.S. Supreme Court: "As we have previously recognized, §206 [of the Advisers Act] establishes 'federal fiduciary standards' to govern the conduct of investment advisers, *Santa Fe Industries, Inc. v. Green, supra*, 430 U.S., at 471, n. 11, 97 S.Ct., at 1300; *Burks v. Lasker*, 441 U.S. 471, 481-482, n. 10, 99 S.Ct. 1831, 1839, 60 L.Ed.2d 404; *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 191-192, 84 S.Ct. 275, 282-283, 11 L.Ed.2d 237. Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations. *See* H.R.Rep.No.2639, 76th Cong., 3d Sess., 28 (1940); S.Rep.No.1775, 76th Cong., 3d Sess., 21 (1940); SEC, Report on Investment Trusts and Investment Companies (Investment Counsel and Investment Advisory Services), H.R.Doc. No.477, 76th Cong., 2d Sess., 27-30 (1939)." *Transamerica Mortgage Advisors, Inc v. Lewis*, 444 U.S. 11, 17-18, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979).

The Advisers Act's fiduciary duties are based upon, and codified, state common law which applied fiduciary duties upon relationships based on trust and confidence as a means of preventing constructive fraud. As stated by the U.S. Supreme Court: "Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries … Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes." *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

The Congress has continuously incorporated the common law of fiduciary duty into numerous federal statutes by simply using the words "fiduciary duty"- *see, e.g.,* §36(b), Investment Company Act, and ERISA. The Supreme Court has repeatedly held that "where Congress uses terms that have settled meaning under common law ... Congress means to incorporate the established meanings of these terms." *NLRB v. Amax Coal Co*., 53 U.S. 322, 101 S.Ct. 2789, 69 L.Ed.2d 672 (U.S.1981) (adopting *Meinhard's* fiduciary standard).

The existence of a "federal fiduciary standard" under the Investment Advisers Act of 1940 does not mean that deference is not provided to the scope of fiduciary duties as they exist under state common law. *See U.S. v. Brennan*, 938 F.Supp. 1111 (E.D.N.Y., 1996) ("Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law. *See, e.g., Varity v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996); *F.D.I.C. v. Wright*, 87 B.R. 1011 (D.S.D. 1988) (bankruptcy).") *Id*. at 1119.

[iii] The recognition of the existence of a fiduciary relationship under the common law is said to consist of two main branches. The first branch of fiduciary status consists of a list of accepted and prescribed relationships — principal and agent, attorney and client, executor or trustee and beneficiary, director or officer in the corporation, partners, joint venturers, guardian and ward, and parent and child. The common law has defined, over the years, these relationships to be fiduciary in nature, and they are generally accepted as such. When a personal financial advisor accepts actual discretion over a client's account, under this branch of fiduciary relationships fiduciary status for the advisor will result (due to the application of agency law). Various court decisions note that common law fiduciary duties arise from the principal-agent relationship, and that these duties will usually be interpreted quite broadly. In essence, since the scope of the agency includes the exercise of discretionary authority to undertake sales and purchases in the account, the agent (registered representative) owes a fiduciary duty to the principal (the customer) in the actions undertaken which exercise that discretion.

The second branch of fiduciary status arises from those relationships which, on their particular facts, are appropriately categorized as fiduciary in nature. Under this test, a variety of circumstances may indicate that a fiduciary relationship exists, as opposed to an arms-length relationship. Such circumstances, or indicia or evidential factors, include influence, placement of trust, vulnerability or dependency, substantial disparity in knowledge, the ability to exert influence, and placement of confidence. Another factor may lie in the ability of the fiduciary, by virtue of his or her position or authority, to derive profits at the expense of his or her client. It is under this branch that most financial advisors will find fiduciary status applied by the common law.

The development of this second branch of fiduciary relationships accelerated during the 20th Century and continues today, in response to the increased complexity of our modern world. Increased amounts of specialization are required in modern

society, and this in turn leads to greater reliance on others in order to obtain greater affluence. As stated by Professor Frankel, "Courts, legislatures, and administrative agencies increasingly draw on fiduciary law to answer problems caused by these social changes." Tamar Frankel, *Fiduciary Law,* 71 Calif. L. Rev. 795, 796 (1983).

Many state courts, applying state common law to relationships based upon trust and confidence, have held that the relationship is or may constitute a fiduciary relationship between the financial advisor and/or investment adviser and the client. *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007) ("Obviously, when a person such as Hutton is acting as a financial advisor, that role extends well beyond a simple arms'-length business transaction. An unsophisticated investor is necessarily entrusting his funds to one who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his investor/entrustor. The relationship goes well beyond a traditional arms'-length business transaction that provides 'mutual benefit' for both parties."). *See also U.S. v. Williams*, 441 F.3d 716, 724 (9th Cir. 2006); *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 4430 (NY 6/2/2005) (NY, 2005); *Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 2005); *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385, 414 (S.D.N.Y., 2005) (the customer "relied upon superior knowledge. Asset Alliance allegedly was plaintiff's investment advisor and committed to 'monitor the status and performance of [Beacon Hill and Bristol] at least once a month and [to] promptly inform Sanpaolo if, for any reason, it believes that [Beacon Hill or Bristol] should be de-selected.' These allegations are sufficient to plead a fiduciary relationship."); *Mathias v. Rosser*, 2002 OH 2531 (OHCA, 2002) ("[T]he evidence established that Rosser was a licensed stockbroker and held himself out as a financial advisor, and that plaintiff was an unsophisticated investor who sought investment advice from Rosser precisely because of his alleged expertise as a broker and investment advisor. Further, Rosser testified that plaintiff had relied upon his experience, knowledge, and expertise in seeking his advice. Therefore, we conclude that plaintiff presented sufficient evidence to establish that she and Rosser were in a fiduciary relationship."); *Cunningham vs. PLI Life Insurance Company*, 42 F.Supp.2d 872 (1990); *MidAmerica Federal Savings and Loan Ass'n v. Shearson / American Express Inc.*, 886 F.2d 1249 (10th Cir. 1989) (The court found a fiduciary relationship under Oklahoma law between a broker and his client in circumstances where the broker held himself out as having superior knowledge and expertise and the client reasonably placed his confidence in the broker.); *Koehler v. Pulvers,* 614 F. Supp. 829 (USDC, Cal, 1985).

Neither federal nor state securities laws generally preempt common law claims based upon breach of fiduciary duty. This is because the securities statutes were modeled after the common law actions of fraud and deceit. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-215, 96 S.Ct. 1375, 1381-1391, 47 L.Ed.2d 668 (1976) (review of legislative history); *see also* Securities Regulation, 69 Am.Jur.2d Sec. 1 *et seq*.

It is noted that all agents, including brokers and investment advisers, are, by definition, fiduciaries under common law, with the scope of those fiduciary duties (care, loyalty, good faith and disclosure) dependent on the powers and responsibilities assumed.

[iv] The text of Section 103 of the proposed Investor Protection Act of 2009, as set forth in the "Discussion Draft" as released by Subcommittee Chair Kanjorski on October 1, 2009 (available at http://www.house.gov/apps/list/press/financialsvcs_dem/investor_protection_act_draft.pdf), provides:

> SEC. 103. ESTABLISHMENT OF A FIDUCIARY DUTY FOR BROKERS, DEALERS, AND INVESTMENT ADVISERS, AND HARMONIZATION OF REGULATION.
>
> (a) IN GENERAL.—
>
> (1) SECURITIES EXCHANGE ACT OF 1934.—Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78) is amended—
>
> (A) by redesignating the second subsection (i) as subsection (j); and
>
> (B) by adding at the end the following new subsections:
>
> (k) STANDARDS OF CONDUCT.—
>
> (1) IN GENERAL.—Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission shall promulgate rules to provide that, with respect to a broker or dealer that is providing investment advice to a retail customer (and such other customers as the Commission may by rule provide), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940. The receipt of compensation based on commission shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer.
>
> (2) RETAIL CUSTOMER DEFINED.—For purposes of this subsection, the term 'retail customer' means an individual, or the legal representative of such individual, who—
>
> (A) receives personalized investment advice from a broker or dealer; and
>
> (B) uses such advice primarily for personal, family, or household purposes.
>
> (l) OTHER MATTERS.—The Commission shall—

(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers; and

(2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors.''

(2) INVESTMENT ADVISERS ACT OF 1940.—Section 211 of the Investment Advisers Act of 1940, as amended by section 102(d), is further amended by adding at the end the following new subsection:

(f) STANDARDS OF CONDUCT.—

(1) IN GENERAL.—Notwithstanding any other provision of this Act or the Securities Exchange Act of 1934, the Commission shall promulgate rules to provide that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.

(2) RETAIL CUSTOMER DEFINED.—For purposes of this subsection, the term 'retail customer' means an individual, or the legal representative of such individual, who—

(A) receives personalized investment advice from a broker, dealer, or investment adviser; and

(B) uses such advice primarily for personal, family, or household purposes.

(g) OTHER MATTERS.—The Commission shall—

(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their 3 relationships with brokers, dealers, and investment advisers; and

(2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors.

(b) HARMONIZATION OF ENFORCEMENT AND REMEDY REGULATIONS.—Section 15 of the Securities Exchange Act of 1934, as amended by subsection (a), is further amended by adding at the end the following new subsection:

(m) HARMONIZATION OF ENFORCEMENT AND REMEDY REGULATIONS.—The Commission shall issue regulations to ensure, to the extent practicable, that the enforcement options and remedies available for violations of the standard of conduct applicable to a broker or dealer providing investment advice to a retail customer are commensurate with those enforcement options and remedies available for violations of the standard of conduct applicable to investment advisers under the Investment Advisers Act of 1940.

[v] SIFMA desires Congress to exclude all non-retail clients from the application of the Advisers Act, which would represent a significant narrowing of the current application of the Advisers Act. Mr. Taft, representing SIFMA, stated: "The federal fiduciary standard that SIFMA supports should apply to individual investors only based on our view that institutional clients are better able to – and in practice do in fact – appreciate and appropriately define the terms of their relationships with investment advisory service providers." U.S. House Of Representatives Committee On Financial Services Hearing On: *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight Of Private Pools Of Capital, And Creating A National Insurance Office*, October 6, 2009, written testimony of John Taft, Head Of U.S. Wealth Management, RBC Wealth Management, Chairman, Private Client Group Steering Committee, Securities Industry And Financial Markets Association.

[vi] Rule § 275.203A-3(a)(2)(ii) defines "Impersonal investment advice" to mean "investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts." The term "accounts" refers to accounts of both retail and non-retail clients.

The Investment Advisers Act of 1940 applies to <u>all</u> clients of investment advisers, whether they are "retail clients" or "institutional clients." The Advisers Act was intended to apply to "personalized investment advice" and to "fiduciary, person-to-person relationships … and that are characteristic of investment adviser-client relationships." *Lowe v. SEC*, 472 U. S. 181, 210 (1985). Investment counsel was characterized in the testimony leading up to the enactment of the Advisers Act "as a personal service profession, and depends for its success upon a close personal and confidential relationship between the investment counsel firm and its client. It requires frequent and personal contact of a professional nature between us and our clients … We must establish with each client a relationship of trust and confidence designed to last over a period of time because economic forces work themselves out slowly." *Id.* at 196-7. "The [Advisers] Act was designed to apply to those persons engaged in the investment-advisory profession -- those who provide personalized advice attuned to a client's concerns, whether by written or verbal communication." *Id.* at 207-8. It is submitted that the term "personalized" refers not to the nature of the client, but rather to the nature of the advice being provided.

Moreover, given the existence of many forms of non-retail clients (i.e., hedge funds, pension funds, mutual funds, small endowment funds, trustees of charitable and private trusts, public entities such as villages, nonqualified retirement fund

trustees, etc.) who could easily be taken advantage as a result of the vast disparity of knowledge between an investment adviser and client, and given the lack of the substantial resources to engage third party experts to monitor the actions of those providing investment advice, there appears insufficient rationale to now deny to non-retail clients of investment advisers the protections afforded by fiduciary law which they presently enjoy.

[vii] Despite assertions to the contrary, the fiduciary standard of conduct is nearly uniformly applied by the courts, whether the standard is imposed by the Investment Advisers Act of 1940 or state common law. The advocates for a "new federal fiduciary standard" unpersuasively argue that there exist "51" different fiduciary standards. They confuse the distinction between the various bodies of law which impose fiduciary status (*i.e., when* fiduciary duties are imposed) and the fiduciary principles which are applied when fiduciary status is found (*i.e., what* fiduciary duties exist). "The laws applicable to the situations in which fiduciary power is delegated should not be confused with the principles of fiduciary law. The *same* fiduciary principles apply to fiduciary power, and are superimposed on the *different* bodies of law governing the contexts in which that power appears." Tamar Frankel, Fiduciary Law, 71 Calif. L. Rev. 795 (1983).

At the U.S. House Of Representatives Committee On Financial Services Hearing On: *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight Of Private Pools Of Capital, And Creating A National Insurance Office*, October 6, 2009, written and oral testimony in support of a "new federal fiduciary standard" was provided on behalf of SIFMA, the broker-dealer trade association, by John Taft, Head Of U.S. Wealth Management, RBC Wealth Management, Chairman, Private Client Group Steering Committee, Securities Industry And Financial Markets Association. In the written testimony, at page 8, in footnote 18, Mr. Taft cites several cases which, he concludes, support the proposition that: "fiduciary law has developed haphazardly and often inconsistently among the 50 states. Consequently, investor protection can actually grow or diminish as an individual investor moves from state to state." *However*, all of these cases only address *when* fiduciary status is applied upon providers of financial advice. Under the second branch of fiduciary relationships – those which are implied by law on the basis of particular facts and circumstances evidencing a relationship based on trust and confidence. The cases provide no support for the proposition that the broad fiduciary duties of due care, loyalty and utmost good faith are unevenly applied. Again, Mr. Taft has mixed up the *context* to which fiduciary duties are applied, and fails to note that the fiduciary principles, once applied by the courts, are very uniformly applied. There does not exist "51" different fiduciary standards of conduct, as Mr. Taft suggests – there is only one fiduciary standard of conduct, and it is well-developed under the law and evenly applied by the courts of all fifty states and the federal courts.

Moreover, the question before Congress is whether to reverse the direction taken by the U.S. Securities and Exchange Commission (SEC) in recent years, in which it has permitted stockbrokers to engage in the delivery of financial and investment advice in an amount which clearly exceeds that permitted under the "solely incidental" language found in the broker-dealer exemption from the Advisers Act. A clear statement by Congress to apply fiduciary standards of conduct to all those who provide investment and financial advice is suggested as a means of rectifying the SEC's interpretation of the "solely incidental" language in such a broad manner that it challenges both the expressed intent of Congress in its enactment of the Advisers Act as well as the validity of the phrase, "words have meaning." Legislation which reverses the SEC's course, by clearly applying fiduciary standards to all providers of financial and investment advice, would create the very uniform application of fiduciary standards which SIFMA complains about does not exist. Moreover, it will avoid continued judicial challenges to the efficacy of the SEC's exercise of its rule-making authority.

In conclusion, as stated by one of our current SEC Commissioners: "There is only one fiduciary standard …." SEC Commissioner Luis A. Aguilar, Speech, "SEC's Oversight of the Adviser Industry Bolsters Investor Protection" (May 7, 2009).

It should be noted that this one fiduciary standard is then given further elaboration in the United States through the frequently-referred to triad of broad fiduciary duties – due care, loyalty, and utmost good faith. *See, e.g., Emerald Partners v. Ber*lin, 787 A.2d 85, 91 (Del. 2001) ("The presumption [afforded by the business judgment rule] can be rebutted by showing that the board violated "any one of its triad of fiduciary duties: due care, loyalty, or good faith."); *also see Malone v. Brincat*, 722 A.2d 5 (DE, 1998) ("The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty. That triparte fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided.") *See also Von Noy v. State Farm Mutual Automobile Insurance Company*, 2001 WA 80 (WA, 2001) (Justice Philip Talmadge, concurring opinion) (""A fiduciary relationship is a relationship of trust, which necessarily involves vulnerability for the party reposing trust in another. One's guard is down. One is trusting another to take actions on one's behalf. Under such circum-stances, to violate a trust is to violate grossly the expectations of the person reposing the trust. Because of this, the law creates a special status for fiduciaries, imposing duties of loyalty, care, and full disclosure upon them. One can call this the fiduciary principle.")

Very recent cases applying fiduciary law in other contexts confirm the uniformity of the application of the fiduciary standard of conduct. *See Robinson v. Global Resources, Inc.*, A09A1682 (Ga. App. 9/3/2009) (Ga. App., 2009) ("Defendants were in a confidential fiduciary relationship with 1st Affinity (or ABI) and owed Plaintiff the highest duties of due care, loyalty, honesty, good faith, and fair dealing.") *Dubroff v. Wren Holdings, LLC*, C.A. No. 3940-VCN (Del. Ch. 5/22/2009) (Del. Ch., 2009) ("The Delaware Supreme Court has held that [w]henever directors communicate publicly or directly with shareholders about the

corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty.”).

[viii] Fiduciary duties must evolve over time to meet the ever-changing business practices of advisors and fraudulent conduct successfully circumscribed. *See Stonemets v. Head*, 248 Mo. 243, 154 SW 108 (1913), in which Judge Lamb of the Missouri Supreme Court stated:

> Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition. Messieurs, the fraud-feasors, would like nothing half so well as for courts to say they would go thus far, and no further in its pursuit.

See also Justice Douglas in *Pepper v. Litton*, 308 U.S. 295, 311 (1939), wherein he stated:

> He who is in such a fiduciary position cannot serve himself first and his cestuis second … He cannot use his power for his personal advantage and to the detriment of [the cestuis], no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis , Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation … Otherwise, the fiduciary duties … would go for naught: exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart.

[ix] The broad judicial descriptions of the fiduciary duty of loyalty, *e.g*., by Justice Cardozo in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928), and by the U.S. Supreme Court in *Michoud v. Girod*, 45 U.S. 503, 4 How. 503, 11 L.Ed. 1076 (1846), were deliberately designed to discourage marginal conduct by making it difficult for fiduciaries to determine the point at which self-serving conduct will be prohibited and thus encouraging conduct well within the borders--the common law of fiduciary duties was developed to perform a prophylactic function; as one court more recently stated, the judicial platitudes on fiduciary duty are “a judicial attempt to emphasize that the heart of a fiduciary's duty is an attitude...and a fiduciary who follows it will fulfill its obligations without the need to worry about detailed rules.” *Chiles v. Robertson,* 784 P.2d 1099, 308 Or. 592 (Or., 1989).

Because fraud is by its very nature boundless, the one fiduciary standard of conduct applicable to investment advisers should not be subjected to attempts to define or restrict it legislatively, by means of any particular definition. *See* Speech, “Diversiform Dishonesty” by Edward H. Cashion, Counsel to the Corporation Finance Division, U.S. Securities and Exchange Commission, on November 17, 1945 to the National Association of Securities Commissioners, where in reference to Section 36 of the Investment Company Act of 1940, Mr. Cashion stated:

> Like fraud, abuse of trust is not a fact but a conclusion to be drawn from facts. *The terms ‘gross abuse of trust’ or ‘gross misconduct’ should not be limited by any hard and fast definition.* Both constitute fraud in its general sense … the interpretation of gross misconduct and gross abuse of trust as used in Section 36 will depend not only upon relevant common law principles but also upon the declaration of policy as set forth in the Act … I believe that any substantial deviation from that codification of the fiduciary obligations imposed upon directors and officers of investment companies, ipso facto, constitutes gross misconduct and gross abuse of trust. [*Emphasis added*.]

The Investment Advisers Act of 1940 “recognizes that, with respect to a certain class of investment advisers, a type of personalized relationship may exist with their clients … The essential purpose of [the Advisers Act] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful.” *Lowe v. SEC*, 472 U.S. 181, 200, 201 (1985). “The Act was designed to apply to those persons engaged in the investment-advisory profession -- those who provide personalized advice attuned to a client's concerns, whether by written or verbal communication.” *Id.* at 208. “The dangers of fraud, deception, or overreaching that motivated the enactment of the statute are present in personalized communications ….” *Id.* at 210.

[x] The distinction between arms-length relationships and fiduciary relationships is illustrated in Exhibit A.

[xi] “Courts have imposed on a fiduciary an affirmative duty of `utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation `to employ reasonable care to avoid misleading' his customers*.” SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

“When a stock broker or financial advisor is providing financial or investment advice, he or she … is required to disclose facts that are material to the client's decision-making.” *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006). A material fact is “anything which might affect the (client’s) decision whether or how to act.” *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 227 Va. 441 (Va., 1984). As stated by Justice Cardoza: “If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity of reservation, in all its stark significance ….” *Wendt v. Fischer*, 243 N.Y. 439, 154 N.E. 303 (1926).

An example of the type of disclosure, when a conflict of interest is present, is revealed in a recent decision arising under the Advisers Act: "[W]hen a firm has a fiduciary relationship with a customer, it may not execute principal trades with that customer absent full disclosure of its principal capacity, as well as all other information that bears on the desirability of the transaction from the customer's perspective.'… Other authorities are in agreement. For example, the general rule is that an agent charged by his principal with buying or selling an asset may not effect the transaction on his own account without full disclosure which 'must include not only the fact that the agent is acting on his own account, but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction, from the viewpoint of the principal.'" *Geman v. S.E.C.,* 334 F.3d 1183, 1189 (10th Cir., 2003), quoting *Arst v. Stifel, Nicolaus & Co*., 86 F.3d 973, 979 (10th Cir.1996) (applying Kansas law) (quoting RESTATEMENT (SECOND) OF AGENCY § 390 cmt. a (1958)).

"[T]he duty of full disclosure was imposed as a matter of general common law long before the passage of the Securities Exchange Act." *In the Matter of Arleen W. Hughes*, SEC Release No. 4048 (February 18, 1948).

Disclosure must be timely provided. "[D]isclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent." *In the Matter of Arleeen W. Hughes*, SEC Release No. 4048 (February 17, 1948), *affirmed* 174 F.2d 969 (D.C. Cir. 1949).

The duty to disclose is an affirmative one, and the failure to disclose by an investment adviser is a violation of the Advisers Act. The fiduciary is required to ensure that the disclosure is received by the client; the "access equals delivery" approach undertaken with regard to disclosures required by the SEC under the '33 and '34 Acts would not qualify as an appropriate disclosure by a fiduciary financial advisor to her or his client. As stated in an early case applying the Advisers Act:

> It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge material facts to the ones whose interests she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure. The statutes and rules discussed above make it unlawful to omit to state material facts irrespective of alleged (or proven) willingness or readiness to supply that which has been omitted.

Hughes v. SEC, 174 F.2d 969 (D.C. Cir., 1949).

The purpose of the fiduciary duty of disclosure is arming the client with sufficient information to undertake an informed decision, when the client is called upon to do so. In the context of conflicts of interest which may exist between the fiduciary and the client, the purpose of full and affirmative disclosure of material facts by a fiduciary financial planner is also to obtain the client's informed consent to proceeding with a recommendation or transaction. Indeed, under traditional notions of fiduciary law, conflicts of interest must be avoided absent the informed consent of the client. However, "informed consent" does not exist if full disclosure of all facts is not undertaken, if the consent is induced, or if the transaction does not remain fair and reasonable to the client. As one court stated:

> One of the most stringent precepts in the law is that a fiduciary shall not engage in self-dealing and when he is so charged, his actions will be scrutinized most carefully. When a fiduciary engages in self-dealing, there is inevitably a conflict of interest: as fiduciary he is bound to secure the greatest advantage for the beneficiaries; yet to do so might work to his personal disadvantage. Because of the conflict inherent in such transaction, it is voidable by the beneficiaries unless they have consented. Even then, it is voidable if the fiduciary fails to disclose material facts which he knew or should have known, if he used the influence of his position to induce the consent or if the transaction was not in all respects fair and reasonable.

Birnbaum v. Birnbaum, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986).

The informed consent of the client to proceed with a transaction recommended by a fiduciary advisor in the presence of a conflict of interest would rarely be given by an informed client if the conflict of interest were not managed to keep the best interests of the client paramount at all times; clients rarely undertake gratuitous transfers to their financial advisors. Hence, courts appear to often find that there was not full disclosure, or that it was not affirmatively undertaken, or that the terms of the transaction were not fair, where the voluntary nature of the consent, or the understanding by the client of the material facts, is suspect. Such cases often arise in the context of the attorney-client relationship. *See, e.g. Schenk v. Hill, Lent & Troescher*, 530 N.Y.S.2d 486, 487 (N.Y. Sup. Ct. 1988) (a lawyer hired to sue another lawyer for malpractice was himself a potential defendant in the same action, and obtained client consent to waive the conflict of interest. In disqualifying the lawyer, the court said: "[T]he consent obtained in this case does not reflect a full understanding of the legal rights being waived … [T]he unsophisticated client, relying upon the confidential relationship with his lawyer, may not be regarded as able to understand the ramifications of the conflict, however much explained to him."); *Wade v. Clemmons*, 377 N.Y.S.2d 415, 419 (N.Y. Sup. Ct. 1975) (striking down contingent fee because client would have refused to agree to settlement offer yielding fee if properly advised).

The fiduciary duty to avoid conflicts of interest, and the necessity to obtain the informed consent of the client as to conflicts of interest not avoided, were well known in the early history of the Advisers Act. In an address entitled "The SEC and the Broker-

Dealer" by Louis Loss, Chief Counsel, Trading and Exchange Division, U.S. Securities and Exchange Commission on March 16, 1948, before the Stock Brokers' Associates of Chicago, the fiduciary duties arising under the Advisers Act, as applied in the *Arleen Hughes* release, were elaborated upon:

> The doctrine of that case, in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to *make a scrupulously full disclosure of every element of its adverse interest in the transaction*.
>
> In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. *He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses*. This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law 'acts not on the possibility, that, in some cases the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.' Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine 'has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.'
>
> *This time-honored dogma applies equally to any person who is in a fiduciary relation toward another*, whether he be a trustee, an executor or administrator of an estate, a lawyer acting on behalf of a client, an employee acting on behalf of an employer, an officer or director acting on behalf of a corporation, *an investment adviser* or any sort of business adviser for that matter, or a broker. The law has always looked with such suspicion upon a fiduciary's dealing for his own account with his client or beneficiary that it permits the client or beneficiary at any time to set aside the transaction without proving any actual abuse or damage. What the recent Hughes case does is to say that such conduct, in addition 'to laying the basis for a private lawsuit, amounts to a violation of the fraud provisions under the securities laws: This proposition, as a matter of fact, is found in a number of earlier Commission opinions. *The significance of the recent Hughes opinion in this respect is that it elaborates the doctrine and spells, out in detail exactly what disclosure is required when a dealer who has put himself in a fiduciary position chooses to sell his own securities to a client or buys the client's securities in his own name …*
>
> *The nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases use of the term 'principal' itself may suffice. In others, a more detailed explanation will be required. In all cases, however, the burden is on the firm which acts as fiduciary to make certain that the client understands that the firm is selling its own securities …*

Id. [*Emphasis added*.]

[xii] Should brokers not be providing investment advice, but instead limit their activities to the sale of an investment product in which only information about the investment product is provided (such as its characteristics, risks, fees, costs), brokers would be able to continue to engage in product sales. However, once brokers provide investment advice, they should be subject to the restrictions on *conduct* imposed by the fiduciary standard of conduct. This does not restrict what investment products may be sold. Since investment advisers possess a fiduciary duty of care, and in connection therewith are required to consider the total fees and costs clients bear in association with any securities recommended, it is likely that the rise of investment advisers will serve to lower the fees and costs of many investment products, as increased competition is created due to increased demand from the knowledgeable representatives of their clients.

[xiii] Brokers have, in recent years, begun to utilize titles which imply relationships based upon trust and confidence, to which fiduciary duties should apply, such as "financial advisor," "financial consultant," "wealth manager," etc. Under state common law, the utilization of such titles remains a significant factor in determining whether a fiduciary relationship exists. *See, e.g., Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 2005) (When a bank held out as either an "investment planner," "financial planner," or "financial advisor," the Wisconsin Supreme Court held that a fiduciary duty may arise in such circumstances.) To alleviate consumer confusion, only those bound by the fiduciary standard of conduct should be permitted to utilize these or similar titles, as consumers often infer that an advisory (fiduciary) relationship as opposed to a sales (arms-length) relationship exists by those who utilize such titles.

[xiv] Once a relation between two parties is established, its classification as fiduciary and its legal consequences are primarily determined by the law rather than the parties. "A fiduciary relation does not depend on some technical relation created by or defined in law. It may exist under a variety of circumstances and does exist in cases where there has been a special confidence reposed in one who, in equity and good conscience, is bound to act in good faith and with due regard to the interests of the one reposing the confidence." *In re Clarkeies Market, L.L.C.*, 322 B.R. 487, 495 (Bankr. N.H., 2005).

One commentator noted the danger of the "check-the-box" approach: "In its written testimony to the House Financial Services Committee, SIFMA argued that investors should have the 'choice to define or modify relationships with their financial services provider based upon the investor's preference' ... as a means of preserving investor choice. Under one interpretation of SIFMA's proposal, Wall Street firms could have their customers sign away the fiduciary standards of conduct by simply signing a lengthy, incomprehensible, multi-page, small print agreement when they enter into a relationship with a broker. This is contrary to fiduciary law, which clearly provides that blanket waivers of fiduciary standards are not permitted. Fiduciary standards of conduct are imposed by law on relationships based on trust and confidence, in recognition of the fact that consumers lack the ability to bargain for the correct standard of conduct." Rhoades, SIFMA's Proposed "New Federal Fiduciary Standard": Consumer Protection … or "A Wolf in Sheep's Clothing"? (Advisor Perspectives, July 21, 2009), available at http://www.advisorperspectives.com/newsletters09/pdfs/SIFMAs_Proposed_New_Federal_Fiduciary_Standard.pdf.

[xv] Marketing investment advisory services or financial planning services as a means to effect the sale of securities may well violate the anti-fraud provisions of Section 206 of the Advisers Act. *See Elmer D. Robinson*, SEC No-Action Letter (Jan. 6, 1986); *Nathan & Lewis*, SEC No-Action Letter (Apr. 4, 1988). [However, a broker-dealer that employs terms such as "financial planner" merely as a device to induce the sale of securities might violate the antifraud provisions of the Securities Act of 1933 and the Exchange Act. *Cf. In re Haight & Co., Inc*., Securities Exchange Act Release No. 9082 (Feb. 19, 1971) (Broker-dealer defrauded its customers in the offer and sale of securities by holding itself out as a financial planner that would give comprehensive and expert planning advice and choose the best investments for its clients from all available securities, when in fact it was not an expert in planning and made its decisions based on the receipt of commissions and upon its inventory of securities.)]"

Professor Tuch noted that: "The standard of conduct required of the fiduciary is not diminished by reason of its organizational structure." Tuch, Andrew, "The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife with Conflicts of Interest" (January 2008).

[xvi] A review of the reasons behind the imposition of fiduciary status is essential to gaining an understanding of subsequent issues which arise in the application of fiduciary duties. The rationale for imposition of fiduciary duties involves a combination of the disparity in knowledge between fiduciaries and their entrustors (clients), the high costs of monitoring fiduciary conduct, and the promotion of public policy.

A. *The Increased Knowledge Gap Between Financial Advisors and Consumers in Today's Complex Financial World.* Without question there exists a substantial knowledge gap between fiduciary investment advisers and the vast majority of their clients in today's modern, complex financial world. Indeed, the world is far more complex for individual investors today than it was just a generation ago. There exists a broader variety of investment products, including many types of pooled and/or hybrid products, employing a broad range of strategies. This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor's portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true 'total fees and costs,' investment characteristics, tax consequences, and risks. Additionally, U.S. tax laws have increasingly become more complex, presenting both opportunities for the wise through proper planning, but also traps for the unwary. As the sophistication of our capital markets had increased, so has the knowledge gap between individual consumers and financial advisors. Investment theory continues to evolve, with new insights gained from academic research each year. In constructing an investment portfolio today a financial advisor must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

   "With the increasing complexity of the financial system, the wide range of choices available and the role of compulsory savings, advice is playing an ever important role for consumers … Deregulation has created a large number of investment alternatives and means of accessing them … that the first priority for most people is to seek advice on the financial strategy that best suits their circumstances. The selection of investment products is secondary, yet still this requires access not only to information on the numerous investments available in the market but also analysis and application of that information to individual circumstances … Strategy plays a key role in effective financial decision making and most consumers will not be in a position to develop their own strategy … **The average person will no more become an instant financial planner simply because of direct access to products and information than they will a doctor, lawyer or accountant.** Despite extensive information being available on drugs (via the internet and by other means) people still seek the advice of a doctor to determine an appropriate response to a medical problem and, where necessary, to prescribe the most suitable drug." "Submission to the Financial System Inquiry by the Financial Planning Association of Australia Limited," December 1996. [**Emphasis in original**.]

B. *The 1995 Tully Report Recognized the Knowledge Gap.* Even the broker-dealer industry, after careful study, acknowledged the wide disparity of knowledge between brokers and their customers in the Tully Report:

> As a general rule, RRs [registered representatives] and their clients are separated by a wide gap of knowledge – knowledge of the technical and financial management aspects of investing. The pace of product innovation in the

> securities industry has only widened this gap. It is a rare client who truly understands the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many. This knowledge gap represents a potential source of client abuse, since uninformed investors have no basis for evaluating the merits of the advice they are given.

Report of the Committee on Compensation Practices (April 10, 1995), also called the "Tully Report," at p. 15.

Yet, the Tully Report, under the influence of the Committee Chairman, Daniel P. Tully (at the time Chairman and Chief Executive Officer, Merrill Lynch & Co., Inc.), did not call for the imposition of fiduciary duties upon registered representatives (and did not even mention the word "fiduciary."). Instead, the Report stated that the knowledge gap "makes communication between a registered representative and an investor difficult and puts too much responsibility for decision-making on the shoulders of RRs [registered representatives] - a responsibility that belongs with the investor." Tully Report at p. 15.

Emotional biases limit consumers' ability to close the knowledge gap. Recent insights from behavioral science call into substantial doubt some cherished pro-regulatory strategies, including the view that if regulators force delivery of better disclosures and transparency to investors that such can be utilized effectively. Calls have been heard that the SEC's emphasis on disclosure is only part of the equation for the protection for consumers. "Two things are needed for the federal securities laws, or any disclosure-based regulatory regime, to be effective. The first is straightforward: information has to be disclosed. The second is equally straightforward, but often overlooked. That is, the users of the information – for example, investors, securities analysts, brokers, and money managers – need to use the disclosed information effectively. The federal securities laws primarily focus on the former – mandating disclosure." Paredes, Troy A., "Blinded by the Light: Information Overload and its Consequences for Securities Regulation" (2003), available at SSRN: http://ssrn.com/abstract=413180 or DOI: 10.2139/ssrn.413180. For years it has been known that that investors do not read disclosure documents. *See, generally,* Homer Kripke, *The SEC and Corporate Disclosure: Regulation In Search Of A Purpose* (1979); Homer Kripke, The Myth of the Informed Layman, 28 Bus.Law.. 631 (1973). See also Baruch Lev & Meiring de Villiers, Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis, 47 Stan. L. Rev. 7, 19 (1994) ("[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures ...."); Kenneth B. Firtel, *Note*, "Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933, 72 S. Cal. L. Rev. 851, 870 (1999) ("[T]he average investor does not read the prospectus ...."). For an overview of various individual investor bias such as bounded irrationality, rational ignorance, overoptimism, overconfidence, the false consensus effect, insensitivity to the source of information, the fact that oral communications trump written communications, and other heuristics and bias, *see* Robert Prentice, "Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future," 51 Duke L. J. 1397 (2002).

The SEC's emphasis on disclosure, drawn from the focus of the 1933 and 1934 Securities Acts on enhanced disclosures, results from the myth that investors carefully peruse the details of disclosure documents that regulation delivers. However, under the scrutinizing lens of stark reality, this picture gives way to an image a vast majority of investors who are unable, due to behavioral biases and lack of knowledge of our complicated financial markets, to undertake sound investment decision-making. As stated by Professor (now SEC Commissioner) Troy A. Paredes:

> The federal securities laws generally assume that investors and other capital market participants are perfectly rational, from which it follows that more disclosure is always better than less. However, investors are not perfectly rational. Herbert Simon was among the first to point out that people are boundedly rational, and numerous studies have since supported Simon's claim. Simon recognized that people have limited cognitive abilities to process information. As a result, people tend to economize on cognitive effort when making decisions by adopting heuristics that simplify complicated tasks. In Simon's terms, when faced with complicated tasks, people tend to "satisfice" rather than "optimize," and might fail to search and process certain information.[xvi]

Troy A. Parades, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 83 Wash.Univ.L.Q. 907, 931-2 (2003).

Note as well that "instead of leading investors away from their behavioral biases, financial professionals may prey upon investors' behavioral quirks … Having placed their trust in their brokers, investors may give them substantial leeway, opening the door to opportunistic behavior by brokers, who may steer investors toward poor or inappropriate investments." Stephen J. Choi and A.C. Pritchard, "Behavioral Economics and the SEC" (2003), at p.18.

Indeed, "when faced with complex, difficult and affect-laden choices (and hence a strong anticipation of regret should those choices be wrong), many investors seek to shift responsibility for the investments to others. This is an opportunity – the core of the full-service brokerage business – to use trust-based selling techniques, offering advice that customers sometimes too readily accept. Once trust is induced, the ability to sell vastly more complicated, multi-attribute investment products goes up. Complex products that have become widespread in the retail sector, like equity index annuities, can only be sold by intensive, time-consuming sales effort. As a result the sales fees (and embedded incentives) are very large, creating the temptation to oversell. In the mutual fund area, the broker channel – once again, driven by generous incentives - sells funds aggressively. Recent empirical research suggests that buyers purchase funds in this channel at much higher cost but performance on average is no better, and often worse, than readily available no-load funds." Donald C.

Langevoort, "The SEC, Retail Investors, and the Institutionalization of the Securities Markets" (Jan. 2009), prior version available at SSRN: http://ssrn.com/abstract=1262322.

Moreover, "not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but … competitive pressures almost guarantee that they will do so." Robert Prentice, "Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis," 2003 U.Ill.L.Rev. 337, 343-4 (2003), *citing* Jon D. Hanson & Douglas A. Kysar, "Taking Behavioralism Seriously: The Problem of Market Manipulation," 74 N.Y.U.L.REV. 630 (1999) and *citing* Jon D. Hanson & Douglas A. Kysar, "Taking Behavioralism Seriously: Some Evidence of Market Manipulation," 112 Harv.L.Rev. 1420 (1999). It should be noted that much training of brokers and advisers involves how to establish a relationship of trust and confidence with the client, following which it is well known that customers / clients, respectively, will generally accede to the recommendations mde by the broker or adviser.

C. *Financial Literacy Efforts, While Important, are Known to be Ineffective.* Financial literacy is important, for the more educated the individual American the better he or she will undertake financial decisions, with or without the aid of an advisor. However, as recently stated by Professor Lauren E. Willis:

> The gulf between the literacy levels of most Americans and that required to assess the plethora of credit, insurance, and investment products sold today—and new products as they are invented tomorrow—cannot realistically be bridged. Educators would need to impart a sophisticated understanding of finance because rules of thumb are not useful for decisions about complex products in a volatile market. Further, high financial literacy can be necessary for good financial decisionmaking, but is not sufficient; heuristics, biases, and emotional coping mechanisms that interfere with welfare-enhancing personal finance behaviors are unlikely to be eradicated through education, particularly in a dynamic market. To the contrary, the advantage in resources with which to reach consumers that financial services firms enjoy puts firms in a better position to capitalize on decisionmaking biases than educators who seek to train consumers out of them.

Willis, Lauren E., "Against Financial Literacy Education," Iowa Law Review, Vol. 94, 2008, at p.3; U of Penn Law School, Public Law Research Paper No. 08-10; Loyola-LA Legal Studies Paper No. 2008-13. Available at SSRN: http://ssrn.com/abstract=1105384. *See also* Lusardi, Annamaria and Mitchell, Olivia S., "Financial Literacy and Planning: Implications for Retirement Wellbeing" (2005). Michigan Retirement Research Center Research Paper No. WP 2005-108, available at SSRN: http://ssrn.com/abstract=881847 noting that "consumers making retirement saving decisions require substantial financial literacy, in addition to the ability and tools needed to plan and carry out retirement saving plans" and confirming "survey findings about financial literacy from Bernheim (1995, 1998), Hogarth and Hilgerth (2002), and Moore (2003), who report that most respondents do not understand financial economics concepts, particularly those relating to bonds, stocks, mutual funds, and the working of compound interest; they also report that people often fail to understand loans and interest rates."

D. *Due to the Knowledge Gap, the Advisor Has The Ability to Abuse Trust and Power.* The expert services of the fiduciary personal financial advisor are socially desirable. As in medicine or law, it can take many years to acquire the requisite degree of knowledge, skill, and experience to be a competent and effective personal financial advisor. Yet it is this very expertise renders clients of personal financial advisors vulnerable to abuse of trust and lack of care. Moreover, the advisory services undertaken by investment advisers are often subject to only general prescriptions, as investment advisors must be free to react to a changing market environment. If the fiduciary does not utilize his or her greater knowledge to promote the client's best interests, the fiduciary could usurp the delegated power, authority, or trust in advice for the fiduciary's own benefit.

E. *Reduction of Transaction Costs, when Monitoring Costs are High***.** In service provider relationships which arise to the level of fiduciary relations, it is highly costly for the client to monitor, verify and ensure that the fiduciary will abide by the fiduciary's promise and deal with the entrusted power only for the benefit of the client. Indeed, if a client could easily protect himself or herself from an abuse of the fiduciary advisor's power, authority, or delegation of trust, then there would be no need for imposition of fiduciary duties. Hence, fiduciary status is imposed as a means of aiding consumers in navigating the complex financial world.

The authors of the Federal Securities Acts contemplated fiduciary advisors, given the inability of individual consumers to interpret complex financial data and concepts. As stated by Professor Steven L. Schwarcz: "Analysis of the tension between investor understanding and complexity remains scant. During the debate over the original enactment of the federal securities laws, Congress did not focus on the ability of investors to understand disclosure of complex transactions. Although scholars assumed that ordinary investors would not have that ability, they anticipated that sophisticated market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors." Steven L. Schwarcz, "Rethinking The Disclosure Paradigm In A World Of Complexity," Univ.Ill.L.R. Vol. 2004, p.1, 7 (2004), *citing* "Disclosure To Investors: A Reappraisal Of Federal

Administrative Policies Under The '33 And '34 Acts" (The Wheat Report), 52 (1969); *accord* William O. Douglas, "Protecting the Investor," 23 Yale Rev. 521, 524 (1934).

F. *Difficulty in Tying Performance Results to One's Obedience to His or Her Fiduciary Duties*. The results of the services provided by a fiduciary advisor are not always related to the honesty of the fiduciary or the quality of the services. For example, an investment adviser may be both honest and diligent, but the value of the client's portfolio may fall as the result of market events. Indeed, rare is the instance in which an investment adviser provides substantial positive returns for each period over long periods of time – and in such instances the honesty of the investment adviser should be suspect (as was the situation with Madoff).

G. *Difficulty in Identifying and Understanding Conflicts of Interest.* Most individual consumers of financial services in America today are unable to identify and understand the many conflicts of interest which can exist in financial services. For example, a customer of a broker-dealer firm might be aware of the existence of a commission for the sale of a mutual fund, but possess no understanding that there are many mutual funds available which are available without commissions (i.e., sales loads). Moreover, brokerage firms have evolved into successful disguisers of conflicts of interest arising from third-party payments, including payments through such mechanisms as contingent deferred sales charges, 12b-1 fees, payment for order flow, payment for shelf space, and soft dollar compensation.

Transparency is important, but even when compensation is fully disclosed, few individual investors realize the impact high fees and costs can possess on their long-term investment returns; often individual investors believe that a more expensive product will possess higher returns. In a recent study, Professors "Madrian, Choi and Laibson recruited two groups of students in the summer of 2005 -- MBA students about to begin their first semester at Wharton, and undergraduates (freshmen through seniors) at Harvard. All participants were asked to make hypothetical investments of $10,000, choosing from among four S&P 500 index funds. They could put all their money into one fund or divide it among two or more. 'We chose the index funds because they are all tracking the same index, and there is no variation in the objective of the funds,' Madrian says … 'Participants received the prospectuses that fund companies provide real investors … the students 'overwhelmingly fail to minimize index fund fees,' the researchers write. 'When we make fund fees salient and transparent, subjects' portfolios shift towards lower-fee index funds, but over 80% still do not invest everything in the lowest-fee fund' … [Said Professor Madrian,] 'What our study suggests is that people do not know how to use information well.... My guess is it has to do with the general level of financial literacy, but also because the prospectus is so long." Knowledge@Wharton, "Today's Research Question: Why Do Investors Choose High-fee Mutual Funds Despite the Lower Returns?" citing Choi, James J., Laibson, David I. and Madrian, Brigitte C., "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds" (March 6, 2008). Yale ICF Working Paper No. 08-14. Available at SSRN: http://ssrn.com/abstract=1125023.

H. *Shifting of Monitoring and Verification Costs to Government*. It is common that fiduciary duties, once they are imposed, result in oversight (monitoring and verification) and enforcement by agencies of government. As stated in a recent Government Accounting Office report:

> In general, regulators help protect consumers/investors who may not have the information or expertise necessary to protect themselves from fraud and other deceptive practices … that the marketplace may not necessarily provide. Through monitoring activities, examinations, and inspections, regulators oversee the conduct of institutions in an effort to ensure that they do not engage in fraudulent activity and do provide consumers/investors with the information they need to make appropriate decisions of financial institutions in the marketplace. However, in some areas providing information through disclosure and assuring compliance with laws are still not adequate to allow consumers/investors to influence firm behavior.

GAO-05-61, "Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure," Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, October 2004.

Fiduciary relationships are relationships in which the fiduciary provides to the client a service that public policy encourages. When such services are provided, the law recognizes that the client does not possess the ability, except at great cost, to monitor the exercise of the fiduciary's powers. Usually the client cannot afford the expense of engaging separate counsel or experts to monitor the conflicts of interest the person in the superior position will possess, as such costs might outweigh the benefits the client receives from the relationship with the fiduciary. Enforcement of the protections thereby afforded to the client by the presence of fiduciary duties is shifted to the courts and/or to regulatory bodies. Accordingly, a significant portion of the cost of enforcement of fiduciary duties is shifted from individual clients to the taxpayers, although licensing and related fees, as well as fines, may shift monitoring costs back to all of the fiduciaries which are regulated.

I. *The Lack of Desire to Expend Time, Resources on Monitoring*. The inability of clients to protect themselves while receiving guidance from a fiduciary does not arise solely due to a significant knowledge gap or due to the inability to expend funds for monitoring of the fiduciary. Even highly knowledgeable and sophisticated clients (including many financial institutions) rely upon fiduciaries. While they may possess the financial resources to engage in stringent monitoring, and may even possess the requisite knowledge and skill to undertake monitoring themselves, the expenditure of time and money to undertake

monitoring would deprive the investors of time to engage in other activities. Indeed, since sophisticated and wealthy investors have the ability to protect themselves, one might argue they might as well manage their investments themselves and save the fees. Yet, reliance upon fiduciaries is undertaken by wealthy and highly knowledgeable investors and without expenditures of time and money for monitoring of the fiduciary. In this manner, "fiduciary duties are linked to a social structure that values specialization of talents and functions." Tamar Frankel, Ch. 12, United States Mutual Fund Investors, Their Managers and Distributors, in CONFLICTS OF INTEREST: CORPORATE GOVERNANCE AND FINANCIAL MARKETS (Kluwer Law International, The Netherlands, 2007), edited by Luc Thévenoz and Rashid Barhar.

J. *For Fiduciaries, the Cost of Proving Trustworthiness is Quite High.* How does one prove one to be "honest" and "loyal"? The cost to a fiduciary in proving that the advisor is trustworthy could be extremely high – so high as to exceed the compensation gained from the relationships with the advisors' clients. This is why it is important to fiduciary advisors to be able to distinguish themselves from non-fiduciaries. A recent example of the problems faced by investment advisers was the "fee-based brokerage accounts" adopted by the SEC in 2005, which would have permitted brokers to provide the same functional investment advisory services as investment advisers but without application of fiduciary standards of conduct. This would have negated to a large degree economic incentives for persons to become investment advisers and be subject to the higher standard of conduct. The SEC's fee-based accounts rule was overturned in *Financial Planning Ass'n v. S.E.C.*, 482 F.3d 481 (D.C. Cir., 2007).

K. *Monitoring and Reputational Threats are Largely Ineffective.* The ability of "the market" to monitor and enforce a fiduciary's obligations, such as through the compulsion to preserve a firm's reputation, is often ineffective in fiduciary relationships. This is because revelations about abuses of trust by fiduciaries can be well hidden (such as through mandatory arbitration clauses and secrecy agreements regarding settlements), or because marketing efforts by fiduciary firms are so strong that they overwhelm the reported instances of breaches of fiduciary duties.

L. *Public Policy Encourages Specialization, Which Necessitates Fiduciary Duties***.** As Professor Tamar Frankel, long the leading scholar in the area of fiduciary law as applied to securities regulation, once noted: "[A] prosperous economy develops specialization. Specialization requires interdependence. And interdependence cannot exist without a measure of trusting. In an entirely non-trusting relationship interaction would be too expensive and too risky to maintain. Studies have shown a correlation between the level of trusting relationships on which members of a society operate and the level of that society's trade and economic prosperity." Tamar Frankel, Trusting And Non-Trusting: Comparing Benefits, Cost And Risk, Working Paper 99-12, Boston University School of Law. Fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment management or law, in recognition of the value such services provide to our society. For example, the provision of investment consulting services under fiduciary duties of loyalty and due care encourages participation by investors in our capital markets system. Hence, in order to promote public policy goals, the law requires the imposition of fiduciary status upon the party in the dominant position. Through the imposition of such fiduciary status the client is thereby afforded various protections. These protections serve to reduce the risks to the client which relate to the service, and encourage the client to utilize the service. Fiduciary status thereby furthers the public interest.

[xvii] The world is far more complex for individual investors today than it was just a generation ago. There exist a broader variety of investment products, including many types of pooled and/or hybrid products, employing a broad range of strategies. This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor's portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true total fees and costs, investment characteristics, tax consequences, and risks. Additionally, U.S. tax laws relating to financial planning and investment decisions have increasingly become more complex, presenting both opportunities for the wise through proper planning, but also traps for the unwary.

As the sophistication of our capital markets had increased, so has the knowledge gap between individual consumers and financial advisors. Investment theory continues to evolve, with new insights gained from academic research each year. In constructing an investment portfolio today a financial advisor must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

Survey after survey (including the Rand Report cited by SIFMA) has concluded that consumers place a very high degree of trust and confidence in their investment adviser, stockbroker, or financial planner. These consumers deal with their advisors on unequal terms. As evidence of the lack of knowledge possessed by consumers, the Rand Report noted that 30% of investors believed that they did not pay their financial consultant any fees! This calls into substantial question the conclusion derived from the Rand Report's survey that most customers of brokers are happy with their financial consultant.

[xviii] We urge Congress not to proceed down the path which will result in an erosion of the fiduciary standard of conduct – a path so long warned about by Justice Benjamin Cardoza:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion of particular exceptions' (*Wendt v. Fisher*, 243 N.Y. 439, 444). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. ***It will not consciously be lowered by any judgment of this court.*** [***Emphasis added.***]

Meinhard v. Salmon, 249 N.Y. 458, 463-4, 164 N.E. 545 (1928).

[xix] "First, there must be recognition that brokers have changed their business practices to become more like advisers—who have generally been successfully regulated under the Investment Advisers Act of 1940 for nearly seven decades. 'Harmonization' that seeks to make advisers more like brokers has no foundation in investor protection." Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, before the Committee on Financial Services, United States House of Representatives, on "Industry Perspectives on The Obama Administration's Financial Regulatory Reform Proposals" (July 17, 2009).

[xx] The framing of the debate by the broker-dealer industry as one of "harmonization" serves to mislead Congress as to the reality of the issue before it and the present circumstances. "To the extent that securities firms that were predominantly broker-dealers are now entering into on-going relationships with clients by emphasizing the offer of investment advice in exchange for a fee based on assets under management, the brokerage industry is moving closer to the investment adviser industry. There is a significant conflict of interest that results when the same entity serves both as an agent selling a security and as one providing investment advice. As a result of this movement by broker-dealers, there has been a great deal of discourse about 'harmonizing' the regulations of broker-dealer versus investment advisers. I think the better way to frame the issue is to ask how broker-dealers who provide investment advice should be regulated. There is a reason that investment adviser services are regulated differently than broker-dealer services." Speech, SEC Commissioner Luis A. Aguilar, "SEC's Oversight of the Adviser Industry Bolsters Investor Protection" (May 7, 2009).

Moreover, as explained by Professor Tamar Frankel, *"harmonizing"* has been used in reference to only the fiduciary duty of care; the real problem of broker dealers ("b/ds") involves the duty of loyalty when brokers provide investment advice. "In light of the confusing state of the law and the different treatment of b/ds, advisers, and financial planners, proposals have used the word "harmonizing" as the objective for rationalizing the current law. However, the word harmonizing has been used to apply to fiduciaries' duty of care rather than to the prohibition of fiduciaries' conflict of interest. [Citation to Lemke/Stone article.] I believe that the emphasis on the duty of care diverts attention from the real problem posed by b/ds and their activities that might lead to fraud. The two duties are fundamentally different. The duty of loyalty aims at preventing the abuse of entrusted property or power. The duty of care is aimed to ensuring expert services and avoiding negligence in the performance of the services." Frankel, Tamar, "Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers" (August 10, 2009). Boston Univ. School of Law Working Paper No. 09-36.
Available at SSRN: http://ssrn.com/abstract=1446750.

As more succinctly set forth by the North American Securities Administrators Association: "We recognize that so-called 'harmonization' of standards is simply code for adoption of a lower standard and is therefore unacceptable." Speech, Denise Voigt Crawford, Texas Securities Commissioner and current NASAA President, before the NASAA Annual Conference (Sept. 15, 2009).