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August 30, 2010
Ms. Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: File No. S7-11-09
The Economic Imperative for the Application of the Fiduciary Standard of Conduct to all Providers of Investment Advice

Dear Ms. Murphy:

We are writing on behalf of The National Association of Personal Financial Advisors (NAPFA)[1] in response to the Securities and Exchange Commission's request for comment on its study of the obligations and standards of care of broker-dealers and investment advisers providing personalized investment advice about securities to retail investors. NAPFA has also contributed to a group letter[2] on the study, which we support.

NAPFA was founded on principles based on fiduciary concepts and the premise of putting the clients' interest first. Given the strong support of our members for the *bona fide* fiduciary standard found in the Advisers Act, and their concern over the efforts of some in the securities industry to diminish that standard, we felt a specific additional letter expressing our members' concerns, and providing further information to the Commission as to the economic rationale for the fiduciary standard and the singular necessity that the fiduciary standard not be eroded by "particular exceptions" or non-application, was necessary.

In this comment letter, NAPFA explores:

(1) The importance of the fiduciary standard, particularly in promoting capital formation and, consequently, economic expansion.
(2) The multiple reasons existing in the law and public policy for the imposition of fiduciary status;

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[1] NAPFA has more than 1,400 NAPFA-Registered Financial Advisors across the United States. All NAPFA-Registered Financial Advisors must submit a comprehensive financial plan and undergo a thorough review of their qualifications prior to admission. NAPFA-Registered Financial Advisors all sign a Fiduciary Oath which states that the advisor will only work in good faith and with the best interests of the consumer at heart. NAPFA-Registered Financial Advisors are strictly Fee-Only®, which means they do not accept commissions or any additional fees from outside sources for the recommendations they make to their clients.

[2] Comment letter of Certified Financial Planner Board of Standards, Inc., Financial Planning Association, and the National Association of Personal Financial Advisors, dated of even date herewith.

(3) The fact that the fiduciary standard found in the Advisers Act is already ONE federal fiduciary standard and it is WELL-DEFINED;

(4) Substantial evidence exists that compels the conclusions that enhanced disclosures, as called for by the Broker Dealer community, are ineffective to protect consumers;

(5) The investment adviser's fiduciary standard is close to a "sole interests" standard, and much higher than the fiduciary standard found under the laws of agency;

(6) The Commission should re-visit the definition of "solely incidental";

(7) Suggested language for the distinctions between investment advisers and brokers is set forth.

We also refute the erroneous statements made by opponents to the fiduciary standard that there are "51 different standards," that a "new federal fiduciary standard" is required," that "fiduciary duties are unenforceable as they are vague and ill-defined." Additionally, we note that all retail consumers will be better-served by application of the fiduciary standard of conduct to all investment advisory activities. Finally, we note that mere disclosure does not meet the fiduciary duty of an investment adviser when a conflict of interest is present. Much more is required of the trusted advisor.

NAPFA encourages the SEC to: (A) Preserve the existing fiduciary standard of conduct found in the Advisers Act; (B) Extend the current fiduciary standard to the investment advisory activities of brokers; and (C) Explore a professional regulatory organization in which individual fiduciaries, not conflicted by the commercial interests of their firms, are able to assist securities regulators (both national and state) in the enforcement of the obligations imposed upon fiduciaries.

Our comment letter is of some length. Our purpose is to demonstrate to those opposed to the fiduciary standard of conduct not only its importance, but also that the current fiduciary standard has been successfully applied for decades. The sections of our comment letter are summarized as follows:

1. <u>The Importance of the Current Fiduciary Standard.</u> The fiduciary standard of conduct's importance to individual Americans, and to America itself, should not be understated.[3]

2. <u>The Rationale for the Imposition of Fiduciary Status.</u> Understanding the reasons for the application of the fiduciary standard is essential in the proper formulation of sound public policies and the regulations which follow.

3. <u>The One Fiduciary Standard Should Continue.</u> The current fiduciary standard of conduct found in the Investment Advisers Act of 1940 ("Advisers Act") is – *already* – a national uniform standard of conduct.

    a. The fiduciary standard is informed by state common law. Application of the state fiduciary standard of conduct under state common law is not preempted by the Advisers Act, under the express provisions of NSMIA.

[3] Advocates for application of the fiduciary standard of conduct, such as NAPFA, are often accused of seeking to further their own self-interest. Nothing could be further from the truth. NAFPA-Registered Financial Advisors, who have all adopted NAPFA's fiduciary oath, are currently able to gain significant market share from non-fiduciary advisors, simply because consumers of financial advice desire to place trust in their financial advisor. Imposing the fiduciary standard on broker-dealers and their registered representatives will negate much of the advantage, which fee-only fiduciary advisors possess today. Despite the potential negative personal economic consequences to NAFPA-Registered Financial Advisors, should fiduciary status be extended to all providers of personalized investment advice to retail consumers, NAPFA and its members believe that their own economic interests do not override the pressing need for Americans to receive trusted advice from fiduciary advisors. The issue is of great importance to individual Americans, as well as to capital formation and the future economic growth of America's economy.

b. No cause exists for diminution of the fiduciary standard of conduct. Justice Cardoza's words of warning should be heeded.

c. No valid reason exists to adopt a "new universal or uniform fiduciary standard" as some have proposed. It already exists!

d. The fiduciary standard is not, as some broker-dealers have suggested, "vague." We offer a summary of the fiduciary duties of due care, loyalty, and utmost good faith.

e. The fiduciary standard is a principles-based standard. While specific rules have been and may be adopted under same, the fiduciary standard must be free to adapt so as to address new forms of improper conduct that seek to get around specific rules.

f. The fiduciary standard calls for more than just "disclosure" when a conflict of interest is present. Avoidance of the conflict is often required. In other situations, the unavoided conflict must be affirmatively disclosed in a manner ensuring client understanding and informed consent, and even then the proposed transaction must be fair to the client.

4. <u>"Enhanced Disclosure" is Insufficient to Protect the Interests of Retail Investors.</u> While enhancing disclosures of the distinctions between advisers and brokers is important, recent academic research reveals the ineffectiveness of disclosure as a means of closing the vast information asymmetry between those providing personalized investment advice and the retail investor.

5. <u>The Fiduciary Duty Found in the Advisers Act is NOT the Lower Standard Found In the Law of Agency; It is a Professional Standard of Conduct, Already Strictly Applied, and Near The "Sole Interests" Standard.</u>

6. <u>Congressional Language and Intent.</u> The "solely incidental" requirement for the broker-dealer exclusion to the definition of "investment adviser" should be defined in such a way as to follow the plain meaning of the words, as well as the intent of both the 1940 Congress and the 2010 Congress.

7. <u>The Use of Titles Which Connote An Advisory Relationship Should Be Prohibited, if The Fiduciary Standard of Conduct Is Inapplicable; The Importance of Effective Disclosures of the Nature of the Relationship.</u>

8. <u>Concluding Thoughts.</u>

Given the importance of the SEC's study and subsequent rule-making, NAPFA discusses each of the foregoing points in detail, with substantial recitation to legal authority.

The underlying question before the U.S. Securities and Exchange Commission (SEC) is how to effect the Congressional intent that the fiduciary standard of conduct[4] operate as a restraint upon greed, in such a

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[4] Although the reason for the distinction remains unclear, many cases allude to the distinction that negligence claims involve the breach of a standard of "care," while fiduciary breach claims involve breach of a standard of "conduct." The word "conduct" is certainly broader in its potential meaning than "care," when used in reference to standards. This appears to be a distinction which the 2010 Congress has noted, for in the Dodd Frank Act is added Section 211(g) to the Advisers Act:

(g) <u>**STANDARD OF CONDUCT**</u>.—

(1) IN GENERAL.—The Commission may promulgate rules to provide that the <u>**standard of conduct**</u> for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities 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

fashion as to enable higher levels of trust in our capital markets system. In this regard, even Adam Smith recognized the necessity of professional standards of conduct, for he suggested qualifications "by instituting some sort of probation, even in the higher and more difficult sciences, to be undergone by every person before he was permitted to exercise any liberal profession, or before he could be received as a candidate for any honorable office or profit."[5]

1. **The Importance of the Current Fiduciary Standard. The fiduciary standard of conduct's importance to individual Americans, and to America itself, should not be understated. Understanding the reasons for the application of the fiduciary standard is essential in the formulation of public policy.**

**Trust, the Formation of Capital, and its Importance for Economic Growth.** Over the past several decades academic research has revealed that robust capital markets are essential to the growth of a nation's economy. "Stock market liquidity - as measured both by the value of stock trading relative to the size of the market and by the value of trading relative to the size of the economy - is positively and significantly correlated with current and future rates of economic growth, capital accumulation, and productivity growth. Stock market liquidity is a robust predictor of real per capita GDP growth, physical capital growth, and productivity growth after controlling for initial income, initial investment in education, political stability, fiscal policy, openness to trade, macroeconomic stability, and the forward looking nature of stock prices."[6]

Yet possessing a liquid securities market is not, in itself, sufficient to promote optimum economic growth. Rather, investor trust in our capital markets system is also required.[7] "Investor trust provides the

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> interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such **standard of conduct** shall be no less stringent than the standard applicable to investment advisers under sections 206(1) and (2) of this Act when providing personalized investment advice about securities, except the Commission shall not ascribe a meaning to the term 'customer' that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser. The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser.

[**Emphasis added.**]

[5] Smith, p. 748, *see also* pp. 734-35. As seen, "Smith embraces both the great society and the judicious hand of the paternalistic state." Shearmur, Jeremy and Klein, Daniel B. B., "Good Conduct in a Great Society: Adam Smith and the Role of Reputation." D.B Klein, *Reputation: Studies In The Voluntary Elicitation Of Good Conduct*, pp. 29-45, University of Michigan Press, 1997. Available at http://ssrn.com/abstract=464023.

[6] Levine, Ross, and Zervos, Sara, "Stock Markets, Banks, and Economic Growth," available at http://www.worldbank.org/html/prddr/prdhome/pdffiles/wp1690.pdf.

[7] *See* Hsiu-Kwang Wu, "An Economist Looks at Section 16 of the Securities Exchange Act of 1934," 68 Colum. L. Rev. 260, 264 (1968) (noting that "[a] liquid stock market presupposes public confidence which creates willingness to purchase shares. Much of the difficulty in organizing capital markets in the less developed countries arises from public distrust and reluctance to invest funds in such markets"); *see also* Victor Brudney, "Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws," 93 Harv. L. Rev. 322, 335 (1979) (arguing that a benefit which flows from an increase in "investor faith in the market would be a reduction in the cost of capital by reason of eliminating the higher risk premiums required by investors to compensate for their fear of overreaching")/

foundation on which the American securities market has been built.  Without such trust, our market would be a thin shadow of its former self."[8]

It is well documented that public trust in the capital markets system is positively correlated with economic growth.[9] Investors' trust arises from either government regulation ensuring advisors honor their fiduciary obligations or the existence of a fiduciary culture[10] (professionalism, if established as a norm in the society, or social capital[11]), or both.

Recent research has even revealed that differences in levels of trust by Americans in different areas of the country substantially affect the economic growth among regions.[12] Hence, particular attention should be paid by policy makers to the important role of individual investors' trust in our capital markets.  One might rightfully ask, would the United States have developed a multi-trillion dollar public securities market, in which governments and corporations can annually raise hundreds of billions of dollars in new capital, without ensuring adequate levels of trust by investors in our capital markets system?[13]

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[8] Stout, Lynn A., "The Investor Confidence Game." UCLA School of Law, Research Paper No. 02-18, at p.3. Available at http://ssrn.com/abstract=322301.  Professor Stout further noted that under the rational expectations investor model, "Rational expectations investors do not invest on faith.  They take nothing for granted.  Rather, they must be provided with evidence that they are adequately protected before they will part with their money. Absent such evidence, they prefer to bury their savings in a coffee can in the backyard."  *Id.* at p. 7.  This, of course, assumes that individual investors behave rationally, possess adequate information, and are not subject to various behavioral biases which may affect their decision-making processes.

[9] *See* Putnam, R., 1993, *Making Democracy Work: Civic Traditions in Modern Italy*, Princeton University Press, Princeton, NJ; La Porta R., F. Lopez-de-Silanes, A.  Shleifer, and R. Vishny, 1998, "Law and Finance," *Journal of Political Economy*, 106, 1113-1155; Knack, S., and P. Keefer, 1997, "Does Social Capital Have An Economic Payoff? A Cross-Country Investigation," *Quarterly Journal of Economics*, 112, 1251-1288; and Zak, P., and S. Knack, 2001, "Trust and Growth," *The Economic Journal*, 111, 295-321.

[10] Carlin, Bruce Ian, Dorobantum, Florin, and Viswanathan, S., "Public Trust, The Law and Financial Investment" (2008), available at http://home.business.utah.edu/finmh/trust7777.pdf ("[T]he ability of clients to rely on others (develop trust) in our model is calculative and arises from two sources: the law and culture. Calculative trust … means that investors rationally compute their trust level based on their subjective beliefs about the gambles they face. In making this calculation, they take into account two primary sources of trust. Trust that arises from the law evolves because investors can rely on the government to make sure that agents honor their fiduciary duty to clients. Trust that arises from culture evolves because investors can rely on a certain amount of professionalism or the social networks that have been established in the population. That is, in the latter type of trust, agents honor the fiduciary duty due to a social norm, not a formal law. In some circumstances, these two sources of trust may be complements, but in others they may be substitutes …."). *Id.* at p.2.

[11] As societies evolve and international competitive pressures break down long-established norms, social capital may need to be replaced by the imposition of legal standards, such as the imposition of fiduciary duties.  *See, e.g.*, Omori, Takashi, "Balancing Economic Growth with Well-Being: Implications of the Japanese Experience," (available at http://www.oecd.org/dataoecd/5/11/1824787.pdf), discussing the demise of a history of mutual trusting between workers and employers and other participants in business: "In Japanese and Asian development, human capital was essential, especially in accumulating technology through learning by doing. Social capital also played an important role, through mutual trust within the general public and thorough cooperative behavior among colleagues and between companies that held long-term relationships … However, just like physical capital, human and social capital may become obsolete. Some aspects of society that helped Japan to grow quickly have become obsolete and are being replaced by market mechanism and formal institutions."  *Id.*  at p. 1.

[12] Dincer, Oguzhan C. and Uslaner, Eric M., "Trust and Growth" (July 2007). FEEM Working Paper No. 73.2007. Available at http://ssrn.com/abstract=999922.   The authors conclude: "Using data from the US states, we provide new evidence of a positive relationship between trust and economic growth and show that even in a high income country such as the US, in which property and contractual rights are protected more than the low income countries, high trust regions achieve higher economic growth."

[13] Stout at p. 35, observing: "[T]here is good reason to suspect that trusting investors may be the heart and soul of the modern market.  Individual investors, most of whom hold rather small portfolios, own nearly 50 percent of all

**Essential Trust Must Exist in the "System."** In whom do individual Americans place their trust? "At a minimum … American investors must believe that somehow the legal system constrains [securities professionals] sufficiently that the benefits of investing outweigh the risks. They must believe that the regulators are regulating, and the watchdogs are watching. In other words, investors may not need to trust *people* before they are willing to give up their hard-earned dollars. But they must at least trust *the system*."[14] Significant evidence reveals that individual consumers do place their trust in systems and institutions, not just in individual persons.[15]

Should individuals be permitted to only trust specific persons, and not trust other persons who undertake similar functions, confusion is likely to reign and standards of conduct will fail to protect consumers. Hence, policy makers should seek to place into effect those reforms which engender trust by individual investors in all institutions and firms which provide investment advice to individual Americans, not just in select market participants.

**Embedding Fiduciary Ties in the "System" Promotes Capital Formation.** The fiduciary relationship fosters expectations of trust and reciprocal obligation. It forms the bridge of trust[16] in our capital markets system by which individual investors form expectations that they will be dealt with properly. These expectations reduce fears of misappropriation, as the client anticipates that the financial advisor will not engage in behavior in which opportunities are usurped for the advisor's own benefit.

When, as currently exists in the United States, trust in financial institutions is low, "government involvement increases public trust and aggregate investment in the market … regulation can be responsible for catalyzing both public trust in the market and economic growth."[17] In essence, public trust in the capital markets can be increased if all individual investors access the capital markets through fiduciary advisors who possess the "responsibility to use the [investor's] capital in the best possible way to maximize the chances that the investment is successful."[18]

This is not to say that all relationships in the capital markets should be embedded with fiduciary ties. A complementary mix[19] of fiduciary relationships (between advisors and their clients) and arms-length relationships (for providers of investment products) can provide the basis for product innovation, while in turn facilitating the entrustment by individual Americans of their savings to the capital markets.

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U.S. corporate equities. Although institutions like mutual funds, pension funds and insurance companies own most of the rest, often these institutions' investment decisions also are influenced by individuals' views of the market." *Id.* at pp.35-6.

[14] Stout at p.21.

[15] Stout at pp. 30-1.

[16] This expression is derived from Klein, D. B. (ed.), 1997, *Reputation. Studies in the Voluntary Elicitation of Good Conduct*, (Ann Arbor: The University of Michigan Press).

[17] Carlin, p. 4. ("We then analyze when it is optimal for a government to intervene in the market to protect investors. We show that when the value to social capital is relatively low and/or the growth potential in the economy is low, it is never optimal to institute a Coasian plan (absence of government regulation). We also show that *ceteris paribus* there should be more government intervention in a low-trust equilibrium than in a high-trust equilibrium." *Id.* at pp.26-7.)

[18] Carlin, p.6.

[19] "I suggest that embedded ties and arm's-length ties are complementary rather than cannibalistic when they are combined within the same network, because one type of tie helps overcome the limitations of the other type while enlarging information and governance benefits." Brian Uzzi, "Embeddedness in the Making of Financial Capital: How Social Relations and Networks Benefit Firms Seeking Financing," *American Sociological Review* (Aug. 1999, Vol. 64), p. 481, 500.

The advantage consumers receive from the receipt of fiduciary advice is in overcoming consumers' own inherent limitations in achieving an understanding of the capital markets. The application of the fiduciary standard of conduct will increase the demand for financial advice,[20] and as a result in greater participation in our capital markets. This in turn will likely provide the individual investors with superior long-term rates of return for investors' portfolios well above the returns offered in bank depository accounts; in turn retirement security is better assured. The advantage product providers and issuers receive is the increased investment by consumers, as capital is allocated with the aid of fiduciary counsel toward investments which are likely to possess superior long-term returns.

**Judicial Recognition of the Importance of the Fiduciary Standard to Investors' Faith in our Capital Markets.** Adherence to the fiduciary standard of conduct by those advisors providing personalized investment advice has been recognized by the courts as heavily influencing retail investors' faith in our capital markets:

> The conduct at issue here, breach of fiduciary duty and fraud both by omission and commission, not to mention defendant's violation of both the law and their own policies governing such accounts, is very serious indeed. Such activity shakes people's faith in the market and their ability to rely upon investment advisors, and demands heavy punishment.[21]

Indeed, the U.S. Supreme Court has also weighed in on the importance of the highest standard of conduct to be applied:

> It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry.[22]

In the first year of his administration, faced with a financial crisis of epic proportions, Franklin Delano Roosevelt told the press that his principal objective was to restore the idea that dealers in securities, both new and old, are fiduciaries.

Shortly thereafter, in 1934, Justice Harlan Stone explained the need for fiduciary capitalism, stating:

> I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.'

Many researchers have also taken note of the importance of strong ethical standards in preserving investor trust, in turn aiding in the formation of capital. As stated in recent dissertation:

> The failure of regulatory authorities to detect wrongdoing, enforce ethical business practices, and obtain adequate investor restitution has been of great concern to policymakers. Investor

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[20] Dr. Michael Finke in his comment letter to the SEC dated August 18, 2010, alludes to the greater potential for investors to commit capital to the markets, as well as the benefits to consumers personally should they be empowered by receipt of advice under an always-applied fiduciary standard of conduct: "It should also be noted that many do not pay for financial advice due to uneven quality and the inability to detect quality prior to purchase. Imposition of a fiduciary standard (and the use of minimum quality standards to license or certify financial advisers) could potentially broaden the market for financial advice as it has for many other professions subject to similar standards. This consumer confidence in financial advice services has never been more important in an era where individuals are increasingly responsible for their retirement and making sound choices in an increasing complex financial marketplace."

[21] *DeRance, Inc. v. PaineWebber Inc.,* 872 F.2d 1312, 1328 (C.A.7 (Wis.), 1989).

[22] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186-87 (1963), *quoting Silver v. New York Stock Exchange*, 373 U.S. 341 (1963).

losses dent investor confidence and lower the overall willingness of the public to invest. This, in turn, hinders the formation of capital in the economy leading ultimately to lower levels of economic growth than could otherwise have been achieved.[23]

**The SEC Should Act to Restore Trust by Application of the Fiduciary Standard of Conduct.** Given the financial shocks experienced by many individual Americans recently,[24] second only to those of the Great Depression, policy makers should act to effect a restoration of trust in our securities markets. Our federal and state securities regulators should build upon the authority granted to them by Congress in 1933-34[25] and 1940[26] (establishing mechanisms for the registration and oversight of securities issuers, brokers, dealers, and investment advisers, and providing for a fiduciary duty for investment advisers). Policy makers should also seek to extend, as was contemplated by Congress in 1934,[27] 1938,[28] and

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[23] Ramphal, Nishal Ray, The Role of Public and Private Litigation in the Enforcement of Securities Laws in the United States, p.1, available at http://www.rand.org/pubs/rgs_dissertations/2007/RAND_RGSD224.pdf.

[24] The "Great Recession" which lingers on was clearly brought about by unconstrained greed. As Professor Tamar Frankel observes, business leaders, regulators, and legislative leaders all share part of the blame:

> Too many American leaders have preached faith in the market to protect the public against dishonesty. The resistance of the leadership to the law and its constraints on the leaders' power is complemented by the elevation of self-interest and the markets. "If each person took care of himself, and if each person catered to his interests, and protected himself from others, society will be served best," they say. "Trust" has given way to "verify." At most law should help trusting persons to obtain true information. But let them make their own decisions. And if they have no expertise, they should seek the advice of private-sector experts. Yet law should be least intrusive in regulating the experts. This message empowers the powerful and releases them from the constraints of accountability to the less powerful and less expert.

Frankel, Tamar, TRUST AND HONESTY, America's Business Culture at a Crossroad (forthcoming, Oxford University Press), Introduction, p.9.

[25] Securities Act of 1933 and the Securities Exchange Act of 1934. For an interesting view of the motivations of these Acts, s*ee* John H. Walsh, "A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry," 29 Hofstra L. Rev. 1015 (2001), and stating: "In August 1932, FDR turned to a moral policy vision. His purpose, he decided, was to ensure the character of the people who composed the securities industry … when the work of creating law and regulation began in earnest, FDR's moral purpose was carried forward by Congress and the newly created Securities and Exchange Commission … In these two proposals, extending the fiduciary doctrine to the buying and selling of securities and creating a code of ethics for the securities industry that would be simple enough for the public to understand, FDR suggested specific regulatory vehicles for implementing his moral purpose." *Id.* at 1017, 1039-40. "FDR's proposals for implementing his vision—fiduciary duties and a simple code of ethics—also speak to modern times. Commentators have recognized that fiduciary duties provide a legal basis for a justifiable expectation of trustworthiness … How does public policy produce trust? More specifically, how does public policy produce trust on a sufficient scale to influence an entire economy? The idea of a simple code, containing basic ethical principles, propagated across an entire industry, is a serious approach to the problem." *Id.* at 1084.

[26] Investment Advisers Act of 1940. As stated by John H. Walsh, "Section 206(2) made it unlawful 'to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client' … All of the themes of this history are reflected in the legislative history of the Advisers Act. First, the Act was explicitly motivated by the desire to protect and enhance advisers' professional ethics. Second, this objective was to be reached by prohibiting conduct inconsistent with the ideal. Third, even associational self-regulation made an appearance in the idea that all advisers suffered from the stigma placed on the unethical fringe elements, and in the idea that federal regulation was needed to support the industry's voluntary effort to establish a code of ethics. The Advisers Act came late in the New Deal,486 but it reflected the same moral purpose that had inspired administrators and legislators throughout the 1930s." *Id.* at 1068.

[27] Walsh, at p.35, stating: "In 1934, the honesty of financial intermediaries was given a role that transcended contemporary conditions. Their probity was now considered an essential element of the modern economy. In articulating this theory, the report issued by Congressman Rayburn's Committee said that '[i]f investor

1940,[29] and in the Dodd-Frank Act[30] (providing additional and express authority to the SEC) - the fiduciary standard of conduct to the investment advisory activities of broker dealers,

2. **<u>The Rationale for the Imposition of Fiduciary Status. Understanding the reasons for the application of the fiduciary standard is essential in the proper formulation of sound public policies and the regulations which follow.</u>**

**The Capital Markets and the Consumer: Problems of Asymmetrical Information.** Many securities industry participants opposed to the impositions of fiduciary duties upon their activities may seek to opine that doing so will destroy the economy and/or renders markets inefficient. Yet, scholars observe that "[t]he reality of how markets operate contrasts sharply with textbook neoclassical theory in which anonymous buyers and sellers meet for an instant to exchange homogeneous goods at preordained equilibrium prices. The idea that prices alone allocate resources in a market economy is at best a limiting case and at worst a straw man."[31] There is diverse and extensive rationale for the imposition of fiduciary status upon providers of personalized investment and financial advice which is explored below.

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confidence [was] to come back to the benefit of exchanges and corporations alike, the law must advance.' Specifically:

> As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position. Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting'—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system.

[*citing* 77 CONG. REC. 2939 (1933)]. Yet, the 1934 Act has not been held to impose fiduciary duties upon broker dealers, except with respect to the scope of their agency (generally, in assuming custody of securities). As stated by Mr. Walsh: "The legislative history of the Exchange Act reveals an ambiguity in Congress's moral purpose." *Id.* at 1051.

[28] Significant evidence exists that Section 15A of the Maloney Act, enacted in 1938, was designed to lead to the imposition of fiduciary standard of conduct upon broker dealers. *See* Address of Chester T. Lane before The Seattle Bond Club (March 14, 1938), available at http://www.sec.gov/news/speech/1938/031438lane.pdf, in which the SEC's then-Assistant General Counsel stated that the SEC desires that the "next stage" of securities reforms – "the job of raising, the standards of those on the edge to. the level of the standards of the best--can best be handled, not by more policemen, but by placing the primary responsibility on the organized associations of security dealers throughout the country." Lane at p.5. Under the legislation "associations [eventually, NASD, now FINRA] will receive … legal rights … power … to establish standards of … professional conduct …." was intended to raise "the standards of those on the edge to the level of the standards of the best." Lane at p.7. For a further discussion of the Maloney Act and its frustrated purpose, *see* text *infra* at notes ___-___.

[29] For the view that the provision of personalized investment advice by broker-dealers is already largely subject to the Advisers Act's fiduciary requirements, *see* text *infra* at notes ___-___.

[30] Section 913(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes the SEC to "promulgate rules to provide that, with respect to a broker or dealer [and investment adviser], when providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may be rule provide), the standard of conduct for such broker or dealer [and investment adviser] with respect to such customers 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."

[31] O'Driscoll, Gerald P., Jr. and Hoskins, Lee, "The Case for Market-Based Regulation," *Cato Journal,* Vol. 26, No. 3 (Fall 2006), pp.469-70.

**The Increased Knowledge Gap between Financial Planners 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.

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[32] 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 needs and goals. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true "total fees and costs,"[33] investment characteristics, tax consequences, and risks. Moreover, U.S. tax laws relating to investment income and returns have also increasingly become more complex, presenting not only opportunities for the wise through proper planning, but also a plethora of tax traps for the unwary.

**Academic Research Reveals Insights into Investment Strategies.** Nearly six decades ago we saw the emergence of Modern Portfolio Theory.[34] Over four decades have passed since the Efficient Markets Hypothesis was promulgated[35] and various academic studies first indicated that active managers, on average, underperform their benchmark indices.[36] Only three decades ago, a comprehensive database of

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[32] 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.

[33] 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."

[34] 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.

[35] 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.

[36] 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.

securities values first became available to researchers,[37] 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.[38] 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, often revealing new insights which practitioners can seek to apply for the benefit of investment clients.

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. Moreover, 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.

**The Tully Report Recognized the Knowledge Gap (But Chose to Address the Problem Incorrectly).** The broker-dealer industry previously acknowledged the wide disparity of knowledge between financial advisor and consumer in the 1995 "Tully Report"[39]:

> "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

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[37] 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.

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

[39] In May 1994, at the request of then-SEC Chairman Levitt, and in response to concerns about actual and potential conflicts of interest in the retail brokerage industry, a "Committee on Compensation Practices" was formed, Chaired by Daniel Tully, then Chairman and CEO of Merrill Lynch & Col, Inc. This committee had three mandates: (1) to review industry compensation practices for registered representatives and their managers; (2) to identify actual and potential conflicts of interest; and (3) to identify "best practices" used in the brokerage industry to eliminate, reduce, or mitigate such practices. In 1995, the Report of the Committee on Compensation Practices, known as the "Tully Report," examined the compensation practices of broker-dealers to consider ways to minimize the conflicts between brokers and their customers. The Tully Report made several recommendations on alterations to the compensation of registered representatives and broker-dealer practices, and also concluded that fee-based programs in some cases might better align broker-dealer and client interests than traditional commission-based programs. Around the same time, broker-dealers began offering these accounts. The ability of broker-dealers to offer these accounts was given sanction by the SEC in a 2005 Final Rule, but this rule was subsequently overturned in the 2007 *Financial Planning Association vs. SEC* decision, on the grounds that fee-based brokerage accounts provided "special compensation" – which is not permitted under the broker-dealer exemption from the application of the Investment Advisers Act of 1940. Following that court decision, fee-based accounts were converted over the following year to "investment advisory accounts" or to some other form of brokerage account.

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."[40]

Yet the Committee which produced the Tully Report, acting 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."[41]

**The Search for Solutions.** Given the increased complexity of our modern financial world and the resulting greater knowledge gap which exists between trained financial and investment advisers and the consumer, policy makers possess several options to counter the difficulties modern consumers of investment products and services face. These options include financial literacy education, enhanced disclosures, product simplification and/or standardization, and the imposition of fiduciary standards upon advice providers.

**Financial Literacy Efforts - While Important, They Are Largely Ineffective as to Investment Decision-Making.** Many academics, as well as consumer advocates and state securities regulators,[42] 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 … Given the current low levels of financial literacy, employers and the

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

[41] *Id.*

[42] 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.

government should devise and encourage programs that simplify financial decision-making as well as provide sources of reliable financial advice.[43]

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 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 … 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.[44]

The huge challenges to be overcome by financial literacy efforts were also noted 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 decision making, 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 decision making biases than educators who seek to train consumers out of them.[45]

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[43] 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.

[44] 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.

[45] 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

**Simplified Products and Decision-Making: At What Cost? Is It Effective?** Given the current low levels of financial literacy, employers and the government can devise and encourage programs that simplify financial decision-making. For example, laws and regulations can be adopted to prohibit certain complex products, or to mandate the inclusion of certain products which appear to be "simpler" or "easier-to-understand."

Great resistance has been shown by the public when government seeks to mandate simpler financial solutions, as this is often viewed as restricting consumer choice. Despite this, investments in certain products, such as hedge funds and certain forms of private equity investments, are often restricted to "sophisticated" investors.

The inherent volatility of values in the equities markets, and the often-emotional (and incorrect) reactions to same, are not concepts that are easily subject to "simplification." Proposals have been advanced to mandate the inclusion of low-cost stock index funds as a choice in defined contribution plans, yet these proposals do not ensure that investors will follow the discipline needed to invest in such vehicles over the long term, through various market cycles.

**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.[46] 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[47] the details of disclosure documents that regulation delivers. However, under the scrutinizing lens of stark reality, this picture gives way to an image of a vast majority of investors who are unable, due to behavioral biases[48] and lack of knowledge of our complicated financial markets, to comprehend the disclosures provided yet alone to undertake sound investment decision-making. As stated by Professor (now SEC Commissioner) Troy A. Parades:

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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."

[46] Only recently have calls 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.

[47] For years it has been known 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 ....").

[48] 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 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.[49]

Investor biases overwhelm the effectiveness of disclosures. As stated by Professor Fisch:

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."[50]

The Inadequacy of disclosures was known even in 1930's. Even back during the consideration of the initial federal securities laws, the perception existed that disclosures would prove to be inadequate as a means of investor protection. As stated by Professor Schwartz:

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.[51]

Behavioral biases also 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.[52] 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,[53] and reveal the inability of individual investors to contract for their own protections.[54]

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[49] Parades at p.3.

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

[51] 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).

[52] *Supra* n. 17.

[53] As stated by Professor Ripken: "[E]ven if we could purge disclosure documents of legalese 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

Given the foregoing, policy makers should seek to ensure that all Americans are encouraged to work with trusted fiduciary advisors, as a means of combating such behavioral biases and ensuring greater individual financial security.

**Financial Advisors Often Use Knowledge of Client Behavior to their Advantage**. 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."[55] 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."[56] Indeed, many brokers and other financial advisors have received training, time and again, stressing the need to first and foremost establish a relation of trust and confidence with the client; after trust is established, it is taught that the client usually defers to the judgment of the advisor as to recommendations made, usually without further inquiry by the client, thereby permitting the financial advisor to take advantage of the client.

Professor Langevoort undertook these further observations regarding "trust-based selling":

> [W]hen 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

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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.

[54] *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 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.

[55] Stephen J. Choi and A.C. Pritchard, "Behavioral Economics and the SEC" (2003), at p.18.

[56] 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).

funds in this channel at much higher cost but performance on average is no better, and often worse, than readily available no-load funds."[57]

**The High Degree of Expertise Must Be Utilized For the Benefit of the Client, and Not to Usurp Opportunities for the Advisor.** 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 that renders clients of personal financial advisors "vulnerable to abuse of trust and lack of care."[58] 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.[59] If the fiduciary does not utilize his or her greater knowledge to promote the client's best interests, the fiduciary could usurp the power, authority, or trust for the fiduciary's own benefit.

**Fiduciary Status is Imposed Due to the Difficulties Consumers Face 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 which are available without commissions (i.e., sales loads). Moreover, Wall Street has gotten extremely good at disguising conflicts of interest arising from third-party payments, including through such mechanisms as contingent deferred sales charges, 12b-1 fees, payment for shelf space, soft dollar compensation and other substantial transaction-related costs derived from trading of securities within pooled investment vehicles. 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.[60]

**Fiduciary Duties Are Imposed to Reduce Transaction Costs, when Monitoring Costs are High.** In service provider relationships which rise to the level of fiduciary relations, it is highly costly for the client

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[57] 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.

[58] Tamar Frankel, *Fiduciary Law* (Fathom Publishing, 2008), p. 30.

[59] *Id.* at p. 61.

[60] 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.

*See also* Lee, Inmoo and Repetto, Eduardo, "Structured Products" (2010), noting that "some investors equate complex instruments with higher expected returns without realizing the fact that the products are simply repackaged versions of portfolios combining multiple securities to generate a certain type of payoff. Consequently, investors may not pay sufficient attention to the possibly high cost of these instruments."

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.[61]

**Imposition of Fiduciary Status Shifts Some 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 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.[62]

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.

**Specialization Leads to Greater Imposition of Fiduciary Duties: Conserving Expenditures of Time and 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

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[61] 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).

[62] 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.

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."[63]

**Fiduciary Duties are Imposed Because Reliance on Market Forces for Monitoring and Enforcement is Often 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 advisors can be well hidden (such as through mandatory arbitration clauses and secrecy agreements regarding settlements), or because marketing efforts by securities firms are so strong that they overwhelm the reported instances of breaches of fiduciary duties. It is often believed that reputation, or rather the fear of its loss, constrains opportunistic behavior. But, in today's world of financial services, in which huge marketing budgets are devoted to reputation building (or re-building), are "bad acts" by the modern large financial services firm sufficient to ensure that reputation acts as a sufficient deterrence to greed? The answer is self-evident, as large financial services firms suffered great hits to their reputation due to revelations of greed-driven and abusive practices, only to continue to prosper within a short time thereafter.

**Public Policy Encourages Specialization, Which - When Affecting Important Areas of a Consumer's Personal Life - Necessitates the Imposition of Fiduciary Duties.** As Professor Tamar Frankel, long a leading scholar in the area of fiduciary law, especially as applied to securities regulation, noted:

> [A] prosperous economy develops specialization. Specialization requires inter-dependence. 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."[64]

Not all specialized services merit the application of fiduciary standards of conduct. While many persons hire others to perform services such as lawn-mowing, the acquisition of the knowledge and skills to undertake that ability one's self are readily available. Other services, such as appliance, electrical, plumbing, or auto repair, involve greater knowledge or skill, but society may perceive that these skills can still be easily acquired, at least by many in our society, or may perceive that if a person is hired to undertake repair or maintenance of equipment that the quality of work of the service provider can be more easily observed by the customer. Additionally, it may be perceived that the risk of harm to the consumer is less than that of a fiduciary service provider.

Undertaking practice as a fiduciary requires a substantial investment in education – often over many years and at the exclusion of other pursuits in life. Fiduciary duties are therefore imposed by law when public policy encourages specialization in particular services, such as investment management or law, in recognition of the need for specialization and the value such services provide to our society.

**Public Policy Encourages Participation in our Capital Markets: Individual Investor Trust in Financial Advisors Through the Imposition of Fiduciary Duties is Essential.** Financial planning

[63] 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.

[64] Tamar Frankel, "Trusting And Non-Trusting: Comparing Benefits, Cost And Risk," Working Paper 99-12, Boston University School of Law.

services encourage participation by investors in our capital markets system, which in turn promotes economic growth. It has been stated that the first and overriding responsibility any financial professional has is to all of the participants of the market. This primary obligation is required in order to maintain the perception[65] and reality that the market is a fair game and thus encourage the widest possible participation in the capital allocation process. The premise of the U.S. capital market is that the widest possible participation in the market will result in the most efficient allocation of financial resources and, therefore, will lead to the best operation of the U.S. and world-wide economy. Indeed, academic research has revealed that individual investors who are unable to trust their financial advisors are less likely to participate in the capital markets.[66]

> 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. Using the services of financial planners thereby encourages more prudent saving and investing, including enhanced participation in the capital markets. Fiduciary status thereby furthers the public interest and promotes economic growth.

**Public Policy Encourages Saving and Proper Investing for Future Financial Needs: Trusted Guidance Is Required.** As stated by Professor Macey: "If people do not make careful, rational decisions about how to self-regulate the patterns of consumption and savings and investment over their life cycles, government will have to step in to save people from the consequences of their poor planning. Indeed the entire concept of government-sponsored, forced withholding for retirement (Social Security) is based on the assumption that people lack the foresight or the discipline, or the expertise to plan for themselves. The weaknesses in government-sponsored social security and retirement systems places increased importance on the ability of people to secure for themselves adequate financial planning."[67]

**Public Policy Encourages the Embrace of Fiduciary Standards by Those Who Provide Financial and Investment Advice.** Why would a person desire to become a fiduciary, knowing that his or her conduct will be subject to a high degree of scrutiny? The law imposes upon the fiduciary duties of

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[65] "Applying the Advisers Act and its fiduciary protections is essential to preserve the participation of individual investors in our capital markets. NAPFA members have personally observed individual investors who have withdrawn from investing in stocks and mutual funds due to bad experiences with registered representatives and insurance agents in which the customer inadvertently placed his or her trust into the arms-length relationship." Letter of National Association of Personal Financial Advisors (NAPFA) dated March 12, 2008 to David Blass, Assistant Director, Division of Investment Management, SEC regarding the Rand Study.

[66] "We find that trusting individuals are significantly more likely to buy stocks and risky assets and, conditional on investing in stock, they invest a larger share of their wealth in it. This effect is economically very important: trusting others increases the probability of buying stock by 50% of the average sample probability and raises the share invested in stock by 3.4 percentage points … lack of trust can explain why individuals do not participate in the stock market even in the absence of any other friction … [W]e also show that, in practice, differences in trust across individuals and countries help explain why some invest in stocks, while others do not. Our simulations also suggest that this problem can be sufficiently severe to explain the percentage of wealthy people who do not invest in the stock market in the United States and the wide variation in this percentage across countries." Guiso, Luigi, Sapienza, Paola and Zingales, Luigi. "Trusting the Stock Market" (May 2007); ECGI - Finance Working Paper No. 170/2007; CFS Working Paper No. 2005/27; CRSP Working Paper No. 602. Available at SSRN: http://ssrn.com/abstract=811545.

[67] Macy, Jonathan R., "Regulation of Financial Planners" (April 2002), a White Paper prepared for the Financial Planning Association; http://fpanet.org/docs/assets/ExecutiveSummaryregulationoffps.pdf provides an Executive Summary of the paper.

loyalty, due care, and utmost good faith. These duties then limit the freedom of the fiduciary and/or require certain additional actions to be undertaken by the fiduciary for the client. However, one benefit of the assumption of fiduciary status is the increased marketability of the fiduciary. By endowing fiduciaries with a reputation for honesty backed by strict adherence to fiduciary standards of conduct and rigid enforcement by federal and state regulators, the financial planner or investment adviser would be the recipient of a greater ability to promote and market his or her services.[68] The client of an investment adviser is then encouraged to enter into the advisory relationship under the assurance that that the law binds the financial planner to a fiduciary role and provides a mechanism for oversight.

*The Rise of Investment Counsel: The Need to Avoid the Stigma of Those Unwilling to Conform to Ethical Standards.* In his influential article discussing the creation of the federal securities acts, and in particular their moral purpose, John Walsh reviewed the legislative history underlying the creation of the Investment Advisers Act:

> As part of a congressionally mandated review of investment trusts the agency also studied investment advisers. The Advisers Act was based on that study. By the time it passed, it was a consensus measure having the support of virtually all advisers.
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> Investment advisers' professionalism, and particularly their professional ethics, dominated the SEC study and the legislative history of the Act. Industry spokespersons emphasized their professionalism. The "function of the profession of investment counsel," they said, "was to render to clients on a personal basis competent, unbiased and continuous advice regarding the sound management of their investments." In terms of their professionalism they compared themselves to physicians and lawyers. However, industry spokespersons indicated that their efforts to maintain professional standards had encountered a serious problem. The industry, they said, covered "the entire range from the fellow without competence and without conscience at one end of the scale, to the capable, well-trained, utterly unbiased man or firm, trying to render a purely professional service, at the other end." Recognizing this range, "a group of people in the forefront of the profession realized that if professional standards were to be maintained, there must be some kind of public formulation of a standard or a code of ethics." As a result, the Investment Counsel Association of America was organized and issued a Code of Ethics. Nonetheless, the problem remained that the Association could not police the conduct of those who were not members nor did it have any punitive power.
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> The SEC Study noted that it had been the unanimous opinion of all who had testified at its public examination, both members and nonmembers of the Association, that the industry's voluntary efforts could not cope with the "most elemental and fundamental problem of the investment counsel industry—the investment counsel 'fringe' which includes those incompetent and unethical individuals or organizations who represent themselves as bona fide investment counselors." Advisers of that type would not voluntarily submit to supervision or policing. Yet, all counselors suffered from the stigma placed on the activities of the individuals on the fringe. Thus, an agency was needed with compulsory and national power that could compel the fringe to conform to ethical standards.
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> As a result of the Commission's report to Congress, the Senate Committee on Banking and Currency determined that a solution to the problems of investment advisory services could not be affected without federal legislation. In addition, both the Senate and House Committees considering the legislation determined that it was needed not only to protect the public, but also to protect bona fide investment counselors from the stigma attached to the activities of unscrupulous tipsters and touts. During the debate in Congress, the special professional

[68] "The law endows fiduciaries with reputation, legitimacy and credibility--a "brand name" as moral and honorable persons, as Judge Cardozo referred to them." Frankel, Tamar, "Trusting And Non-Trusting: Comparing Benefits, Cost And Risk" (1999), Boston University School of Law Working Paper 99-12, available at SSRN: http://ssrn.com/abstract=214588 or DOI: 10.2139/ssrn.214588.

relationship between advisers and their clients was recognized. It is, said one representative, "somewhat [like that] of a physician to his patient." The same Congressman continued that members of the profession were "to be complimented for their desire to improve the status of their profession and to improve its quality."[69]

*There Must Exist an Ability to Distinguish between Fiduciary and Non-Fiduciaries Working in the Same Industry.* It is important to fiduciary advisors to be able to distinguish themselves from non-fiduciaries. The "fee-based brokerage accounts" SEC 2005 Final Rule,[70] which would have permitted registered representatives to provide the same functional investment advisory services but without application of fiduciary standards of conduct, would have negated to a large degree economic incentives[71] for persons to become investment advisers. The SEC's 2005 Final Rule was overturned by the courts in the 2007 decision, *Financial Planning Association v. S.E.C.*[72]

The economic effects of disparate standards of conduct for the same functional services should not be overlooked. Should the regulatory body permit others to undertake substantially the same services as those provided by the fiduciary without imposition of fiduciary status, the increased marketability of the fiduciary is thwarted. As Professor Macey in his 2002 Financial Planning Association white paper addressing the regulation of financial planners observed:

> Each financial planner has incentive to develop and maintain a reputation for honesty and competence in order to increase the demand for his services. All financial planners suffer when the reputation of the profession suffers because consumers are unable to distinguish between high-quality services of ethical or competent financial planners and low-quality services of unethical or incompetent financial planners. This, in turn, reduces the market's demand and willingness to pay for financial planners. The practical implications of this basic problem, described by economists as 'information asymmetry' because of the fact that consumers have less information than producers (and therefore the distribution of information between the sellers of services and the buyers of services is asymmetric) are important for the future of any industry or profession … The general problem was first described in a famous article by George Akerloff, in which he showed what would happen to an industry if consumers were unable to distinguish between high quality producers and low quality producers.[73] The consequences of this problem are far more severe than may appear at first blush. The structure of the problem can be described with reference to the financial planning profession as follows: suppose, for the sake of clarity and simplicity, there are only three types of financial planners, excellent quality planners, whose work is worth $900 per hour, medium quality financial planners, whose work is worth $300 per hour, and low quality financial planners, whose work is worth minus $300 per hour because of the costs that such planners impose on their clients through incompetence and fraud. Imagine further that consumers are unable to differentiate among these various types of financial planners until after they have received their services. They don't know whether the advice they are getting is of high, medium or low quality until they have purchased the advice.

[69] John H. Walsh, "A Simple Code Of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry," 29 Hofstra L.Rev. 1015, 1066-8 (2001), *citing* SEC, REPORT ON INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES (1939).

[70] SEC Release IA-2376, "Certain Broker-Dealers Deemed Not To Be Investment Advisers" (April 12, 2005), available at http://sec.gov/rules/final/34-51523.pdf.

[71] "Regulation of Financial Planners," White Paper Prepared for the Financial Planning Association by Jonathan R. Macey, April 2002, available at http://www.fpanet.org, under "Government Relations" / "White Papers."

[72] 482 F.3d 481 (D.C. Cir., 2007).

[73] *Citing* George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," 84 Q. J. ECON.488 (1970)].

> Where this is true, economists have shown that the products all will sell for the same price, because consumers who pay more than the standard market price still will be unable to increase the probability that they are receiving high quality advice.

**Are We Witnessing the Emergence of a "Fiduciary Society"?** As specialization of services has arisen, and our society has grown more complex, the ability of individuals to protect themselves through their own "due diligence" has been negated in an increasing number of contexts. Several decades ago, Professor Tamar Frankel wrote:

> I submit that we are witnessing the emergence of a society predominately based on fiduciary relations. This type of society best reflects our contemporary social values. In our society, affluence is largely produced by interdependence, but personal freedom is cherished. Society's members turn to an arbitrator, the government, to obtain protection from personal coercion by those on whom they depend for specialized services. A fiduciary society attempts to maximize both the satisfaction of needs and the protection of freedom.[74]

While deregulation efforts of the past few decades may have largely succeeding in stalling progress toward a fiduciary society, the financial crisis (occasioned in large part by greed among actors in the financial services industry) is likely to rekindle an affinity toward embracing fiduciary duties. Consumers and policy makers seek to impose higher morals[75] upon financial services intermediaries, as a means of restoring trust in the fairness of our capital markets, and as one of the means to guard against the rise of new systemic risks to the financial system.[76]

> Yet the application of fiduciary duties to personalized investment advice, whether through legislation or administrative rule-making, is resisted by many in the securities industry. This resistance has the effect of leading many, many consumers to adopt a cynical attitude[77] toward financial intermediaries.

**<u>Reflections on the Effects of Disintermediation and Re-intermediation.</u>** From the 1975 end to fixed commission rates on the major exchanges, to the increased use of mutual funds and ETFs, to target date

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[74] Frankel, Fiduciary Law (1983).

[75] The moral underpinnings behind the application of fiduciary status should not go unnoticed. Fiduciary duties are applied in situations where "the law demands an unusually high standard of ethical or moral conduct with reference to one another." 1 Bogert, TRUSTS AND TRUSTEES, §§ 1, 3 (2d ed.1984). "Moral purpose played a fundamental role in creating the federal regulatory regime for the securities industry." John H. Walsh, "A Simple Code Of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry," 29 Hofstra L.Rev. 1015, 1016 (2001). (John Walsh serves as Chief Counsel in the Office of Compliance Inspections and Examinations of the United States Securities and Exchange Commission.) "When FDR signed the Advisers Act, he recognized this legacy. Since 1933, he said, it had been his 'purpose to aid the honest businessman and to assist him in bringing higher standards to his particular corner of the business community … In every direction … a conscientious and successful effort ha[d] been made to require the investment banker, the broker, and the dealer, the security salesman, the issuer, and the great financial institutions themselves to recognize the high responsibilities they owe to the public." *Id.* at 1068-9. "[M]oral concepts are receiving renewed attention as important elements in the creation of prosperity." *Id.* at 1082.

[76] Arguably, the rise of the sale of asset-backed securities (and other structured products) would have been tempered had customers who purchased these securities been represented by knowledgeable fiduciary advisors who adhered to their fiduciary duty of due care and undertook appropriate due diligence. The due diligence of additional knowledgeable fiduciaries serve to make the capital markets more efficient through the higher level of due diligence required of them, and the impact of these due diligence efforts on weighing risks and returns.

[77] This author has had many conversations with individual investors who have fled the capital markets altogether, for the "safety" of bank depository accounts, not because of the volatility of the markets, but primarily due to their perspective that the "games" existing in the stock market are "stacked in favor of Wall Street."

retirement funds, disintermediation has occurred with respect to several aspects of investment portfolio management. An ever-growing 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 Effects Cost Reductions and Leads to Product Sales Difficulties.** Disintermediation[78] 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.).[79] 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.

With increased access to information, 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 SEC should not, unintentionally, adopt rules which, in effect, slow down this process of disintermediation, as the broker-dealer and insurance industry desire. Adopting only "casual disclosures" of conflicts of interest, permitting hidden payments to brokers which are not affirmatively disclosed and quantified, permitting the use of titles which evoke a relationship of trust and confidence by brokers, and permitting expanded activities of an investment advisory nature without application of the Advisers Act's fiduciary requirements, are all instances where the Commission has, albeit unintentionally, slowed down the process of disintermediation. It is not the job of the SEC to preserve business models, especially when the archaic product-sales-driven business model of broker-dealer firms is no longer desired by the vast majority of Americans in today's far more complicated financial world.

At the same time, NAPFA acknowledges that 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

[78] 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.

[79] 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."

seek financial planning and/or investment advice from lower-fee providers, a task made easier through greater transparency in fee arrangements[80] and the application of a common fiduciary standard to all those who provide investment advice.

3. **The One Fiduciary Standard Should Continue. The current fiduciary standard of conduct found in the Investment Advisers Act of 1940 ("Advisers Act") is – *already* – a national uniform standard of conduct.**

**3.a. Arms-Length vs. Fiduciary Relationships. The fiduciary standard is informed by state common law.**

Understanding fiduciary duties begins with an understanding of the two general types of relationships between product and service providers and their customers or clients under the law – "arms-length relationships" and "fiduciary relationships."[81]

**Arms-Length Relationships, Generally.** "Arms-length" relationships apply to the vast majority of service provider–customer engagements.[82] In arms-length relationships, the doctrine of "caveat emptor"[83] generally applies,[84] although there are many exceptions made to this doctrine which effectively compel

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[80] 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. Currently, SEC-registered advisers may, but are not required to, file Part II with the IARD.

[81] "The legal system provides for only two levels of trust and their differentiation is necessary for them to be useful tools for parties setting up relationships ... In essence, legal systems provide only two levels of loyalty between contracting parties, arm's-length and fiduciary relationships. The difference in the degree of trust that the two levels of loyalty entitle the parties is dramatic. Fiduciary relations impose a pure duty of loyalty, according to which the fiduciary must place the interests of his employer before his own. Arm's-length relations, by contrast, allow exploitation within the parameters of good faith." Georgakopoulos, Nicholas L., "Meinhard v. Salmon and the Economics of Honor" (April 1998, revised Feb. 8, 1999). Available at SSRN: http://ssrn.com/abstract=81788 or DOI: 10.2139/ssrn.81788.

[82] *See, for example, Hartman v. McInnis, No. 2006-CA-00641-SCT (Miss. 11/29/2007)* ([O]rdinarily a bank does not owe a fiduciary duty to its debtors and obligors under the UCC ... the power to foreclose on a security interest does not, without more, create a fiduciary relationship ... a mortgagee-mortgagor relationship is not a fiduciary one as a matter of law."). "[T]he significant weight of authority holds that franchise agreements do not give rise to fiduciary ... relationships between the parties." *GNC Franchising, Inc. v. O'Brien*, 443 F.Supp.2d 737, 755 (W.D. Pa., 2006).

[83] *Caveat emptor* is Latin for 'Let the buyer beware.' In its purest form at common law, in the absence of fraud, misrepresentation or active concealment, the seller is under no duty to disclose any defect; it therefore provides a safe harbor to a seller to not to disclose any information to a buyer. *See* Alex M. Johnson, Jr., "An Economic Analysis Of The Duty To Disclose Information: Lessons Learned From The Caveat Emptor Doctrine" (2007), available at

http://law.bepress.com/cgi/viewcontent.cgi?article=9154&context=expresso. It means that a customer should be cautious and alert to the possibility of being cheated. The doctrine supports the idea that buyers take responsibility for the condition of the items they purchase and should examine them before purchase. This is especially true for items that are not covered under any warranty. *See, e.g. SEC v. Zandford*, 535 U.S. 813 (2002).

[84] "When parties deal at arm's length the doctrine of caveat emptor applies, but the moment that the vendor makes a false statement of fact, and the falsity is not palpable to the purchaser, he has an undoubted right to implicitly rely upon it. That would indeed be a strange rule of law which, when the seller has successfully entrapped his victim by false statements, and was called to account in a court of justice for his deceit, would

affirmative disclosure of adverse material facts in many contexts.[85] In other words, non-fiduciaries who contract with each other can engage in "conduct permissible in a workaday world for those acting at arm's length."[86]

In arms-length, commercial relationships, the level of trust or confidence reposed by the customer in the other party is not exceptional**.** "Mere subjective trust does not transform arms-length dealing into a fiduciary relationship."[87] "Absent extraordinary circumstances parties dealing at arms-length in a commercial transaction lack the requisite level of trust or confidence between them necessary to give rise to a fiduciary obligation."[88] Ordinary "buyer-seller relationships" do not give rise to the imposition of fiduciary duties upon the seller.[89]

Yet, commercial good faith is required in contract performance. Actors in arms-length relationships are always subject to the requirement of "mere good faith and fair dealing"[90] in the performance of their

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permit him to escape by urging the folly of his dupe was not suspecting that he (the seller) was a knave." *Holcomb v. Zinke*, 365 N.W.2d 507, 511 (N.D., 1985).

[85] It is well settled that fraud may occur without the making of a false statement. *Dvorak v. Dvorak*, 329 N.W.2d 868 (N.D.1983). The suppression of a material fact, which a party is bound in good faith to disclose, is equivalent to a false representation. *Verry v. Murphy*, 163 N.W.2d 721 (N.D.1969).

[86] *Meinhard v Salmon*, 249 NY 458, 464 (N.Y. 1928).

[87] *Exxon Corp. v. Breezevale Ltd*., 82 S.W.3d 429 (Tex. App., 2002).

[88] *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423, 460 (S.D.N.Y., 2006), *citing Nat'l Westminster Bank, U.S.A. v. Ross*, 130 B.R. 656, 679 (S.D.N.Y.1991) ("Where parties deal at arms length in a commercial transaction, no relation of confidence or trust sufficient to find the existence of a fiduciary relationship will arise absent extraordinary circumstances." (*citing, inter alia, Grumman Allied Indus., Inc. v. Rohr Indus., Inc*., 748 F.2d 729, 738-39 (2d Cir.1984); *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, N.A*., 731 F.2d 112, 122 (2d Cir. 1984))), *aff'd, Yaeger v. Nat'l Westminster*, 962 F.2d 1 (2d Cir.1992) (table); *Beneficial Commercial Corp. v. Murray Glick Datsun, Inc*., 601 F.Supp. 770, 772 (S.D.N.Y. 1985) ("[C]ourts have rejected the proposition that a fiduciary relationship can arise between parties to a business transaction." (*citing Grumman Allied Indus., Inc*., 748 F.2d at 738-39; *Wilson-Rich v. Don Aux Assocs., Inc.,* 524 F.Supp. 1226, 1234 (S.D.N.Y.1981); *duPont v. Perot,* 59 F.R.D. 404, 409 (S.D.N.Y.1973))); *WIT Holding Corp. v. Klein*, 282 A.D.2d 527, 724 N.Y.S.2d 66, 68 (App.Div.2001) ("Under these circumstances, where the parties were involved in an arms-length business transaction involving the transfer of stocks, and where all were sophisticated business people, the plaintiff's cause of action to recover damages for breach of fiduciary duty should have been dismissed.").

[89] *In re Prudential Ins. Co. of America Sales Prac*., 975 F.Supp. 584 (D.N.J., 1996), where, in a case involving sales by life insurance agents of variable appreciable life insurance products as "investment plans," the court stated: "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. Obviously, this dynamic does not adhere in the ordinary buyer-seller relationship. Thus, 'the efforts of commercial sellers — even those with superior bargaining power — to profit from the trust of consumers is not enough to create a fiduciary duty. If it were, the law of fiduciary duty would largely displace both the tort of fraud and much of the Commercial Code.' *Committee on Children's Television, Inc., v. General Foods Corp*., 35 Cal.3d 197, 221, 197 Cal.Rptr. 783, 789, 673 P.2d 660, 675 (1983) (en banc)." *In re Prudential Ins. Co. of America Sales Prac.* At 616.

[90] *See GNC Franchising, Inc. v. O'Brien*, 443 F.Supp.2d 737, 755 (W.D. Pa., 2006) ("A party bound by a fiduciary duty must advance the interests of the *cestui que* trust above its own and act scrupulously in the other's interests. Imposition of this degree of duty—*i.e.,* selfless service as opposed to merely good faith and fair dealing—would generally be inapplicable as between parties to a commercial relationship knowingly entered into for each party's own profit"). In arms-length relationships, the burden of proof of lack of fair dealing rests on the person alleging that the other party acted in such manner. This contrasts with the burden of proof where a fiduciary relationship exists, where the burden of proof of fair dealing rests with the fiduciary. *See ABN Amro Mortgage Group, Inc. v. Pristine Mortgage, LLC,* No. CV 04-4005389 (CT 9/8/2005) (CT, 2005) ("The significance of the establishment of a fiduciary relationship is twofold. First, the burden of proving fair dealing shifts to the fiduciary. Secondly, the standard of proof for establishing fair dealing is not the ordinary standard of fair preponderance of evidence but requires proof of clear and convincing evidence.")

obligations; this doctrine is fundamental to all commercial transactions.[91] Good faith requires that each party perform their respective obligations and enforce their rights honestly and fairly.[92]

While there is no general duty to disclose material facts in arms-length transactions, actual or "common law" fraud is prohibited in the formation of commercial relationships. There is generally no duty to undertake full disclosure of material facts in the negotiation of commercial contracts,[93] except where one party's superior knowledge renders non-disclosure of an essential fact inherently unfair[94] or a "special relationship" exists.[95] Instead, actors in commercial relationships generally possess a duty to undertake diligent inquiry in order to ascertain facts.[96] However, if disclosures are undertaken by a party, the

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[91] The doctrine of good faith requires that the parties also perform their respective obligations and enforce their rights honestly and fairly. *See* Restatement (Second) Contracts (1981) at §205, "Duty of Good Faith and Fair Dealing," stating: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." The *Comment* to this section adds: "Good faith is defined in Uniform Commercial Code § 1-201(19) as 'honesty in fact in the conduct or transaction concerned.' 'In the case of a merchant' Uniform Commercial Code §2-103(1)(b) provides that good faith means 'honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.' The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness. Failure to abide by the duty of good faith may constitute fraud (in the event of intentional misrepresentation) or breach of contract."

[92] For example, the Uniform Commercial Code, adopted by every state except Louisiana, explicitly imposes a good faith obligation on the performance and enforcement of every contract falling within its scope. UCC § 1-304, as amended (2003). Essentially, the Restatement of Contracts adopts the view that "bad faith in performance" is a violation of the good faith obligation. As stated by Professor Emily S.H. Hough: "The subcategories of bad faith in performance further delineated by Summers include 'evasion of the spirit of the deal,' 'lack of diligence and slacking off,' 'willfully rendering only 'substantial performance,'' 'abuse of power to determine compliance,' and 'interfering with or failing to cooperate in the other party's performance.'" All of these subcategories contemplate cases in which judges would feel comfortable using their discretionary and equitable powers to find a breach of good faith where the express language of the contract might not otherwise support a claim for breach of contract." Houh, Emily, "The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessell?" Utah Law Review, 2005. Available at SSRN: http://ssrn.com/abstract=622982.

[93] *See Southern Intermodal Logistics, Inc. v. Smith & Kelly Co*., 190 Ga.App. 584, 379 S.E.2d 612, 613-4 (1989) ("While concealment of material facts may amount to fraud when the concealment is of intrinsic qualities the other party could not discover by the exercise of ordinary care … in an arms-length business or contractual relationship there is no obligation to disclose information which is equally available to both parties").

[94] *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423 (S.D.N.Y., 2006), stating: "Even absent the existence of a fiduciary relationship, however, a party's duty to disclose a material fact to another party it is negotiating with is triggered where 'one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge.' *Grumman Allied Indus., Inc*., 748 F.2d at 739 (*quoting Aaron Ferer & Sons Ltd*., 731 F.2d at 123; Jana *L. v. W. 129th St. Realty Corp*., 22 A.D.3d 274, 802 N.Y.S.2d 132, 134 (App.Div.2005) ('It is well established that, absent a fiduciary relationship between the parties, a duty to disclose arises only under the `special facts' doctrine `where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair.'' (*quoting Swersky v. Dreyer & Traub*, 219 A.D.2d 321, 643 N.Y.S.2d 33, 37 (App.Div. 1996)." *Henneberry* at 461.

[95] *See Giles v. General Motors Acceptance Corp*., 494 F.3d 865, 881 (9th Cir., 2007) ("Nevada also recognizes "special relationships" giving rise to a duty to disclose, such that '[n]ondisclosure . . . become[s] the equivalent of fraudulent concealment.' *Mackintosh v. Jack Matthews & Co*., 109 Nev. 628, 855 P.2d 549, 553 (1993). In order to prove the existence of a special relationship, a party must show that (1) 'the conditions would cause a reasonable person to impart special confidence' and (2) the trusted party reasonably should have known of that confidence. *Mackintosh v. Cal. Fed. Sav. & Loan Ass'n*, 113 Nev. 393, 935 P.2d 1154, 1160 (1997) (per curiam). '[T]he existence of the special relationship is a factual question . . . .' *Id.*)

[96] *See Burger King Corp. v. Austin*, 805 F.Supp. 1007, 1019 (S.D. Fla., 1992) ("Florida law additionally charges a claimant with knowledge of all facts that he could have learned through diligent inquiry … In absence of a

statements made must be truthful and complete[97] or actual fraud[98], also called "common law fraud,"[99] exists. Hence, while commercial good faith does not automatically extend to the area of contract negotiations, misrepresentations made during the formation of a contract may constitute either actual fraud or breach of contract.[100] To put it much more simply, don't lie, cheat, deceive or steal – even in commercial arms-length relationships.

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fiduciary relationship, mere nondisclosure of material facts in an arm's length transaction is ordinarily not actionable misrepresentation unless some artifice or trick has been employed to prevent the representee from making further independent inquiry, though non-disclosure of material facts may be fraudulent where the other party does not have an equal opportunity to become appraised of the facts."), *citing Taylor v. American Honda Motor Co*., 555 F.Supp. 59, 64 (M.D.Fla.1982).

[97] *See Playboy Enterprises v. Editorial Caballero,* 202 S.W.3d 250, 260 (Tex. App., 2006), stating: "In addition to situations where there is a fiduciary or confidential relationship … a duty to speak may arise in an arms-length transaction in at least three other situations: (1) when one voluntarily discloses information, he has a duty to disclose the whole truth; (2) when one makes a representation, he has a duty to disclose new information when the new information makes the earlier representation misleading or untrue; and (3) when one makes a partial disclosure and conveys a false impression, he has the duty to speak."

[98] "Actual fraud is where one person causes pecuniary injury to another by intentionally misrepresenting or concealing a material fact which from their mutual position he was bound to explain or disclose." Charles Sweet, *A Dictionary of English Law* (1883).

[99] The distinctions between "common law fraud" and "equitable fraud" (or "constructive fraud") in English law, from which U.S. law is derived, was explained by English Judge Henry Litton in his speech, "Of Rogues and Amiable Lunatics" (1988):

> In the common law courts, the expression 'fraud' is used in the sense of actual dishonesty whereas in the Court of Chancery [*i.e.,* courts of equity, before they merged with the common law courts] 'fraud' is used in a wider sense. For example, in a common law action of deceit, nothing short of proof of a fraudulent intention to deceive would suffice, whereas for equitable fraud to be established it is not necessary for the plaintiff to prove an actual intention to cheat. The best illustration of this distinction is, perhaps, the leading case of Nocton v Ashburton [1914] AC 932 where the solicitor (Nocton) [an attorney-at-law] had improperly and in bad faith advised the respondent, Lord Ashburton, to release from his mortgage a valuable part of the security in order that he (the solicitor) might benefit in respect of a charge in which he was interested, by rendering his charge a first charge. The trial judge had expressly negatived actual fraud on the part of the solicitor although he thought the solicitor's conduct fell far short of that which he should have performed as a solicitor. The Court of Appeal reversed the trial judge on his finding of fact: a course which the House of Lords thought 'a rash proceeding on the part of the Court of Appeal.' The question was whether, without actual fraud (that is to say intent to cheat) being established, Lord Ashburton could nevertheless succeed on the grounds of 'equitable fraud.' Because the solicitor was standing in a fiduciary position vis-a-vis Lord Ashburton, the House of Lords came to the view that 'constructive fraud' was established. Viscount Haldane remarked (at 943): 'The trustee who purchases the trust estate, the solicitor who makes a bargain with his client that cannot stand, have all for several centuries run the risk of the word fraudulent being applied to them. What it really means in this connection is, not moral fraud in the ordinary sense, but breach of the sort of obligation which is enforced by a court that from the beginning regarded itself as a court of conscience.'

[100] Waller, Spencer Weber and Brady, Jillian G., "Consumer Protection in the United States: An Overview; Strengthening the Consumer Protection Regime" (2007), available at SSRN:

http://ssrn.com/abstract=1000226. Private actions alleging actual fraud form an important, though often expensive and difficult, avenue for protection of the rights of a contracting party. "A consumer may file a lawsuit for deceit or fraud when a vendor intentionally conceals a material fact or makes a false representation of a material fact, knows that the representation is false, and meant to induce the consumer to act based on the misrepresentation. In order for the consumer to be successful in court, a plaintiff must also reasonably rely on the misrepresentation and suffer damage as a result of the reliance. Deceit can occur when a vendor makes a direct false statement, or when a misrepresentation is achieved through silence, concealment, half-truths, or ambiguity about a good. While misrepresentation of product facts may bring legal action, mere puffery and sales representative opinions are generally not subject to lawsuits for deceit." *Id.* at p. 13.

In arms-length relationships, the parties are generally free to contract with each other and are largely free to determine the terms of their contract. Neither the service provider in an arms-length relationship, nor the customer, possesses any duty to take care of the other party.

**’33 Act and ’34 Act Disclosure-Based Regulatory Regimes.** At times the law sees fit to impose additional obligations in arms-length relationships, as a means of aiding the consumer to access information which might be necessary to make an informed decision. This is seen in the **disclosure** regimes of the 1933 and 1934 Federal securities laws. The 1933 Securities Act and the Securities and Exchange Act of 1934 both adopt a “full disclosure” regime as a protection for individual investors.[101] Over the decades, federal securities laws and regulations have evolved to protect investors largely through requiring the disclosure of information – whether it be of material facts regarding an issuer of a security, or of compensation paid to financial services intermediaries, or of conflicts of interest which exist as to financial services intermediaries. Indeed, it has been stated that in the United States, “federal securities law’s exclusive focus is on full disclosure.”[102] Yet, as will be observed shortly, the Advisers Act imposes duties far beyond that of casual disclosure.

**FINRA’s Regulations: “Good Faith” plus “Suitability.”** Through rules adopted by a broker-dealer self-regulatory organization (formerly NASD, now FINRA),[103] broker-dealer firms and their registered representatives are prohibited from an act which would “effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.”[104] Additionally, broker-dealers and registered representatives must ensure that a securities

[101] Section 10(b) of the Securities Exchange Act makes it "unlawful for any person ... [t]o use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U. S. C. §78j. Rule 10b-5, which implements this provision, forbids the use, "in connection with the purchase or sale of any security," of "any device, scheme, or artifice to defraud" or any other "act, practice, or course of business" that "operates ... as a fraud or deceit." 17 CFR §240.10b-5 (2000). Among Congress' objectives in passing the Act was "to insure honest securities markets and thereby promote investor confidence" after the market crash of 1929. *United States v. O'Hagan*, 521 U. S. 642, 658 (1997); *see also United States v. Naftalin*, 441 U. S. 768, 775 (1979). More generally, Congress sought “to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.” *Affiliated Ute Citizens of Utah v. United States*, 406 U. S. 128, 151 (1972) (*quoting SEC v. Capital Gains Research Bureau, Inc*., 375 U. S. 180, 186 (1963)).

[102] Thomas Lee Hazen, *The Law Of Securities Regulation*, Vol. 1, § 8.1[1][B], at 740 (4th ed. 2002).

[103] Where did FINRA (formerly NASD) get its authority to impose the suitability standard upon broker-dealers, thereby further modifying the arms-length relationship with their customers (beyond certain disclosures)? After four years of discussion between the SEC and industry groups, and multiple amendments in Congress, in 1938 the Maloney Act was passed. This Act amended the 1934 Act to provide for the establishment of one or more national self-regulatory organizations for broker-dealers, the rules of which must be “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest ....” Subsequently, in 1939 the “National Association of Securities Dealers” (NASD) was formed, which initially provided self-regulation of the over-the-counter market, and which since (through a merger with NYSE of certain regulatory functions) has become the “Financial Industry Regulatory Authority” (FINRA), with broader authority over the conduct of broker dealers. In 1983 Congress legislated that all BDs must become members of NASD (now FINRA).

[104] FINRA Rule 2020, which further states: “(a)(1) Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public. (2) This does not mean that legitimate sales efforts in the securities business are to be discouraged by requirements which do not take into account the variety of circumstances which can enter into the member-customer relationship. It does mean, however, that sales efforts must be judged on the basis of whether they can be reasonably said to represent

product be "suitable" for an individual investor as it relates to a recommendation or a particular transaction.[105] Once applied, the suitability obligation generally ceases within the same timeline of the transaction itself.

Despite over seven decades of experience with the suitability standard, and despite arguments that it is a "clear" standard and hence easy to enforce, the suitability standard does little to offer real protection to individual investors. The suitability obligation consists of two inter-related dimensions. The first is "know-your-customer" suitability, which focuses on the circumstances of the particular customer. The second is "know-your-security" suitability (also called "reasonable-basis suitability"), which focuses on the characteristics of the recommended security.

Yet, a "suitable investment" is one that is "just OK" from the standpoint of the investment product's risk characteristics, as pertaining to that customer.[106] The broker-dealer and its registered representatives are not generally required, as part of suitability, to ensure that the fees and costs paid by the customer are low. In a recent comment letter submitted by Maria Elena Lagomasino, Chief Executive Officer of GenSpring Family Offices, the limited protection afforded to individual investors by the suitability standard was noted:

> The "suitability standard" is a lower level of conduct that brokers, as salespeople, are required to meet—and the one that most private banks are now regulated under. It is a sales standard. Suitability for brokers requires only that what they sell is a type of security that is not 'unsuitable' for your goals—for example, this stock fund or another stock fund if your goal is equity market exposure. But under the suitability standard of conduct, they can sell you the fund that pays them the most compensation, with the highest expenses—even if there is another one with reasonable expenses that would be better for you—and that's perfectly legal under this 'suitability' or sales standard. In other words, they don't have to put your interests ahead of their own—or their firm's. They don't have to disclose what they and the firm make on the transaction. They are supposed to disclose conflicts but don't have to avoid them or to manage conflicts in your best interest. Under the suitability standard it can be very difficult for clients to understand and interpret any potential conflicts of interest.[107]

Practically speaking the suitability rule is a low standard and very narrow in the scope of obligation imposed on broker-dealers and their registered representatives. It may be viewed as "more concrete" as a rules-based prescription, but only because its lack of breadth and the low level of obligation imposed on broker-dealers makes it "easier" to enforce. The anatomy of the cockroach may be simpler and easier to

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fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers."

[105] FINRA Rule 2310, Recommendations to Customers (Suitability), states: "(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."

[106] *See* Speech by Former SEC Commissioner Cynthia Glassman (April 6, 2005), in which she stated: "Generally speaking, when a broker makes a recommendation, the recommendation must be a suitable, although not necessarily the best, recommendation for the client."

[107] "Not All Advisors Are the Same – How Can You Tell the Difference?" submitted August 18, 2010, available at http://sec.gov/comments/4-606/4606-1395.pdf.

understand than the anatomy of a human being, but that does not mean we should rush to embrace the cockroach over our fellow humans.

**Suitability Requirements Are Imposed On Both Broker-Dealers and Investment Advisers.** It should further be recognized that "suitability" is also, generally, one of the many requirements imposed upon investment advisers. "[S]uitability is also applied to investment advisers – it is part of (but does not supersede) the adviser's fiduciary obligations.[108] In Release No. 1406, the SEC proposed a rule under the Act's anti-fraud provisions requiring advisers give clients only suitable advice. Although the rule was never adopted, the SEC staff takes the position that the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the Act."[109]

However, a broker-dealer is generally not in a fiduciary relationship with a client. For this reason, a broker's best execution obligation largely focuses on the price at which the client's order is executed in the marketplace, without considering the amount of commission that the broker receives, although the amount of commissions (or sales loads) may be capped by FINRA rules. In contrast, the investment adviser's best execution obligation focuses on the client's total fees and costs relating to the transaction or investment.[110]

**The *Quasi-Fiduciary* Duties of Broker-Dealers.** Are broker-dealer firms and their registered representatives fiduciaries? Yes, and always, as to the scope of their agency. In this regard the 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 registered representatives owe "limited fiduciary duties" or "quasi-fiduciary duties" to the customer. However, no broad fiduciary duties exist with respect to most registered representatives and their broker-dealer firms under the law of agency, at least with respect to non-discretionary accounts.

By way of further explanation, often the question is posed, "Are broker-dealer firms and their registered representatives fiduciaries?" The answer is always "yes." In this regard, the 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 registered representatives owe "limited fiduciary duties" or "quasi-fiduciary duties" to the customer. However, no broad fiduciary duties to exist with respect to most RRs and their broker-dealer firms, under the law of agency, at least with respect to non-discretionary accounts, unless applied under another theory.

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108 *See* Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994).

109 Plaze, Robert E. Plaze, Outline, The Regulation of Investment Advisers by The Securities and Exchange Commission, at p.39, fn. 82, available at http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042006.pdf.]

110 *See In the Matter of Jamison, Eaton & Wood,* Investment Advisers Act Release No. 2129 (May 15, 2003) ["One of an investment advisers "basic duties" is to seek to obtain best execution – '[T]o execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.' *In re Kidder, Peabody & Co., Inc*., 43 S.E.C. Docket 911 (October 16, 1968). A number of factors go into an analysis of best execution, including trading prices, commissions, speed of execution and certainty of execution. As part of the duty, an adviser is required to review periodically and systematically the quality of execution services received. The scope of the duty evolves as changes occur in the market that give rise to improved execution, including opportunities to trade at more reasonable prices. *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc*., 135 F.3d 266, 270-271 (3d Cir. 1998); *In re Portfolio Advisory Services, LLC*, Advisers Act Rel. No. 2038 (June 30, 2002); *Order Execution Obligations*, Exch. Act Rel. No. 34-37619A, 62 S.E.C. Docket 2210, 2243 (September 12, 1996)."]

The duties which arise out of the agency relationship were summarized in a recent decision:

> Where the account is a nondiscretionary account such as the account maintained by the Millars, the duties of the broker include: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis; (2) the duty to carry out the customer's orders promptly m a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security; (5) the duty not to misrepresent any fact material to the transaction; and (6) the duty to transact business only after receiving prior authorization from the customer.[111]

Other duties may exist.[112]

The differences in duties between arms length relationships and fiduciary advisor relationships are summarized in the table below. Generally, an arms length transaction generally begins with the product and ends with the customer; while the fiduciary relationship begins with the client and ends with the product.

[111] *Merrill Lynch, Pierce, Fenner & Smith v. Millar*, (W.D. Pa. 2003), citing *Merrill Lynch, Pierce, Fenner & Smith v. Perelle*, 514 A.2d 552,561 (Pa. Super. 1986), quoting *Leib v. Merril lLynch, Pierce, Fenner & Smith, Inc*., 461 F. Supp. 951,953 (E. D. Mich.1978).

[112] "These duties as outlined in *Perelle*, however, are not all encompassing." *Millar*.

# Arms-Length vs. Fiduciary Relationships, Generally.

## 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.

A.

**The "Fiduciary Relationship."** In contrast to arms-length relationships, the law imposes upon one party to some contracts a special position – status as a fiduciary. This other form of commercial relationship is called the "fiduciary relationship" or "fiducial relationship." One upon who fiduciary duties are imposed is known as the "fiduciary" and is said to possess "fiduciary status."

**The "Fiduciary Principle."** "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 circumstances, 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 upon them the duties of loyalty, due care, and full disclosure. This can be called the "fiduciary principle."[113]

**Fiduciary Status Address "Overreaching" When Person-to-Person Advice is Provided.** 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."[114] "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.[115] The dangers of fraud, deception, or overreaching that motivated the enactment of the statute are present in personalized communications …."[116]

**Fiduciaries Possess a Much Higher Standard of Conduct Under the Law Than Non-Fiduciary Financial Services Intermediaries.** "There is a crucial distinction between surrendering control of one's affairs to a fiduciary or confidant or party in a position to exercise undue influence and entering an arms-length commercial agreement, however important its performance may be to the success of one's business."[117] The fiduciary relationship is distinct from arms-length relationships, in that in which the law requires the fiduciary to carry on the fiduciary's dealings with the client (or "entrustor") at a level far above ordinary, or even "high" commercial standards of conduct.

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[113] *Von Noy v. State Farm Mutual Automobile Insurance Company*, 2001 WA 80 (WA, 2001) (Justice Philip Talmadge, concurring opinion).

[114] *Lowe v. SEC*, 472 U.S. 181, 200, 201 (1985).

[115] *Id.* at 208.

[116] *Id.* at 210.

[117] *Ettol, Inc. v. Elias/Savion Advertising, Inc.*, 811 A.2d 10, 23 (Pa. Super. Ct., 2002), stating: "Most commercial contracts for professional services involve one party relying on the other party's superior skill or expertise in providing that particular service. Indeed, if a party did not believe that the professional possessed specialized expertise worthy of trust, the contract would most likely never take place. This does not mean, however, that a fiduciary relationship arises merely because one party relies on and pays for the specialized skill or expertise of the other party. Otherwise, a fiduciary relationship would arise whenever one party had any marginally greater level of skill and expertise in a particular area than another party. Rather, the critical question is whether the relationship goes beyond mere reliance on superior skill, and into a relationship characterized by "overmastering influence" on one side or "weakness, dependence, or trust, justifiably reposed" on the other side. *Basile v. H & R Block,* 777 A.2d 95, 101 (Pa.Super.2001). A confidential relationship is marked by such a disparity in position that the inferior party places complete trust in the superior party's advice and seeks no other counsel, so as to give rise to a potential abuse of power." *Id.*

Perhaps the most famous judicial expression of fiduciary duties is Justice Cardozo's famous lines in which he expresses a lofty vision of the duties owed by fiduciaries. “Generations of corporate lawyers have been schooled in its memorable language finding broad fiduciary obligations on managers of other peoples' money.”[118] Justice Cardoza opined:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arms length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. 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 [citation]. 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. [119]

Justice Cardoza, by noting that the fiduciary obligation is “stricter than the morals of the marketplace,”[120] emphasizes that the fiduciary relationship is different and distinct from arms-length relationships. Conduct which might be permitted in a commercial relationship, even one in which “fair dealing” is required and other specific conduct rules apply, is nevertheless prohibited, supervised, or restricted by the fiduciary’s duties of loyalty and due care.

Justice Cardoza “holds” fiduciaries to the “rule of undivided loyalty,” reflecting that the client places in the fiduciary the client’s “emotional unconditional trust.”[121] Legislators or government agencies should act with great caution when they seek by law, or by the exercise of rulemaking authority, to increase either the quantity or quality of “particular exceptions” to the principle of undivided loyalty. The danger is in diminishing the fiduciary principle, not just within the realm of investment advice, but throughout the realm of fiduciary law. The consequence of the grant of more particular exceptions to this “highest standard under the law” is the danger of erosion of that high degree of trust, unique to the fiduciary relationship, which is so essential to the functioning of today’s complex modern society.

**Fiduciary Status as the Adoption of the Client’s Ends.** Given that core fiduciary duties are not, in the context of investment adviser regulation, subject to alteration by agreement between the parties, the fiduciary obligation can perhaps best be understood as one which requires the fiduciary “to adopt the

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[118] Georgakopoulos, Nicholas L.,Meinhard v. Salmon and the Economics of Honor(April 1998). Available at SSRN: http://ssrn.com/abstract=81788 or DOI: 10.2139/ssrn.81788.

[119] *Meinhard vs. Salmon*, 164 N.E. 545 (N.Y. 1928). “Justice Cardozo held that a nonmanaging partner could share in a deal that the owner of the property the partnership managed had offered to the managing partner although the deal would begin after the termination of the partnership's 20-year term and included significant property beyond what the partnership had managed. Meinhard provides a workable definition of fiduciary duties as requiring the obligated party to act with the ‘finest loyalty’ to the owner's interests.” Ribstein, Larry E., “The Structure of the Fiduciary Relationship” (January 4, 2003). U Illinois Law & Economics Research Paper No. LE03-003. Available at SSRN: http://ssrn.com/abstract=397641 or DOI: 10.2139/ssrn.397641

[120] The standard of conduct expected of the actors in arms-length relationships has been described by the courts as the “morals of the marketplace.” [In re Auto Specialties Mfg. Co., 153 B.R. 457, 488 (Bankr. W.D. Mich., 1993).]

[121] Frankel, Tamar, and Gordon, Wendy, “Symposium Trust Relationships Part 1 Of 2: Introduction,” 81 B.U.L. Rev. 321 (2001).

principal's goals, objectives, or ends."[122] "It is what makes fiduciary law unique and separates fiduciaries from other service providers."[123] As Professor Laby further explains:

> Some even use the phrase "alter ego" to reference the fiduciary norm. This personalizes the duty in a particular way. The fiduciary must appropriate the objectives, goals, or ends of another and then act on the basis of what the fiduciary believes will accomplish them – a happy marriage of the principal's ends and the fiduciary's expertise. The fiduciary does not eliminate its own legal personality, rather it must consider the principal's delegation of authority to the fiduciary from the perspective of fidelity to the principal's objectives as the fiduciary understands them.[124]

**"Constructive Fraud" Constitutes a Breach of Fiduciary Duty.** A violation of a fiduciary duty results from "constructive fraud," and a finding of "actual fraud" is not required, a distinction long recognized by the law.[125] As stated in 1886 by an English law dictionary:

> Fraud sometimes exists where no wrongful intention is proved. In this sense of the word, 'fraud,' or 'constructive' or 'legal fraud' … indicates the cases in which a Court will not enforce or will set aside a contract, instrument, or transaction, in which the Court is of opinion that it is unconscientious for a person to avail himself of the … advantage which he has obtained … the fraud may be presumed from the circumstances and condition of the parties contracting, by that rule of equity established to prevent one person from taking surreptitious advantage of the weakness or necessity of another, which knowingly to do is equally against conscience as to take advantage of his ignorance; a person is equally unable to judge for himself in one as the other. The principal instances of this kind of fraud occur … (1) where there is a confidential or fiduciary relation between the parties … (2) where one person takes an unfair advantage of the necessities or inexperience of another … [or] [3] a transaction may be fraudulent on the ground of public policy.[126]

**State Common Law: Imposition of Fiduciary Status On Those In Relationships of Trust and Confidence.** Regardless of how an individual financial advisor is registered – as an investment adviser (representative), registered representative of a broker-dealer, dual registrant, or insurance agent – another body of law serves to impose fiduciary status upon the financial advisor – the "common law." Regardless of any rules issued by the U.S. Securities and Exchange Commission (SEC), which generally imposes fiduciary status only upon those the SEC believes fits within the definition of "investment adviser" (and who are not excluded therefrom), or when legislatures see fit to impose fiduciary status in other "technical

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[122] Laby, Arthur B., "The Fiduciary Obligation as the Adoption of Ends," Buffalo L. Rev 99, 103 (2008), available at available at: http://ssrn.com/abstract=1124722.

[123] Laby at 130.

[124] Laby at 135.

[125] At the beginning of the nineteenth century, in *Gibson,* 31 Eng. Rep. 1044 (1801), the English court, while explaining the decision to rescind the sale of an annuity by an attorney to his client, announced that "[one] who bargains in matter of advantage with a person placing confidence in him is bound to sh[o]w, that a reasonable use has been made of that confidence; a rule applying to trustees, attorneys or anyone else." The courts eventually settled on "fiduciary" to denominate relationships of trust and confidence and denominated the doctrine (applied in Gibson) denoting abuse of these confidential relationships as "constructive fraud." By the mid-nineteenth century, the doctrine of "constructive fraud" was said to arise from some peculiar confidential or fiduciary relation between the parties. In other words, a breach of fiduciary duty in many instances may constitute a "constructive fraud."

[126] Charles Sweet, *A Dictionary of English Law* (1882), at p. 375 (citations omitted).

relations," state courts can find fiduciary status to exist and impose upon the advisor the fiduciary duties of due care, loyalty, and utmost good faith through the application of state common law.[127]

**Fiduciary Status Under the Common Law – Two Main Branches Exist.** The recognition of the existence of a fiduciary relationship under the common law is said to consist of two main branches:[128]

*First Branch: "Per se" or "Express" or "Generally Accepted and Prescribed Relationships."* 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, parent and child, spouses, and fiancés.[129] The common law has defined, over the years,[130] these relationships to be fiduciary in nature, and they are generally accepted as such. They are sometimes called "*per se*" or "express"[131] fiduciary relationships. Some of these relationships were recognized to involve fiduciary status for several centuries or longer (such as trustee relationships), while other relationships were only recently universally recognized as such (director or officers of corporations, for example). 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

[127] "A fiduciary relationship is one founded on trust or confidence reposed by one person in the integrity and fidelity of another. The term is a very broad one. It is said that the relation exists, and that relief is granted in all cases in which influence has been acquired and abused, in which confidence has been reposed and betrayed. The origin of the confidence and the source of the influence are immaterial. The rule embraces both technical fiduciary relations and those informal relations which exist whenever one man trusts in and relies upon another. Out of such a relation, the laws raise the rule that neither party may exert influence or pressure upon the other, take selfish advantage of his trust or deal with the subject matter of the trust in such a way as to benefit himself or prejudice the other except in the exercise of utmost good faith ... A fiduciary relation exists when confidence is reposed on one side and there is resulting superiority and influence on the other." *Mobil Oil Corporation v. Rubenfeld*, 72 Misc.2d 392, 339 N.Y.S.2d 623, 632 (1972), *rev'd on other grounds*, 48 A.D.2d 428, 370 N.Y.S.2d 943 (1975); *accord, CBS, Inc. v. Ahern*, 108 F.R.D. 14 (S.D.N.Y.1985).

[128] "Generally, under North Carolina law, there are two types of fiduciary relationships: 1) those that arise from 'legal relations such as attorney and client, broker and client ... partners, principal and agent, trustee and cestui que trust,' and 2) those that exist 'as a fact, in which there is confidence reposed on one side, and the resulting superiority and influence on the other.'" *Frizzell Const. v. First Citizens Bank & Trust*, 759 F.Supp. 286, 290 (E.D.N.C., 1991).

[129] *See Giles v. General Motors Acceptance Corp.*, 494 F.3d 865 (9th Cir., 2007) ("The Nevada Supreme Court has held that fiduciary duties arise as a matter of law in certain categories of relationships ... insurers and insured ... attorney and client ... spouses ... *Fick v. Fick*, 109 Nev. 458, 851 P.2d 445, 449-50 (1993) (fiancés) ... corporate officers or directors and corporation") (*citations omitted*).

[130] The foundations of fiduciary law originated in courts of equity where it was developed to address claimed abuses by one who had accepted a position of authority with regard to the affairs of another. Eileen A. Scallen, "Promises Broken v. Promises Betrayed: Metaphor, Analogy, and The New Fiduciary Principle," 1993 U.Ill.L.Rev. 897, 905-06. As the medieval use developed into the modern law of trusts, the ancient rule encompassed in the fiduciary principle that no man can serve two masters was enforced by courts of equity in England and later in the United States. In the leading [English] case of *Keech v. Sandford, Chancery*, 1726, Sel. Cas. Ch. 61, 25 Eng. Rep. 223. the trustee held a profitable lease in trust for an infant beneficiary. On renewal of the lease, the lessor refused to renew without a covenant that the infant could not enter into, so the trustee took the renewal for himself. The court held that this was a breach of trust." Joseph F. Johnston, Jr., "Natural Law and the Fiduciary Duties of Business Managers," 8 J. MARKETS & MORALITY 8 (2005): 27, 30.

[131] *See In re Meridian Asset Management, Inc.,* 296 B.R. 243, 262 (Bankr. N.D. Fla., 2003) ("A fiduciary relationship can either be express or implied ... An express fiduciary relationship is created by a contract between the two parties, as in principal/agent, or through a legal proceeding in the case of a guardian/ward.")

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. Some state courts go further and apply the very broad triad of fiduciary duties – loyalty, due care, and utmost good faith – when the broker-dealer possesses discretion over a customer's account.[132]

*Second Branch: "Implied in Law" Fiduciary Relations, or Relationships Deemed Fiduciary on the Basis of Specific Facts and Circumstances*. The second branch of fiduciary status arises from those "informal"[133] or "implied in law"[134] relationships which, on their particular facts, are appropriately categorized as fiduciary in nature.[135] As the common law has evolved,[136] some commentators have attempted to cull from the cases the major factors which tend to result in a finding of fiduciary status:

> Much academic ink has been spilt on seeking a definition of a fiduciary relationship. Four central ideas have predominated. Firstly, the fact that one person has undertaken or is to be taken to have undertaken to act for and on behalf of another person. Secondly, the fact that the other person in the relationship has relied or is entitled to rely on the other to act in his interests to the exclusion of his own interests. Thirdly, the fact that the alleged fiduciary has control over some of the property or affairs of the other. And fourthly, the fact that the relationship between the parties is such that the fiduciary is in a position to act to the detriment of another person and that other person is accordingly vulnerable to abuse by the fiduciary of his position. The problem is that whilst one or more of these four factors appears in most if not all established cases of fiduciary relationship they also appear in many relationships which are not generally considered as fiduciary.[137]

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[132] *See Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., 461 F Supp 951, 953 (ED Mich. 1978), stating that, ["[u]nlike the broker who handles a non-discretionary account, the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense."].

[133] "An informal relationship may give rise to a fiduciary duty where one person trusts in and relies on another, whether the relation is a moral, social, domestic, or purely personal one." *Western Reserve Life Assur. v. Graben*, 233 S.W.3d 360, 374 (Tex. App., 2007), *citing Schlumberger Technology Corp. v. Swanson,* 959 S.W.2d 171, 176 (Tex. 1997).

[134] "Under Florida law, a fiduciary relationship may be implied in law based on the specific facts and circumstances surrounding the parties relationship and the transaction in which they are involved." *Thunder Marine, Inc. v. Brunswick Corporation*, No. 07-13907 Non-Argument Calendar (11th Cir., 2008), at p.5.

[135] *See Ware v. D.R.G., Inc*. (1st Dist.1974), 17 Ill.App.3d 758, 761-2, 307 N.E.2d 740, 743 ("A fiduciary relationship is not limited to cases of trustee and cestui que trust, guardian and ward, attorney and client, and other recognized legal relationships, but extends to every possible case in which there is confidence reposed in one side and a resulting superiority and domination on the other. The origin of the confidence may be moral, social, domestic, or merely personal. If the confidence in fact exists and is accepted by the other the relation is fiduciary and equity will regard dealings between the parties according to the rules which apply to such relations.")

[136] During the 20th Century, and with the rise of specialization in modern society, the courts developed fiduciary law through analogy. The courts identified paradigm cases in which a fiduciary relationship was found to exist and examined whether the relationship under consideration "is sufficiently like those in the paradigm cases to support an extension of the obligation to that relationship." Deborah A. DeMott, "Beyond Metaphor: An Analysis of Fiduciary Obligation," 1988 Duke L.J. 879.

[137] John McGhee, "The Role of Fiduciary Obligations in Commercial Disputes," at p. 8, available at http://www.maitlandchambers.com/Files/Article/PDF/art-fiduciaryobligations-jmqc.pdf, citing

Oakley, *Constructive Trusts* (1997) p.90 *et seq.*, and noting: "[S]ociety has seen an enormous growth in the number of types of professionals who are trusted for their advice. The courts can be expected increasingly to impose fiduciary duties on such persons knowing that they are paid for their advice and are generally insured against the consequences of litigation."

The test of whether a fiduciary relationship exists under the common law often requires a fact-intensive inquiry.[138] 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[139] or dependency, substantial disparity in knowledge,[140] the ability to exert influence, placement of confidence,[141] the actual exercise of control over a party, and (in a commercial transaction) whether "the parties have shared goals in each other's commercial activities."[142] 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. Factors indicating that fiduciary duties should not be applied include, in the context of commercial relations, the presence of legal counsel or other professional advisors representing both parties.[143]

**State Courts Increasing Apply Broad Fiduciary Duties to Financial Advisory Relationships, Applying State Common Law.** While most issues involving the application of common law fiduciary duties to the activities of financial intermediaries serving individual investors are not made public due to

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[138] *See ARA Automotive Group v. Central Garage, Inc*., 124 F.3d 720,723 (C.A.5 (Tex.), 1997) ("The existence of a fiduciary relationship, outside of formal relationships that automatically give rise to fiduciary duties, is usually a fact intensive inquiry").

[139] However, merely because some degree of vulnerability exists does not necessarily give rise to a fiduciary relationship. *See New England Surfaces v. E.I. Du Pont De Nemours*, 517 F.Supp.2d 466, 488-9 (D. Me., 2007) ("In *Webber Oil Co. v. Murray*, Webber agreed to provide gasoline to the public through pumps owned by Webber at a convenience store owned by Murray … Murray staffed the pumps, collected the sales and paid the proceeds to Webber. Id Through the course of their relationship, Webber loaned money to Murray, and Murray and his wife signed promissory notes to Webber … the Law Court declined to find a fiduciary relationship in this situation. 'The evidence here showed no such relationship, but rather only a conventional business deal. Certainly one party was economically stronger than the other, but that is often the case in a business deal, and not the basis for a finding of a relationship of confidence.'" *Quoting Webber Oil Co. v. Murray*, 551 A.2d 1371(Me.1988).)

[140] Yet, superior knowledge or expertise, standing alone, has been held to be insufficient to impose fiduciary status on the one with the higher level of knowledge or expertise. *See Henneberry v. Sumitomo Corp. of America*, 532 F.Supp.2d 523, 550 (S.D.N.Y., 2007) ("a fiduciary obligation will not be imposed on one party 'merely because it possesses relative expertise as compared to the other' … 'Allegations of reliance on another party with superior expertise, standing by themselves, will not suffice'") (*citations omitted*).

[141] A fiduciary relationship "is a relationship founded upon trust or confidence reposed by one person in the integrity and fidelity of another … in which influence has been acquired and abused, in which confidence has been reposed and betrayed …." *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423, 458 (S.D.N.Y., 2006). "A fiduciary relationship may exist where one party reposes confidence in another and reasonably relies on the other's superior expertise or knowledge." *WIT Holding Corp. v. Klein*, 282 A.D.2d 527, 724 N.Y.S.2d 66, 68 (App.Div.2001). However, the mere exchange of confidential information does not give rise to a fiduciary relationship. *See U.S. v. Cassese*, 273 F.Supp.2d 481, 487 (S.D.N.Y., 2003) ("The present case is also similar to *Walton v. Morgan Stanley & Co. Inc*., 623 F.2d 796 (2d Cir.1980). In *Walton*, the Second Circuit held that when two corporations' management were 'at all times responsible for different interests, and … had no relationship to each other before or other than in the acquisition discussions,' they 'must be presumed to have dealt, absent evidence of an extraordinary relationship, at arm's length.' *Id*. at 798. The fact that information exchanged between the two parties is confidential does nothing to change their relationship from arms-length into a fiduciary relationship. *Id.* at 799.")

[142] *Hartman v. McInnis*, No. 2006-CA-00641-SCT (Miss. 11/29/2007) ("This Court considers a number of factors in determining whether a fiduciary relationship exists in a commercial transaction, including: whether (1) the parties have shared goals in each other's commercial activities, (2) one of the parties places justifiable confidence or trust in the other party's fidelity, and (3) the trusted party exercises effective control over the other party.")

[143] *See Pan Am Corp. v. Delta Air Lines, Inc*., 175 B.R. 438, 512 (Bankr. S.D.N.Y., 1994) ("[A] fiduciary relationship generally cannot be implied between parties to a commercial transaction when each party is represented by counsel and other professional advisors who have been retained to protect their best interests. *Grumman Allied Indus., Inc. v. Rohr Indus., Inc*., 748 F.2d 729, 739 (2d Cir.1984).")

the confines of mandatory arbitration, some cases do emerge. These cases indicate a variety of facts might give rise to a finding fiduciary status for a personal financial advisor, and in each case the court must undertake a fact-specific inquiry.[144] Actually providing financial advisory services to a non-sophisticated client is a key factor. However, nearly as important in some of the decisions is the use of titles, such as "financial planner," "financial advisor," "investment planner," "investment counselors," and "estate planner," which denote the existence of a relationship based upon trust and confidence.[145]

**Under the Common Law, No Contract is Required between the Parties which Expressly Sets Forth Fiduciary Status.** Courts have held that a fiduciary relationship under state common law need not be created by the express terms of a contract. It may arise out of any relationship where a special trust or confidence has been reposed by the client in the fiduciary. "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." While some communication between the parties may be required, there is no requirement for any written contract between the parties in order for a fiduciary relationship to be found to exist.

**State Common Law Informs Federal Law, in the Application of the Fiduciary Standard Upon Investment Advisers.** While the Advisers Act is not bound by state common law, the Federal Courts routinely look to state common law to "inform" the Federal law.[146] 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."[147]

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[144] In determining whether a fiduciary relationship exists, a court will "conduct a fact-specific inquiry into whether a party reposed confidence in another and reasonably relied on the other's superior expertise or knowledge." *Lumbermens Mut. Cas. Co. v. Franey Muha Alliant Ins. Servs*., 388 F.Supp.2d 292, 305 (S.D.N.Y.2005).

[145] For a discussion of various cases in which state common law fiduciary duties were found to exist for brokers, insurance agents, and financial planners when a relationship of trust and confidence was found to exist, *see* Rhoades, Ron A., "State Common Law Applying Fiduciary Duties Upon Financial Advisors" (Aug. 15, 2008), available at
http://www.fiduciarynow.com/2050StateCommonLawApplyingFiduciaryDutiesUponFinancialAdvisors08152008.pdf.

[146] 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. For an example in a related context, "[i]ssues of relinquishment of rights and waiver are governed by federal common law developed in ERISA cases rather than by particular state law although state law may inform the development of the federal common law." *Rodriguez-Abreu v. Chase Manhattan Bank*, 986 F.2d 580 at 587.

[147] *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180 (1963). The Investment Advisers Act of 1940 was not altogether new in its approach to the duties imposed on investment advisers. As stated by the U.S. Supreme Court in its 1963 decision, there was "growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that accordingly, the doctrines must be adapted to the merchandise in issue." *SEC v. Capital Gains Research Bureau*, 375 U.S., at 194, 84 S.Ct., at 284. "[The] 1909 New

As a general rule, the nature of an investment adviser's fiduciary duties is determined by reference to the common law principles applicable to fiduciaries.[148] In fact, the SEC very early on opined that registered investment advisers remain bound by the dictates of state common law.[149]

Even SIFMA has acknowledged import role common law plays in the application of the Advisers Act. SIFMA recently wrote that an investment adviser's fiduciary obligation to seek best execution for client trades has its roots in the "common law obligation imposed on an agent to act exclusively in its principal's best interests."[150]

It should be recognized that in a few instances the Advisers Act modifies common law rules. For example, Section 215 of the Advisers Act specifically prohibits a client from waiving the investment adviser's duties. In contrast, Section 206(3) expressly permits an investment adviser to engage in principal transactions with clients, but only upon satisfaction of the specific procedures set forth in the Advisers Act. Additionally, the Advisers Act requires disclosures to prospective clients; under the common law the duty of disclosure commences at the formation of the client relationship, although general principles of common law applicable to all forms of relationships would still prohibit certain acts of misrepresentation to prospective customers or clients.

**Investment Advisers Act's Imposition of Fiduciary Status, Generally.** Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") make it unlawful for an investment adviser to "employ any device, scheme, or artifice to defraud any client or prospective client"[151] or to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[152] In the landmark decision *SEC vs. Capital Gains Research Bureau*, the U.S. Supreme Court held that these provisions imposed broad fiduciary duties upon investment advisers. [153]

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York case of *Ridgely v. Keene*, 134 App. Div. 647, 119 N. Y. Supp. 451, illustrates the continuing development in the application of fiduciary duties under state common law. An investment adviser, who published an investment advisory service, agreed for compensation paid by a promoter of the security to influence his clients to buy shares in that certain security. The investment adviser did not disclose the agreement to his client. The court declared the act in question 'a palpable fraud.'" *SEC v. Capital Gains Research Bureau*, 375 U.S. ___.

[148] Frankel, The Regulation of Advisers – Mutual Funds and Investment Advisers at §14.01 (2002 Supp.). While the federal fiduciary standard imposed by the Advisors Act is informed by state common law, it is not necessarily identical to the fiduciary standards found in the common law of one or all of the states. "Federal courts applying a 'federal fiduciary principle' ... could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system." *Santa Fe Industries, Inc v. Green*, 430 U.S. 462, 479, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). However, as noted elsewhere in this comment letter, there is an amazing degree of uniformity in the judicial decisions when the fiduciary standard of conduct is applied upon investment advisers under state common law, as to the standard of conduct to be observed.

[149] *See* Investment Advisers Act Release No. 40 (Jan. 5, 1945) ("It is clear, however, that investment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship.").

[150] SIFMA, "Best Execution Guidelines for Fixed-Income Securities," White Paper, January 2008. Although the SEC often speaks of an investment adviser's duty to obtain best execution, this duty is not expressly stated in the federal securities laws. The SEC has asserted that a duty of best execution arises from an adviser's fiduciary duty obligation under common law to exercise reasonable care to obtain the most favorable terms for its clients. Many of the specific rules applicable to investment advisers are likewise derived from the investment adviser's broad duties of due care, loyalty, and utmost good faith.

[151] 15 U.S.C. § 80b-6(1).

[152] 15 U.S.C. § 80b-6(2).

[153] 375 U.S. 180, 194 (1963). In this landmark decision, the Investment Advisers Act of 1940 ("Advisers Act"), which does not utilize the term "fiduciary" at any time in its statutory text, was construed to apply broad fiduciary

**Discretion Is Not Required for an Advisor to Attain Fiduciary Status.** It has been an assumption by some commentators that the Advisers Act was intended to only regulate accounts for which discretion over the making of investment decisions and placement of trades was granted by the client. This is not the case, and confuses concepts arising from the law of agency with the adoption in the Advisers Act of fiduciary status arising from relationships built upon trust and confidence. As the U.S. Supreme Court noted in reviewing the legislative history of the Advisers Act: "The Report also analyzed the nature of services of investment-counsel firms to their clients: 'The powers of investment counsel firms with respect to the management of the funds of their investment company clients were either discretionary or advisory. Discretionary powers imply the vesting with an investment counsel firm control over the client's funds, with the power to make the ultimate determination with respect to the sale and purchase of securities for the client's portfolio. In contrast, vesting advisory powers with an investment counsel firm merely means that the firm may make recommendations to its client, with whom rests the ultimate power to accept or reject such recommendations.'"[154]

**Investment Advisers are "Professionals."** The domain of the investment counselor has previously been described as the "investment advisory profession."[155] Justice White went on to explain: "Clients trust in investment advisers, if not for the protection of life and liberty, at least for the safekeeping and accumulation of property. Bad investment advice may be a cover for stock-market manipulations designed to bilk the client for the benefit of the adviser; worse, it may lead to ruinous losses for the client. To protect investors, the [SEC] insists, it may require that investment advisers, like lawyers, evince the qualities of truth-speaking, honor, discretion, and fiduciary responsibility[156] … Douglas T. Johnston, Vice President of the Investment Counsel Association of America, stated in part: 'The definition of 'investment adviser' … include[s] those firms which operate on a *professional basis* and which have come to be recognized as investment counsel."[157]

**The "Best Interests" vs. The "Sole Interests" Standard.** The fiduciary standard of conduct is a <u>tough standard</u> that should not be diminished merely to accommodate someone's business model. However, it is the "best interests" standard of conduct, not the (higher) "sole interests" standard found in trust law and in some aspects of ERISA.

<u>*The "Best Interests" Standard, Generally.*</u> 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 "best interests" standard[158] found in the Investment Advisers Act of 1940, which is a codification of state common law.

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duties upon investment advisers. An "investment adviser" as defined under the Advisers Act is a fiduciary. *Capital Gains Research Bureau, Inc*., 375 U.S. at 191-92, 194, 201; *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). 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*." SEC v. DiBella*, Slip Copy, 2007 WL 2904211 (D.Conn. 2007) (*citing SEC v. Moran*, 922 F.Supp. 867, 895-96 (S.D.N.Y. 1996)); *see also Capital Gains Research Bureau, Inc*., 375 U.S. at 194.

[154] *Lowe v. SEC,* 472 U.S. 181 (1985), fn. 31.

[155] *Lowe v. SEC,* 472 U.S. 181, 229 (1985) (White, J., dissenting opinion).

[156] *Id*.

[157] *Lowe v. SEC,* 472 U.S. 181 (1985), fn. 38.

[158] 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

*The Advisors Act Does Not Impose a "Sole Interests" Standard*. In contrast to some aspects of ERISA, the Advisers Act does not impose a "sole interests" standard. Under a "sole interests" standard, any form of self-dealing is essentially prohibited.[159]

**3.b. Application of the state common law fiduciary standard of conduct under state common law is not preempted by the IAA, under the express provisions of NSMIA.**

"[I]nvestment advisers, *in addition to* complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship".[160] [*Emphasis added*.]

***Capital Research vs. Brown* (2007): Federal Securities Laws Do Not Pre-empt the States' Broad Anti-Fraud Authority.** Despite preemption of state authority on securities regulation in some areas by NSMIA, state regulatory authority with respect to regulation against fraudulent sales or advisory activities was retained. This was made clear by an early 2007 decision, *Capital Research and Management Company v. Brown*, wherein the court stated:

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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.') …."

[159] 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

[160] SEC Release IA-40 (Jan. 5, 1945).

> NSMIA's savings clause is sufficiently broad to permit the Attorney General of California to pursue injunctive relief and penalties against a covered security's investment advisor and wholesale broker-dealer who allegedly made inaccurate or inadequate representations to purchasers … The plain language of the savings clause and its legislative history persuade us that Congress intended to preserve the states' antifraud authority to control the conduct of brokers and dealers, notwithstanding that the exercise of such controls might prospectively influence the disclosures made by a covered security. … The Joint Conference Report of both houses offers a similar insight into the purpose of the savings clause. 'The [statute preserves] the authority of the states to protect investors through application of state antifraud laws. This preservation of authority is intended to permit state securities regulators to continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses, such as churning accounts or misleading customers.'[161]

The Federal Court went on to note the following:

> Our conclusion is supported by the clear statement of Congressional intent expressed at the time the savings clause was enacted. By way of example, a Senate Report explained that the statute preserved the states' authority to "continue their role in regulating broker-dealer conduct whether or not the offering is subject to state review. The [Senate] Committee believes that allowing the states to oversee broker-dealer conduct in connection with preempted offerings will ensure continued investor protection. As long as states continue to police fraud in these offerings, compliance at the federal level will adequately protect investors. In preserving this authority, however, the Committee expects the states only to police conduct — not to use this authority as justification to continue reviewing exempted registration statements or prospectuses. The Committee clearly does not intend for the `policing' authority to provide states with a means to undo the state registration preemptions … The Attorney General's enforcement action, which challenges broker-dealer conduct, cannot reasonably be construed as an effort to regulate a non-party issuer."

**There Is No Preemption Of State Common Law Breach Of Fiduciary Duty Claims By Securities Legislation.** Neither federal nor state securities laws generally preempt common law claims based upon breach of fiduciary duty.[162] This is because the securities statutes were modeled after the common law actions of fraud and deceit.[163] The fiduciary concept derives from trust and agency principles. Actions contrary to the duties of loyalty and care are remedied by giving the beneficiary of the relationship the right to recover for the fiduciary's breach.[164]

Accordingly, the Commission should be wary of any proposal which, through SEC rule-making, would result in a lesser standard of conduct than that found under state common law. Moving to a federal regime of lower standards would result in non-uniformity between federal law and state common law – precisely the problem advocates for a "new federal fiduciary standard" state they wish to avoid.

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[161] 53 Cal.Rptr.3d 770, 147 Cal.App.4th 58 (Cal. App., 2007). *See also People v. Edward D. Jones & Co*., 65 Cal.Rptr.3d 130, 154 Cal.App.4th 627 (Cal. App., 2007) ("Edward Jones's argument fails because the People's action is a type of action expressly permitted by the NSMIA. That which is expressly permitted cannot be implicitly prohibited." *Id.* at 138.

[162] However, some specific federal statutes, such as ERISA and SLUSA, do preempt state common law in specific situations.

[163] *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.

[164] See RESTATEMENT (2d) of Agency Secs. 387-398 (1957); Weinrib, The Fiduciary Obligation, 25 U. Toronto L.J. 1 (1975); Langevoort, Fraud and Deception by Securities Professionals, 61 ex.L.Rev. 2347, 2348 n. 9 (1983). *See Gochnauer v. A.G. Edwards & Sons, Inc*., 810 F.2d 1042 (C.A.11 (Fla.) (1987).

Moreover, the adoption of lower standards of conduct for fiduciary providers of investment advisory services at the federal level would lead some advisers into a false belief that certain conduct was therefore permissible under state common law, thereby increasing the prospect for potential liability for an unwitting breach of the state common law fiduciary standard. Again, those who promote a lower federal fiduciary standard of conduct argue that liability of the current standard is too great. In reality, the adoption of a lower federal fiduciary standard does not result in lesser liability, but only increases the likelihood that advisers will fail to adhere to the state common law standards, resulting in liability.

**3.c. No cause exists for diminution of the fiduciary standard of conduct. Justice Cardoza's words of warning should be heeded.**

> 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 market place. 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 . . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that troddened by the crowd. It will not consciously be lowered by any judgment of this court.[165]

As commentators have noted, "[t]he quotation above from Justice Benjamin Cardozo of the New York Court of Appeals has set the standard for fiduciary conduct since it was written many years ago. Although the quotation arose out of a question of trustee loyalty and is cited to hold fiduciaries to a standard requiring that the beneficiary's interest be placed first, it is an example of the high standards to which fiduciaries are held."[166] In contrast to the views expressed by Posner and Easterbrook[167] in certain writings taking the view that fiduciary duties are waivable default contract terms, "most state judges instead treat fiduciary duties as sacrosanct and recoil from any attempt to loosen them[168] … Although now nearly 80 years old, *Meinhard* embodies a reverence state judges routinely still share. According to a simple Lexis search, over the five years from 2001 to 2005 judges cited *Meinhard* 80 times, the majority of those in state courts."[169] Another search of the case law from January 2006 through July 2010 reveals another more than seventy citations of the *Meinhard* decision, confirming its relevance today.

[165] *Meinhard v. Salmon*, 164 N.E. 545–546 (1928).

[166] Char, Patricia, and Gespass, Andrew, "Emerging Issues for Fiduciaries," ALI-ABA Estate Planning Course Materials Journal (Oct. 2009), at p.22.

[167] *See* Easterbrook, Frank H. and Fischel, Daniel R. "The Economic Structure of Corporate Law" (Cambridge: Harvard University Press, 1991). In more recent writings, many academics now reject the contractual hypothesis, with Professor Arthur Laby noting that even the *Meinhard* decision itself (often cited as the source of the contractualists argument) "debunks the contractual thesis put forth in a leading article by Easterbrook and Fischel that perhaps the leading fiduciary duty case is a closet contractual decision." Laby, Arthur B., "The Fiduciary Obligation as the Adoption of Ends," 56 Buffalo L. Review 100, 118-9 (2008).

[168] Ramsey, J. Mark, "Not-so-ordinary Judges in Ordinary Courts: Teaching *Jordan vs. Duff & Phelps*," p.5, available at http://www.law.harvard.edu/faculty/ramseyer/wpnotordinary.pdf.

[169] *Id. at p.6*, adding: "Indeed, in another opinion arising out of the same Duff & Phelps sale, the Eleventh Circuit claimed it 'a violation of fiduciary principles to require employees to contract away their right to make a return on their investment."

**3.d. No valid reason exists to adopt a "new universal or uniform fiduciary standard" as some have proposed. It already exists!**

There already exists one fiduciary standard applicable to investment advisers.[170]

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).[171] There is surprising uniformity by the courts in describing the parameters of the fiduciary standard of conduct in the body of state common law which applies the fiduciary standard of conduct, and the state common law remains very closely aligned with the application of the fiduciary standard found in the Advisers Act.[172]

Given that there is one fiduciary standard, as applied to the activities of investment advisers, whether under federal law or state law, why is there any justification for a "new" federal fiduciary standard?

Indeed, looking through the arguments of broker-dealer and insurance company advocates, who promote the idea of a "new uniform federal fiduciary standard," it is clear that what is being suggested is not a fiduciary standard at all.

Will the SEC preserve the *bona fide* fiduciary standard of conduct found in the Advisers Act? Or will the Commission seek to somehow "consciously lower" the fiduciary standard of conduct, by adopting a "new universal fiduciary standard" as many broker-dealers and their organizations have proposed.

**3.e. The fiduciary standard is not, as some broker-dealers have suggested, "vague." We offer a summary of the fiduciary duties of due care, loyalty, and utmost good faith.**

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170 SEC Commissioner Luis Aguiliar, in a recent speech to the Investment Adviser Best Practices Summit, observed, "[T]here is only one fiduciary standard, and it means an affirmative obligation to act in the best interests of the client and to put a client's interests above one's own." *See also* comments of David Tittsworth, Executive Director of the Investment Adviser Association, ""We have a federal fiduciary standard. It's been in existence for 50 years and it's been consistently approved by the courts." Jessica Holzer and Fawn Johnson, "Brokers, Critics Spar Over 'Fiduciary Rule,'" *Wall Street Journal*, Aug. 18, 2010.

NAPFA does not assert that there is only one fiduciary standard under all forms of law. For example, ERISA adopts a "sole interests" fiduciary standard, similar to the one imposed upon trustees, albeit with statutory exceptions. The "best interests" fiduciary standard is imposed upon investment advisers, which, although not prohibiting conflicts of interest, require much in the way of ensuring the clients' best interests are preserved at all times, as will be subsequently addressed.

171 *See also* Professor Frankel's observation that "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).

172 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.").

At least one law firm (which commonly represents broker-dealer firms) has written that the "term fiduciary is too amorphous and too difficult to implement."[173] This begs the questions … how have investment advisers been successfully regulated under the fiduciary standard for seven decades? Would one also argue that attorneys' fiduciary duties are "too amorphous" and "too difficult to implement" that their fiduciary standard should be abandoned?

Despite the misleading assertion that "the broker-dealer regulatory regiment provides better protection to their customers, because the rules are clear and specific,"[174] it should be noted that the fiduciary standard of conduct is well-defined in the case law. It is admittedly a much more broad imposition of a set of principles directed at the delivery of investment advice. One reason broker-dealers possess so many specific rules is because they engage in so many diverse activities; in reality, the rules directed at their conduct in the market in the delivery of advice to retail consumers are minor in nature. Certainly a rule that imposes little protection for the retail investor, as is the case with "suitability," is easier to apply than a more robust standard like the fiduciary standard of conduct.

Despite arguments advanced by the broker-dealer community that "no one understands the fiduciary duty," there is a large body of case law which assists investment advisers in interpreting and applying the fiduciary standard. In the United States we frequently refer to a triad of broad fiduciary duties – due care, loyalty, and utmost good faith.

NAPFA offers a more detailed summary of this triad of broad fiduciary duties, based upon a review of the case law applicable to investment advisers and personal financial advisors:

> ***Summary Recitation of the Parameters of the Fiduciary Duty of Due Care*. An advisor shall act with due care. In connection therewith (and not by way of limitation):**
>
> **An advisor possesses a fiduciary duty to the client to exercise with good judgment, knowledge, and due diligence[175] as to the investment strategies, the investment products,[176]**

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[173] Morgan Clemons, "Harmonization vs. Demarcation: The Problems with a Broker Fiduciary Duty and the Benefits of the Merrill Rule," p.12.

[174] SEC has received "Comment Letter A," orchestrated by insurance firm and broker-dealer interests, which states in part: "In comparing the investment adviser and broker-dealer regulatory regimes, the broker-dealer regulatory regime provides better guidance to registered representatives and their supervisors, and therefore better protection to their customers, because the rules are clear and specific, and the conduct of registered representatives is capable of being monitored and audited. By contrast, the principles-based nature of the investment adviser regulatory regime is more difficult to follow and enforce."

[175] "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).

[176] 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

**and the matching of those strategies to meet the needs and objectives of the client,[177] and with that degree of care ordinarily possessed and exercised in similar situations by a competent professional properly practicing in his or her field.**

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

***Summary Recitation of the Parameters of the Fiduciary 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):**

**The advisor shall at all times place and maintain his or her or its client's best interests[178] first and paramount to those of the advisor; [179]**

**The advisor shall not, through either false statement nor through omission,[180] mislead his or her or its clients;**

**The advisor shall affirmatively provide full and fair disclosure of all material facts[181] to his or her or its client prior to a client's decision[182] on a recommended course of**

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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.").

[177] "[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).

[178] 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.

[179] "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).

[180] "[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).

[181] "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). Section 206(2) of the Advisers Act makes it unlawful for an adviser to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client. An adviser violates Section 206(2) if it makes material misstatements or omissions to clients. *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 200 (1963). If the misstatement or omission of a material fact is negligent, then Section 206(2) is violated; if the misstatement or omission is made with scienter, then Section 206(1) is violated. *Steadman v. SEC*, 603 F.2d 1126, 1134-1135 (5th Cir. 1979).

**action,[183] including but not limited to: (1) all fees and costs[184] 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.**

**The advisor is under an affirmative obligation to reasonably avoid conflicts of interest[185] 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[186] and**

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[182] "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).

[183] 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)).

[184] Disclosure of just the "disclosed fees" and costs of a pooled investment vehicle is inadequate, in the view of one NAPFA member, 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. Moreover, providing a Summary Prospectus or Prospectus does not necessarily mean that all material facts have been effectively and affirmatively communicated to the client. "[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).

[185] "[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.

[186] "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 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.

**shall ensure the intelligent, independent and informed consent[187] of his or her or its client is obtained with regard thereto. In any event, the proposed arrangement should be prudently managed in order that the client's best interests are preserved[188] and that the proposed arrangement is substantively fair to the client.**

[187] 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 …*

[*Emphasis added*.]

[188] *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.")

***Summary Recitation of the Parameters of the Fiduciary Duty of Utmost Good Faith.* An advisor shall act with utmost good faith[189] 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.**

Hence, and contrary to assertions by broker-dealers that investment advisers lack specific rules, there do exist numerous additional specific standards of conduct applicable to investment advisers. Moreover, the SEC has imposed numerous highly specific compliance requirements and has further set forth additional specific fiduciary duties of investment advisers.[190]

Despite the detailing of the fiduciary standard set forth above, and the specific SEC rules and rulings referenced in the paragraph above, the foregoing remains only a summary of the broad fiduciary duties imposed on investment advisers. However, this summary is already far more elaborate in defining the investment adviser's standard of conduct than those standards of conduct set forth in FINRA's manual for registered representatives when engaging in providing advice to individual investors. Indeed, one might argue, correctly, that FINRA's suitability standard is the far more vague standard of conduct – and a much lower standard.

Despite the presence of mandatory arbitration in many instances (which deters the formation of case law), both the suitability standard and the fiduciary standard have volumes of reported cases (including SEC administrative decisions) which interpret the standards. Any regulatory standard receives illumination through such decisions, together with ongoing commentary from industry organizations (including education on best practices). Hence, as the body of interpretative law builds over time – as it has under the Advisers Act for seven decades – any "vagueness" – if it even exists – becomes less so.

Of course, should the SEC accept the broker-dealer industry associations' incomprehensible assertion that a "new federal fiduciary standard" is required, then all of that body of case law could well disappear. Indeed, it appears that the broker-dealer and insurance companies are so unhappy with the existing constraints imposed upon their profit-making activities by the Advisers Act and state common law fiduciary standard, that instead they desire a much more vague "new federal fiduciary standard." Such a "new federal fiduciary standard" would be unencumbered by the past decisions which interpret the fiduciary standard, and would ignore the principles expressed by Justice Cardoza, and would result in no informing of federal law by state common law. This enactment of a lower standard of conduct is something which Congress chose not to pursue, and indeed would be contrary to expressed legislative intent.[191]

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[189] "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).

[190] *See* Plaze, Robert E., "The Regulation of Investment Advisers by The Securities and Exchange Commission" (2006), at pp. 13-30. Mr. Plaze, Asst. Director of the SEC's Division of Investment Management, further notes that "[t]he law governing SEC-registered advisers imposes five types of requirements on an adviser: (i) a fiduciary duty to clients; (ii) substantive prohibitions and requirements; (iii) contractual requirements; (iv) recordkeeping requirements; and (v) administrative oversight by the SEC, primarily by inspection." *Id.* at 13.

[191] Rep. Paul Kanjorski, Chair of the Capital Markets Subcommittee, emphasized that a chief reform in the area of investor protection is that the Dodd-Frank Act provides that the SEC, after it conducts a study, may issue new rules establishing that every financial intermediary who provides personalized investment advice to retail customers will have a fiduciary duty to the investor. According to Rep. Kanjorski, a traditional fiduciary duty includes an affirmative duty of care, loyalty and honesty; an affirmative duty to act in good faith; and a duty to act in the best interests of the client. Through this harmonized standard of care, both broker and investment advisers will place customers' interests first. Rep. Kanjorski noted that regulators, practitioners, and investor advocates have become increasingly concerned that investors are confused by the legal distinction between

**<u>3.f. The fiduciary standard is a principles-based standard. While specific rules have been and may be adopted under same, the fiduciary standard must be free to adapt so as to address new forms of improper conduct that seek to get around specific rules.</u>**

By its terms, the Advisers Act sets out few specific prohibitions on conduct, relying instead on broad proscriptions, including the imposition of the fiduciary standard of conduct, to curtail fraudulent conduct by investment advisers.[192] One of the arguments for the proposition that the fiduciary standard is "vague" is that it is capable of evolution. Yet the proponents of such argument appear to fail to understand that fraud is infinite, and the fiduciary standard of conduct must be free to combat fraud.

The fiduciary standard must be permitted to evolve. While the fiduciary standard of conduct for investment advisers and personal financial planners is generally uniform, it must be noted that fiduciary duties are not static; rather, they must evolve over time to meet the ever-changing business practices of investment advisers and to ensure that fraudulent conduct is successfully circumscribed.

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. This was recognized early on, in 1945, at the Commission:

> 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.[193] [*Emphasis added*.]

**<u>3.g. The fiduciary standard calls for more than just "disclosure" when a conflict of interest is present. Avoidance of the conflict is often required. In other situations, the unavoided conflict must be affirmatively disclosed in a manner ensuring client understanding and informed consent, and even then the proposed transaction must be fair to the client.</u>**

> *The temptation of self interest is too powerful and insinuating to be trusted. Man cannot serve two masters; he will forsake the one and cleave to the other. Between two conflicting interests,*

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broker-dealers and investment advisers. The two professions currently owe investors different standards of care, even though their services and marketing have become increasingly indistinguishable to retail investors. The issuance of new rules will fix this long-standing problem, in his view. Cong. Record, June 30, 2010, p. H5237.

[192] SEC Staff has recognized this fact. For example, in 2008 the Director of the SEC's Division of Investment Management noted: "When enacting the Investment Advisers Act of 1940, Congress recognized the diversity of advisory relationships and through a principles-based statute provided them great flexibility, with the overriding obligation of fiduciary responsibility." Andrew J. Donohue, Director, Division of Investment Management, Securities & Exchange Commission, Keynote Address at the 9th Annual International Conference on Private Investment Funds (Mar. 10, 2008).

[193] Cashion, Edward, H., Speech, Counsel to the Corporation Finance Division, U.S. Securities and Exchange Commission, "Diversiform Dishonesty", given on November 17, 1945 to the National Association of Securities Commissioners (NASD), in reference to Section 36 of the Investment Company Act of 1940, which also applies a fiduciary standard of conduct.

*it is easy to foresee, and all experience has shown, whose interests will be neglected and sacrificed. The temptation to neglect the interest of those thus confided must be removed by taking away the right to hold, however fair the purchase, or full the consideration paid; for it would be impossible, in many cases, to ferret out the secret knowledge of facts and advantages of the purchaser, known to the trustee or others acting in the like character. The best and only safe antidote is in the extraction of the sting; by denying the right to hold, the temptation and power to do wrong is destroyed.*

- *Thorp v. McCullum*, 1 Gilman (6 Ill.) 614, 626 (1844)[194]

Fundamentally, opponents of the current fiduciary standard refuse to accept the proposition that the fiduciary standard requires much more than just disclosure of a conflict of interest. It requires forsaking the serving of two masters – a fundamental core of fiduciary law known for over two centuries. It requires accepting restrictions upon one's conduct, which restrictions largely do not exist in arms-length relationships. Yet, increasingly, advocates of a "new uniform federal fiduciary standard" appear to advocate only for "enhanced disclosures"[195] – as a means of fulfilling the fiduciary obligation – or as a substitution therefore. These arguments ignore the reality that the fiduciary obligation imposes far more requirements than mere disclosure of a conflict of interest, as well as leading academic research demonstrating what broker-dealer firms and insurance companies already know – disclosures are ineffective, as consumers don't read them and/or don't understand them, for a variety of reasons.

**The Duty of Loyalty: The General Requirement of Disclosure of All Material Facts.** The core duty of a fiduciary is found in the requirement of loyalty to the client. One 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."

*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.[196]

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[194] This early opinion from the Illinois Supreme Court has been "oft-quoted." Langbein, John H., "Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?" 114 Yale Law Journal 929, 934 (2005). While Professor Langbein acknowledges that "[a]ny conflict of interest … that is, any opportunity for the trustee to benefit personally from the trust, is potentially harmful to the beneficiary"(*Id.*), he notes that the "sole interest rule" under trust law has been mitigated by various exclusions (settler authorization, beneficiary consent, and advance judicial approval) (*Id.* at 963).

[195] "Comment Letter A" to the SEC provides in pertinent part: "Existing FINRA and Commission rules are extensive, but those rules, if necessary, could be supplemented with additional disclosures of the role in which a financial services professional is operating, including additional disclosures of the existence of any conflicts. I believe investors, if presented with appropriate information, can make a choice that is right for them."

[196] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963), holding that "the Investment Advisers Act of 1940 empowers the courts, upon a showing such as that made here, to require an adviser to make full and frank disclosure of his practice of trading on the effect of his recommendations," and quoting De Funiak, Handbook of Modern Equity (2d ed. 1956), 235, for the proposition that: "Fraud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element" and quoting *Moore v. Crawford*, 130 U.S. 122, 128 (in turn quoting 1 Story, Equity Jur. § 187) for the proposition that: "Fraud indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another." *See also Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 17 (1979).

Engaging in transactions with clients without making required disclosures of material facts is one possible violation of Section 206 of the Advisers Act.[197]

*The Common Law Requirement to Disclose Material Facts by Fiduciaries.* Where fiduciary duties arise out of the common law, there also exists a duty to disclose all material facts. "[T]he duty of full disclosure was imposed as a matter of general common law long before the passage of the Securities Exchange Act."[198]

*What is a Material Fact?* "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."[199] A material fact is "anything which might affect the (client's) decision whether or how to act."[200] 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.'[201]

*Disclosures of Material Facts 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."*[202]

*Disclosure of All Material Facts Must Be Affirmatively Made.* Additionally, the duty to disclose is an affirmative one,[203] and the failure to disclose by an investment adviser is a violation of the Advisers

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197 Section 206(1) and 206(2) impose an obligation on investment advisers to fully and fairly disclose all material information to the clients. A violation of Section 206 may be based on an affirmative misstatement or the failure to disclose material facts. *See Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 16 (1979), stating: "§206 … broadly proscribes fraudulent practices by investment advisers, making it unlawful for any investment adviser 'to employ any device, scheme, or artifice to defraud . . . [or] to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client,' or to engage in specified transactions with clients without making required disclosures."

198 *In the Matter of Arleen W. Hughes*, SEC Release No. 4048 (February 18, 1948).

199 *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

200 *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 227 Va. 441 (Va., 1984). A fact is considered material if there is a substantial likelihood that a reasonable investor would consider the information to be important in making an investment decision. *TSC Industries, Inc. v. Northway, Inc*., 426 U.S. 438, 449 (1976); Basic, Inc. v. Levinson, 485 U.S. 224, 233 (1988).

201 *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)).

202 *In the Matter of Arleeen W. Hughes,* SEC Release No. 4048 (February 17, 1948), *affirmed* 174 F.2d 969 (D.C. Cir. 1949).

203 *In the Matter of Arleen W. Hughes, supra* n.___; *see also In the Matter of Robert Radano*, SEC Rel. No. IA-2750 (June 30, 2008) ("an investment adviser has an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts …"). *See also Michael Batterman*, 57 S.E.C. 1031, 1043 (2004) (noting investment adviser's "affirmative duty" to disclose material facts and "affirmative obligation" to exercise reasonable care to avoid misleading clients*), aff'd*, No. 05-0404 (2d Cir. 2005) (unpublished).

Act.[204] 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[205] would not likely qualify as an appropriate disclosure by a fiduciary advisory 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.[206]

**The Fiduciary's Duty to Disclose Conflicts of Interest.** The Advisers Act and state common law applying fiduciary duties upon investment advisers require much more of those in fiduciary relationships with their clients than mere disclosure. 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.

<u>*Conflicts of Interest Are Always Material Facts.*</u> Due to the risks posed by a conflict of interest,[207] the presence of a conflict of interest is always a material fact[208] which must be disclosed in fiduciary relationships[209] by the fiduciary.

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[204] "Section 206 … 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, *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180 (1963) at 191-92, 194, and it is also more likely to fulfill Congress's general policy of promoting "full disclosure" in the securities industry, *id*. at 186." *SEC v. Washington Investment Network,* 435 F.3d 392, 404 (D.C. Cir. 2007).

[205] *See* SEC Release No. 33-8998, "Enhanced Disclosure And New Prospectus Delivery Option For Registered Open-End Management Investment Companies," (Jan. 13, 2009) ("The Commission is also adopting rule amendments that permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site.")

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

[207] Consider a "contract between an investor and a financial service provider whereby the provider, who is the investor's agent, may not fulfill his or her obligations. This is commonly known as agency risk. Agency risk may result either from self-interested or opportunistic behavior by an agent or from the inability of an agent to serve all customers or clients (the principals) equally well … Conflict of interest rules can thus be understood as rules that reduce the agency risk to investors from financial service providers in their roles as agents and fiduciaries. This risk may result either from opportunistic, self-interested behavior or from having one's interests subordinated to those of others." Boatright, John R., "Conflict of Interest in Financial Services: A Contractual Risk-Management Analysis."

[208] The existence of a conflict of interest is a material fact that an investment adviser must disclose to its clients because it "might incline an investment adviser -- consciously or unconsciously -- to render advice that was not disinterested." *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. at 191-192.

[209] "Traditionally, the law only intervenes in situations in which one party owes the other party a specific duty of loyalty; something more than the ordinary duty to act in good faith in business. In such circumstances, the first party must protect and promote the interests of the other party. In other words, the first party is in a delicate situation, being in charge of two conflicting interests." Bahar, Rashid and Thévenoz, Luc, "Conflicts of Interest: Disclosure, Incentives, and the Market." *Conflicts Of Interest: Corporate Governance & Financial Markets*, Luc Thévenoz and Rashid Bahar, eds., Kluwer Law International and Schulthess, 2007, at p. 2. Available at SSRN: <u>http://ssrn.com/abstract=964778</u>.

*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."[210]

*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.

*The Compensation of the Investment Adviser 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."[211]

At the inception of the fiduciary relationship, the investment adviser 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.

> *Full Disclosure" of the Ramifications of the Conflict of Interest is also Required.* The fiduciary duty of disclosure extends not just to the *existence* of a conflict, nor as to 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 a client by a fiduciary, 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."[212]

**The Purpose of Disclosure when a Conflict of Interest is Present (Part One): Obtaining Client Understanding.** One 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.[213] In the context

[210] Antonio Argandoña, "Conflicts of Interest: The Ethical Viewpoint" (2004).

[211] Bahar, Rashid and Thévenoz, Luc, "Conflicts of Interest: Disclosure, Incentives, and the Market," *Conflicts Of Interest: Corporate Governance & Financial Markets*, Luc Thévenoz and Rashid Bahar, eds., Kluwer Law International and Schulthess, 2007, at p.2.

[212] SEC Release No. 4048, *In the Matter of Arleen W. Hughes* (Feb. 18, 1948), *citing* 2 Restatement of Agency, Section 390, comment a. *See also Arst v. Stifel, Nicolaus & Co*., 86 F.3d 973, 979 (10th Cir.1996) (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.") (applying Kansas law) (quoting Restatement (Second) of Agency § 390 cmt. a (1958)). *Cited* approvingly in *Geman v. S.E.C.*, 334 F.3rd 1183, 1189 (10th Cir., 2003)

[213] *See, e.g., In re Kingsley, Jennison, McNulty & Morse, Inc*., 50 S.E.C. Docket 310, 1991 WL 288369, at 11 (S.E.C. Nov. 14, 1991) (censuring investment adviser and its principal for failing to disclose to clients its

'soft dollar' commission arrangement with brokerage firm and stating that 'whenever trading by an investment advisor raises the possibility of a potential conflict with the interests of his advisory clients, the investment adviser has an affirmative obligation before engaging in such activities to obtain the informed consent of his 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 full understanding, followed by the client's informed consent to proceeding with a recommendation or transaction.[214]

*Disclosure Must Be Sufficient to Obtain Client "Understanding."* As stated in an early decision by the U.S. Securities and Exchange commission:

> [We] may point out that no hard and fast rule can be set down as to an appropriate method for registrant to disclose the fact that she proposes to deal on her own account. The method and extent of disclosure depends upon the particular client involved. The investor who is not familiar with the practices of the securities business requires a more extensive explanation than the informed investor. The explanation must be such, however, that *the particular client is clearly advised and understands* before the completion of each transaction that registrant proposes to sell her own securities. [*Emphasis added.*][215]

*The Burden is on Adviser to Ensure "Client Understanding" of the Conflict of Interest and its Ramifications.* 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 by Louis Loss in 1948, the fiduciary duties arising under the Advisers Act, as applied in the *Arleen Hughes* release, were elaborated upon, revealing insight into the importance of disclosure, its affirmative nature, and the burden of the investment adviser to ensure client understanding:

> 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.'

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clients on the basis of full and fair disclosure of all material facts' (*quoting In re Kidder, Peabody & Co., et al.*, 43 S.E.C. 911, 916 (1968)).

[214] *See, e.g.,* "Information for Newly-Registered Investment Advisers," prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations "As a fiduciary, you are required to act in the best interests of your advisory clients, and to seek to obtain the best price and execution for their securities transactions … whenever trading may create a conflicting interest between you and your clients, you have an obligation, before engaging in the activity, to obtain the informed consent from your clients after providing full and fair disclosure of all material facts."

[215] *Id.*

> *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, <u>the burden is on the firm which acts as fiduciary to make certain that the client understands</u> that the firm is selling its own securities …*[216]

<u>*Disclosures of Conflicts of Interest Must "Lay Bare the Truth … in All Its Stark Significance*."</u> 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 …."[217] The extent of the disclosure required is made clear by cases applying the fiduciary standard of conduct in related advisory contexts. "The fact that the client knows of a conflict is not enough to satisfy the attorney's duty of full disclosure.[218] "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 interest in such detail so that they can understand the reasons why it may be desirable for each to [withhold consent].")[219] A client of a fiduciary is not responsible for recognizing the conflict and stating his or her lack of consent in order to avoid waiver.[220] Rather, "[t]he 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."[221]

**The Purpose of Disclosure when a Conflict of Interest is Present (Part Two): Obtaining Client's Informed Consent.**

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[216] "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.

[217] *Wendt v. Fischer*, 243 N.Y. 439, 154 N.E. 303 (1926).

[218] *In re Src Holding Corp*., 364 B.R. 1 (D. Minn., 2007).

[219] *Florida Ins. Guar. Ass'n Inc. v. Carey Canada, Inc*., 749 F.Supp. 255, 259 (S.D.Fla.1990) (*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.").

[220] *Manoir-Electroalloys*, 711 F.Supp. at 195.

[221] *In re Src Holding Corp.*, 364 B.R. 1, 48 (D. Minn., 2007)

*The Consent of the Client 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."[222] [*Emphasis added*.]

*Close Scrutiny Occurs to Ensure the Informed Consent is Valid.* "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.[223]

**Even with Informed Consent, the Proposed Transaction Must Be Fair and Reasonable to the Client.** As stated by one court:

> 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. [Emphasis added.][224]

It is important to emphasize that while a critical and important aspect of compliance with the fiduciary duty of loyalty is adequate disclosure of a conflict of interest, disclosure remains but one of the elements of compliance with the investment adviser's fiduciary duty. As stated in the *Rocky Mountain Financial Planning* SEC No-Action Letter:

> We do not agree that an investment adviser may have interests in a transaction and that his fiduciary obligation toward his client is discharged so long as the adviser makes complete disclosure of the nature and extent of his interest. While section 206(3) of the [Advisers Act] requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, **the adviser's fiduciary duties are not discharged merely by such disclosure and consent**.[225] [**Emphasis added.**]

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

[223] *Birnbaum v. Birnbaum*, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986) (Where estate assets were transferred to a co-executor, the court, applying state common law principles, stated: "(A)ny acquisition of the shares of the beneficiaries by one of the fiduciaries must be dealt with as presumptively void unless affirmative proof is made by the fiduciary that their dealing with each beneficiary was in every instance above board and fully informative. The fiduciaries in such circumstances have the obligation to show affirmatively not only that they acted in good faith but that they volunteered to the beneficiaries every bit of information which personal inquiry by the beneficiaries would have disclosed." *Id.* at 456.

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

[225] *Rocky Mountain Financial Planning, Inc*. (pub. avail. March 28,1983).

Moreover, disclosure does not meet the investment adviser's duty of fair dealing, in general, and the duty to render disinterested advice, in particular.[226]

**Clients Who Truly Understand the Conflict and Its Ramifications Do Not Provide Informed Consent to Actions Which Are Not the Best for the Client.** NAPFA submits that the *informed consent* of the client to proceeding 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[227] 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.[228] Moreover, the presence of significant conflicts of interest, either in quality or number, may impair the relationship between the fiduciary and the client, and disclosures do not provide full relief from this impairment.[229]

**The Existence of Multiple Conflicts, by Reason of Affiliated Business Units, Does Not Negate or Excuse the Fiduciary Duties of the Provider of Investment Advice.** The diverse activities of multi-faceted financial services firms, which often create more conflicts of interest, do not justify any limitation

[226] "[A]n investment adviser has a fiduciary relationship with its clients that requires fair dealing, in general, and disinterested advice, in particular. This requires at a minimum that the investment adviser have a reasonable belief that a transaction recommended by the adviser is in the client i s interest. See, for example, subparagraph (c) of Rule 206 (3) -2 (the agency cross transaction rule), which provides that the rule shall not be construed as relieving the obligation of an adviser to act in the best interests of the client, including the duty to obtain best price and execution. Section 206 of the Advisers Act requires that the fee arrangement described in your letter be disclosed to the client to enable him to evaluate the investment adviser's motivation in giving the advice. *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963); *Arleen W. Huqhes,* 27 SEC 629 (1948); *Robert Cashmore Associates*(pub. avail. Sept. 28, 1983); *Rocky Mountain Financial Planning, Inc*. (pub. avail. March 28,1983)." SEC Division of Investment Management No-Action Letter, United Missouri Bank of Kansas City (Jan. 23, 1995).

[227] If a client did undertake a gratuitous transfer, this in itself may run afoul of Codes of Ethics adopted by the investment adviser or financial planner or his or her firm. While there is no requirement under the Advisers Act regulations to possess a gift policy, in a letter from the Investment Adviser Association (IAA), the IAA noted an instance wherein SEC staff expressly stated that an investment adviser should possess a gifts policy, including a gifts threshold. Letter from Karen L. Barr, General Counsel of IAA, to Lori Richards, Director, OCIE at n. 10 (Mar. 29, 2006).

[228] 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).

[229] "Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are honestly disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse." Cain, Daylian M., Loewenstein, George, and Moore, Don A., "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest"(2003).

on the principle of full, affirmative disclosures, client understanding, and informed consent.[230] As observed by Professor Tuch:

> When an investment bank performs one of its traditional functions – underwriting securities offerings or providing financial advisory services to clients involved in mergers, acquisitions and other strategic transactions – it may under general law be a fiduciary of its client and thereby be required to avoid positions of conflict without its client's informed consent. Yet the conglomerate structure of the firm may make conflicts of interest an inescapable feature of its doing business.[231]

Importantly, Professor Tuch further notes that:

> The standard of conduct required of the fiduciary is not diminished by reason of its organizational structure.[232]

Fortunately, Congress appears to have directed the SEC to ensure that large multi-faceted financial services companies not be granted special favor. New Section 211(g) of the Advisers Act authorizes the SEC to issue rules imposing a fiduciary standard on broker-dealers, but it limits that authority in two important respects. First, to the extent the SEC promulgates a rule under Section 211(g), the rule must impose a standard of care on broker dealers that is at be "no less stringent" as the standard applicable to investment advisers under Sections 206(1) and (2) of the Advisers Act. Additionally, in confirmation of the Advisers Act fiduciary duty requirements under the fiduciary duty of loyalty, any such rule must require that broker-dealers operate in the best interest of their customers and disclose any material conflicts and obtain consent thereto from the customer.

**A Fundamental Misinterpretation of *SEC vs. Capital Gains* by Some Proponents of "Disclosure Is All That Is Required."**

Despite all of the case law and prior SEC decisions which specify the parameters of an investment adviser's fiduciary duty, some broker-dealer legal counsel, perhaps by way of "wishful thinking," believe that *SEC vs. Capital Gains* provides a "roadmap" for adherence to the fiduciary standard of conduct, when a conflict of interest is present – and all that this roadmap requires is disclosure.[233] Indeed, 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.

As noted in the U.S. Supreme Court's seminal 1963 decision, "nondisclosure" is "one variety of fraud or deceit." *SEC v. Capital Gains Research Bureau Capital Gains Research Bureau, Inc*., 375 U.S. at 181-

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[230] "The classic formulation of fiduciary obligations requires the fiduciary to avoid conflicts of interest without a client's fully informed consent and not to obtain any unauthorised profit from the fiduciary relationship." Tuch, Andrew, "The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife with Conflicts of Interest" (January 2008) (Australia), *citing Breen v. Williams* (1996) 186 C.L.R. 71, at 113 (Gaudron and McHugh JJ.), 137-138 (Gummow J.).

[231] *Id.* at p.41.

[232] *Id.* at p.30, discussing *Commonwealth Bank of Australia v. Smith* (1991) 42 F.C.R. 390 at 392, and *Aequitas Ltd. v. Sparad No. 100 Ltd*, (2001) 19 A.C.L.C. 1006, at 1065.

[233] It appears that the SEC may have erroneously adopted this view, ignoring its own precedent and establish principles of fiduciary law. In SEC Rel. No. IA-2711, the SEC stated: "the U.S. federal securities laws do not … preclude advisers from having substantial conflicts of interest that might adversely affect the objectivity of the advice they provide. Rather, investors have the responsibility, based on disclosure they receive, for selecting their own advisers, negotiating their own fee arrangements, and evaluating their advisers' conflicts." SEC Release No. IA-2711 at p. 4.

82. However, it is not the only form of constructive fraud which may arise under the broad fiduciary standard of conduct. And disclosure, alone, does not meet the investment adviser's legal requirements in adhering to his, her or its fiduciary duties, as evidenced by the clear authority discussed above.

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:

(1) The "No Conflict" Rule: A fiduciary must not place itself in a position where its own interests conflict with those of its client.
(2) 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.[234]
(3) 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.

These separate rules are alive and well in the United States. A closer examination of the U.S. Supreme Court's 1963 decision, and of the structure of the Advisers Act, lead to the following conclusions.

**What SEC v. Capital Gains Really Stands For: The "No-Profit" and "No-Conflict" Rules Remain Imbedded In the Advisers Act.** In the seminal 1963 decision of *SEC v. Capital Gains Research Bureau*, the U.S. Supreme Court stated:

> An adviser who, like respondents, secretly trades on the market effect of his own recommendation may be motivated – consciously or unconsciously – to recommend a given security not because of its potential for long-run price increase (which would profit the client), but because of its potential for short-run price increase in response to anticipated activity from the recommendation (which would profit the adviser). (Citation omitted.) *An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure,* in deciding whether an adviser is serving 'two masters" or only one, 'especially . . . if one of the masters happens to be economic self-interest.'[235] [*Emphasis added.*]

This section of the opinion may appear to suggest that, with disclosure of a conflict of interest, all that is required is that the client of the adviser be given the option of proceeding with the advisor's counsel. However, at a footnote to this section of the opinion, the U.S. Supreme Court went further, explaining the "no conflict" rule and providing alternative rationales behind the prohibition on serving two masters:

> This Court, in discussing conflicts of interest, has said: '*The reason of the rule inhibiting a party who occupies confidential and fiduciary relations toward another from assuming antagonistic positions to his principal in matters involving the subject matter of the trust is sometimes said to rest in a sound public policy, but it also is justified in a recognition of the authoritative*

[234] 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.

[235] 375 U.S. 180, ___, *citing United States v. Mississippi Valley Co*., 364 U.S. 520, 549.

> *declaration that no man can serve two masters*; and considering that human nature must be dealt with, *the rule does not stop with actual violations of such trust relations, but includes within its purpose the removal of any temptation to violate them* .... In *Hazelton v. Sheckells*, 202 U.S. 71, 79, we said: 'The objection . . . rests in their tendency, not in what was done in the particular case … The court will not inquire what was done. If that should be improper it probably would be hidden and would not appear.'[236] [*Emphasis added*.]

Moreover, the U.S. Supreme Court in the *Capital Gains* decision only held that the fiduciary investment adviser had an affirmative obligation to "to make full and frank disclosure of his practice of trading on the effect of his recommendations."[237] Why did the U.S. Supreme Court not go further, and hold that the Advisers Act prohibited the very existence of such a conflict of interest? The answer lies in the decision itself:

> It is arguable – indeed it was argued by 'some investment counsel representatives' who testified before the Commission -- that any 'trading by investment counselors for their own account in securities in which their clients were interested ….' creates a potential conflict of interest which must be eliminated. <u>*We need not go that far in this case*</u>, *since here the Commission seeks only disclosure of a conflict of interests with significantly greater potential for abuse than in the situation described above*.[238] [<u>*Emphasis added*</u>.]

In other words, it was not necessary to the U.S. Supreme Court decision that it find that the Advisers Act outlaws significant conflicts of interest between investment advisers and their clients. Yet in the decision, the Supreme Court went to great lengths to recite legislative history, especially portions which discussed prohibitions on conflicts of interest as applied to investment advisers:

> Although certain changes were made in the bill following the hearings, there is nothing to indicate an intent to alter the fundamental purposes of the legislation. *The broad proscription against 'any ... practice … which operates … as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end.* And *the Committee Reports indicate a desire to preserve 'the personalized character of the services of investment advisers,' and 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 Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as 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. [*Emphasis added*.]

Hence, since the U.S. Supreme Court was not called upon to decide if conflicts of interest should be avoided by investment advisers, this does not lead to the conclusion that that the "no conflict" and "no profit" rules do not remain imbedded within the Advisers Act. Nor can it be concluded from the decision, as some interpreters may have done, that all that is required when a conflict of interest exists is that disclosure of material facts to the client occur, followed by the client's consent to proceed with the recommendation or transaction despite the presence of the conflicts of interest.

Some key aspects of the legislative history underlying the Advisers Act were further summarized by the U.S. Supreme Court's landmark 1963 decision, *SEC v. Capital Gains Research Bureau*, and this additional legislative history bolsters the conclusion that the "no-profit" and "no-conflict" rules are firmly embedded within the Advisers Act. The U.S. Supreme Court, in fact, expressly states the Congressional intent to *eliminate* conflicts of interest in the investment advisory profession:

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[236] *Id.* at p.___, fn. 50, *citing United States v. Mississippi Valley Co*., 364 U.S. 520, 550, n. 14.

[237] *Id.* at p.___.

[238] *Id.* at p.___.

The Public Utility Holding Company Act of 1935 'authorized and directed' the Securities and Exchange Commission 'to make a study of the functions and activities of investment trusts and investment companies ….' Pursuant to this mandate, the Commission made an exhaustive study and report which included consideration of investment counsel and investment advisory services. This aspect of the study and report culminated in the Investment Advisers Act of 1940.

The report reflects the attitude - shared by investment advisers and the Commission - 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*.' The report stressed that affiliations by investment advisers with investment bankers, or corporations might be 'an impediment to a disinterested, objective, or critical attitude toward an investment by clients …'

*This concern was not limited to deliberate or conscious impediments to objectivity*. Both the advisers and the Commission were well aware that whenever advice to a client might result in financial benefit to the adviser – other than the fee for his advice – 'that advice to a client might in some way be tinged with that pecuniary interest [whether consciously or] subconsciously motivated ….' The report quoted one leading investment adviser who said that he 'would put the emphasis . . . on subconscious" motivation in such situations. It *quoted a member of the Commission staff who suggested that a significant part of the problem was not the existence of a 'deliberate intent' to obtain a financial advantage, but rather the existence 'subconsciously [of] a prejudice' in favor of one's own financial interests*. The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations, which contained the following canon:

> '[An investment adviser] should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, *conscious* or *unconscious*; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect.' [*Emphasis added* in Supreme Court's own decision.]

Other canons appended to the report announced the following guiding principles: that *compensation for investment advice 'should consist exclusively of direct charges to clients for services rendered*"; that the adviser should devote his time 'exclusively to the performance' of his advisory function; that *he should not 'share in profits' of his clients*; and that *he should not 'directly or indirectly engage in any activity which may jeopardize [his] ability to render unbiased investment advice.'* These canons were adopted 'to the end that the quality of services to be rendered by investment counselors may measure up to the high standards which the public has a right to expect and to demand.'

This study and report -- authorized and directed by statute – culminated in the preparation and introduction by Senator Wagner of the bill which, with some changes, became the Investment Advisers Act of 1940. In its 'declaration of policy' the original bill stated that 'Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission … it is hereby declared that the national public interest and the interest of investors are adversely affected - … (4) when the business of investment advisers is so conducted as to defraud or mislead investors, or *to enable such advisers to relieve themselves of their fiduciary obligations to their clients.* 'It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are *to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section*.' S. 3580, 76th Cong., 3d Sess., § 202.

Hearings were then held before Committees of both Houses of Congress. In describing their profession, leading investment advisers emphasized their relationship of 'trust and confidence' with their clients and the importance of "strict limitation of [their right] to buy and sell securities in the normal way if there is any chance at all that to do so might seem to operate against the interests of clients and the public.' The president of the Investment Counsel Association of America, the leading investment counsel association, testified that the 'two fundamental principles upon which the pioneers in this new profession undertook to meet the growing need for unbiased investment information and guidance were, first, that they would *limit* their efforts and activities to the study of investment problems from the investor's standpoint, *not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their investment judgment*; and, second, that their remuneration for this work would consist *solely* of definite, professional fees fully disclosed in advance.'[239]

> Although certain changes were made in the bill following the hearings, there is nothing to indicate an intent to alter the fundamental *purposes* of the legislation. The broad prescription against 'any … practice … which operates … as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end. And the Committee reports indicated a desire to preserve 'the personalized character of the services of investment advisers' and 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 Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as 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.* [Citations omitted.] [*Emphasis added*.][240]

As seen in the text above, the U.S. Supreme Court's recitation of the legislative history of the Advisers Act references aspects of both the "no conflict" and "no profit" rule, and appears to indicate that the scope of an investment adviser's activities should be limited so as to avoid conflicts of interest and the derivation of profits (except as to profits derived from compensation paid directly by the client).

And, while some commentators have advanced the argument that the Advisers Act's purpose was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*," a closer reading of the decision reveals that this purpose was set forth as a *"common"* purpose of the federal securities acts enacted in the 1930's and in 1940. This does not lead to the conclusion that the Advisers Act's <u>*only*</u> purpose was to require disclosure; it was merely one means by which Congress sought to protect clients of investment advisers; the Advisers Act, through its imposition of the fiduciary standard of conduct on investment advisers, requires much more than the disclosures required under the '33 Act and '34 Act regimes.

Moreover, other commentators on the decision have focused on the language found in the last paragraph quoted above of the decision, that the "congressional intent" was "at least to expose" conflicts of interest. And they seize upon this language of the decision:

> An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving "two masters" or only one, "especially . . . if one of the masters happens to be economic self-interest." *United States v. Mississippi Valley Co.*, 364 U.S. 520, 549.

[239] 375 U.S. 180, ____, *citing* "Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services," H. R. Doc. No. 477, 76th Cong., 2d Sess., 1.

[240] 375 U.S. 180, ____-____.

While certainly disclosure is one means by which the intent of Congress was put into practical effect, at least in some instances, the *avoidance* of conflicts of interest is another fundamental purpose of the Advisers Act.

**The Structure of the Advisers Act and the "No Profit" and "No Conflict" Rules.** This conclusion – that the "no conflict" and "no profit" rules are alive and well in the Investment Advisers Act of 1940, can also be inferred by examining the structure of the Investment Advisers Act of 1940.

*Omission of Statement of Public Policy.* Unlike the Investment Company Act of 1940, the Advisers Act did not, in its final form, contain a recitation of the public policy or intent of Congress sought to be effected. As noted in footnote 34 of the U.S. Supreme Court's decision in *SEC v. Capital Gains*, the omission of this statement of public policy cannot result in the inference that the intent of Congress changed during the drafting process.

*Applying Principles of Statutory Construction to the Advisers Act.* Certain principles of statutory construction can be applied to the Advisers Act to discern when investment advisers are permitted to possess conflicts of interest, or under what circumstances. As stated in *Financial Planning Association vs. SEC*, "[a]pplying the "traditional tools of statutory construction … the [courts look] to the text, structure, and the overall statutory scheme, as well as the problem Congress sought to solve." Hence, a review of the structure of the Advisers Act, and specifically at Section 206, is merited. That section provides:

> It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.

The general anti-fraud provisions are found in subsections "(1)" and "(2)" of Section 206. Subsection "(4)" was added later, as a means of providing the SEC with rulemaking authority in this area.

Subsection "(3)" contains a specific exemption from the broad language of subsections "(1)" and "(2)" – in which principal trading by investment advisers is authorized under a very strict set of requirements. It is submitted that principal trading is already barred by subsections "(1)" and "(2)" of Section 206 and the fiduciary duty of loyalty these sections impose on investment advisers (and the resulting duty to avoid conflicts of interest). Subsection "(3)" was designed *not* as an additional prohibition but rather as a limited and very specific form of relief from subsections "(1)" and "(2)."

The Advisers Act only contains this specific exemption – for certain principal trades - from the "no conflict" rule applicable to fiduciaries, generally.

**Disclosure of a Conflict of Interest Does Not "Cure It" – Proper Management of the Conflict of Interest is Still Required.** The SEC itself has long recognized that *avoidance* of many conflicts of interest, not just their disclosure, may be required for the investment adviser to adhere to its legal obligations:

> [Investment advisers] have a fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients' best interests. You owe your clients a duty of undivided loyalty and utmost good faith. You should not engage in any activity in conflict with the interest of any client…"[241]

It is therefore important to not confuse the disclosure-based regime of the Securities Act of 1933 / Securities Exchange Act of 1934[242] (which regime, as previously noted, contemplates only an arms-length relationship between the issuer or broker and customer, aided by certain mandatory disclosures to the customer of information), and the regime of investment advisers, in which broad fiduciary obligations are imposed by the Advisers Act and state common law.

In summary, affirmative disclosure in a manner to ensure client understanding and obtaining the client's informed consent is but one part of an investment adviser's legal obligation when a conflict of interest is present. Even then, the action recommended to the client must be that which is best for the client, not that which is best for the investment adviser. Indeed, not all conflicts of interest may be adequately addressed through disclosure, and some must be avoided.

The 2010 Congress expressly provided in Section 913(g) of the Dodd-Frank Act to the Advisers Act that the SEC, should it impose a fiduciary standard on broker-dealers, create a "no less stringent" standard of conduct "without regard to the financial interest" of the broker dealer.[243] In other words, the SEC should not erode the current fiduciary standard of conduct applicable to investment advisers, and the SEC should utilize its authority to impose the same fiduciary standard found in the Advisers Act upon broker-dealers providing advice. It is important that the SEC, as it undertakes its Study and subsequent rule-making efforts, "get it right" by acknowledging, again, that the "no conflict" and "no profit" rules exist in the Advisers Act. Any exceptions which are now statutorily provided to those rules should be addressed by the imposition, through rule-making, of restrictions designed to ensure that the client's best interests are protected at all times.

4. **"Enhanced Disclosure" is Insufficient to Protect the Interests of Retail Investors. While enhancing disclosures of the distinctions between advisers and brokers is important, recent academic research reveals the ineffectiveness of disclosure as a means of closing the vast**

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241 See "Information for Newly-Registered Investment Advisers" (Prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations) available at http://www.sec.gov/divisions/investment/advoverview.htm.

242 "[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).

243 Section 913(g) of the Dodd Frank Act provides in pertinent part: "Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission may promulgate rules to provide that, with respect to a broker or dealer, when providing personalized investment advice about securities 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." Section 913(g) of the Dodd Frank Act also provides in pertinent part: "The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers,

and investment advisers, when providing personalized investment advice about securities 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***. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that ***such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of this Act when providing personalized investment advice about securities*** …."

**information asymmetry between those providing personalized investment advice and the retail investor.**

Under Section 913 of the Dodd Frank Act, the SEC is directed to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers, including any material conflicts of interest. However, as will be seen, while enhancing disclosures is strongly desired, disclosures – whether they be of the terms of a relationship, or otherwise – are generally ineffective as a means of ensuring protection of the individual investor.

## 5. The Fiduciary Duty Found in the Advisers Act is NOT the Lower Standard Found In the Law of Agency; It is a Professional Standard of Conduct, Already Strictly Applied, and Near The "Sole Interests" Standard.

It has been suggested that the Commission adopt the lower fiduciary standard of conduct found in the law of agency as the standard under the Advisers Act. This would be counter to existing, established standards already defined by the case law and by the Commission itself in various administrative decisions. Moreover, adopting a lesser fiduciary standard runs counter than that currently found in the Advisers Act runs contrary to the express language of the Dodd Frank Act (except as specifically noted therein), and contrary to public policy considerations.

**Breach of Fiduciary Duty Claims: Greater Number of Remedies; Easier Proof.** For many centuries Anglo-American has recognized an equitable claim for breach of duty on the part of a variety of persons whom the law denominates "fiduciaries." These persons include trustees, agents, directors and officers of business entities, and others. In addition, the variety of persons has grown to include certain specific professionals, such as attorneys.[244]

The two main consequences of imposition of fiduciary status are profound. First, the range of remedies broadens significantly. Rather than just recover for proximate damages caused by negligence, a breach of fiduciary duty claim can invoke other remedies, such as the equitable remedies of fee disgorgement, imposition of an constructive trust, and the remedy of injunction (sometimes utilized to prevent a fiduciary's threatened or continued fiduciary breach).

Second, once fiduciary status is demonstrated, the burden of proof shifts to the fiduciary defendant. In essence, the law adopts the proposition that, given the occasional need to evaluate the conduct of the fiduciary at some later time, and given the need to look objectively at the facts and circumstances surrounding the fiduciary's judgment at the time the fiduciary exercised his or her judgment, that the fiduciary preserve such proof. It is therefore right that the fiduciary - who was in the best position to have anticipated and obviated the need for proof in a later evidentiary showing – bears the burden of producing proof that his, her or its conduct is in accord with the fiduciary standard of conduct.

**Different "Flavors of Fiduciary" Exist, for Different Types of Fiduciaries.** Regrettably, few if any authorities have attempted to contrast the fiduciary duty of loyalty of an investment adviser (whether the federal fiduciary standard under the Advisers Act or the standards from which the federal standards is informed – state common law standards) with the duties of other forms of fiduciaries – attorneys, trustees, agents, corporate directors, and the like. In each realm the law has managed, over time, to move well beyond an individual judge's expression of moral outrage and individualized conclusions, which is in

[244] A lawyer has the duty of acting with the highest "degree of honesty, forthrightness, loyalty, and fidelity"? Singleton v. Foreman, 435 F.2d 962, 970 (5th Cir. 1970) (citing Smyrna Dev., Inc. v. Bornstein, 177 So. 2d 16, 18 (Fla. Dist. Ct. App. 1965)).

itself a modern version of the old adage that equity was to be measured by the chancellor's foot. In each realm different rules exist for key issues arising under fiduciary law, such as how conflicts of interest must be either avoided, or disclosed and properly managed.

Different types of fiduciaries are bound by different versions of the fiduciary duty of loyalty. In simplistic terms, the basic distinction is between the "sole interests" and the "best interests" standard. However, in the modern world there are exceptions which either universally or specifically applied to the "sole interests" standard in the realms in which it applies (generally, trustees and ERISA fiduciaries). Additionally, there are instances where the "best interests" standard is strengthened by the imposition of additional restrictions, or weakened by further particular exceptions.

**The Trustee's Duty of Loyalty: A Strict "Sole Interests" Standard (With Particular Exceptions).** For example, the very strict "sole interests" fiduciary standard found in the common law surrounds the duties of trustees, and as a result most conflicted transactions are prohibited.[245]

There are various rationales advanced for the strictness of the trustee's duty of loyalty. One commentator succinctly advanced this rationale:

> As legal owners of trust property, trustees have the power (though not the right) to do just about anything they want to do with it. The potential for abuse is obvious and is the reason why trust law imposes strict fiduciary duties on trustees, including a duty of undivided loyalty to the interests of the beneficiaries. Trustees' use of trust property to serve their own personal interests is strictly forbidden.[246]

There are, of course, limited exceptions provided to enable the trustee-beneficiary relationship to function. These limited common law exceptions permit the trustee to: (1) receive reasonable compensation; (2) perform special services, such as providing legal counsel to the trust, that the trustee has the skill and facilities to perform; (3) advance funds to the trust estate for proper expenses; and (4) deal with other trusts for which the trustee is a fiduciary.[247]

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[245] "The duty of loyalty requires a trustee 'to administer the trust solely in the interest of the beneficiary.' This "sole interest" rule is widely regarded as 'the most fundamental' rule of trust law. John H. Langbein, "Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?" 114 Yale Law Journal 929, 931 (2005). The "no-profit rule" firmly embedded in trust law is evidenced in the Restatement 3rd Trusts, which describes a "fiduciary relationship" as follows:

> b. Fiduciary relationship. The trust relationship is one of many forms of fiduciary relationship, each of which reflects the legal principles of the substantive area of law in which it has developed. …
>
> Despite the differences in the legal circumstances and responsibilities of various fiduciaries, one characteristic is common to all: a person in a fiduciary relationship to another is under a duty to act for the benefit of the other as to matters within the scope of the relationship. …
>
> In matters within the scope of a fiduciary relationship, the fiduciary is under a duty ***not to profit*** at the expense of the other . . . ***unless properly authorized to do so by a court or by the terms of the arrangement under which the relationship arose***. In such matters, if the fiduciary enters into a transaction with the other and fails to make full disclosure of all relevant circumstances known to the fiduciary, or if the transaction is unfair to the other, the transaction can be set aside by the other.
>
> [***Emphasis added.***]

RESTATEMENT (THIRD) OF TRUSTS § 2, cmt b.

[246] Roth, Randall, "Trustee-Beneficiary and Attorney-Client Relationships: General Overview and Hawai'i Case Study" (2000).

[247] Section 78(2) of the Restatement (Third) of Trusts, at cmts. C(4)-c(7).

This is not to say that, at times, the various legislatures have not relaxed the trustee's strict fiduciary duty of loyalty at times. For example, as banks and their trust departments sought to switch from "common trust funds"[248] to proprietary mutual funds for their trust clients, various state statutes were enacted which permitted the conflict of interest, [249] albeit with certain safeguards which vary from state to state.[250]

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[248] The Uniform Common Trust Fund Act (UCTFA) (1938) overcomes the rule against commingling trust assets and expressly enabling banks and trust companies to establish common trust funds. The Prefatory Note to the UCTFA explains: "The purposes of such a common or joint investment fund are to diversify the investment of the several trusts and thus spread the risk of loss, and to make it easy to invest any amount of trust funds quickly and with a small amount of trouble." 7 Uniform Laws Ann. 402 (1985). "Virtually all trust and fiduciary accounts participating in a common trust fee are already paying a trustee's fee to the bank, so the common trust fund does not usually charge a fund management fee separate and apart from that trustee's fee. The sponsoring bank is required to absorb all of the costs of establishing or reorganizing the common trust fund, and the common trust fund usually bears the cost of its ongoing operations to the extent permitted by state law." Lybecker, Martin E., "Comparison of the Regulation of Common Trust Funds under the Office of the Comptroller of the Currency's Regulation 9 and the Regulation of Mutual Funds under the Federal Securities Laws by the Securities and Exchange Commission" (March 16, 2007).

[249] Section 802(f) of the Uniform Trust Code (2005 amendment) reflects the actions undertaken by many of the states, as it now provides:

> An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee is not presumed to be affected by a conflict between personal and fiduciary interests if the investment otherwise complies with the prudent investor rule of [Article] 9. In addition to its compensation for acting as trustee, the trustee may be compensated by the investment company or investment trust for providing those services out of fees charged to the trust. If the trustee receives compensation from the investment company or investment trust for providing investment advisory or investment management services, the trustee must at least annually notify the persons entitled under Section 813 to receive a copy of the trustee's annual report of the rate and method by which that compensation was determined.

The comments to Section 802 provide this explanation of Section 802(f) and its application:

> Subsection (f) creates an exception to the no further inquiry rule for trustee investment in mutual funds. This exception applies even though the mutual fund company pays the financial service institution trustee a fee for providing investment advice and other services, such as custody, transfer agent, and distribution, that would otherwise be provided by agents of the fund. Mutual funds offer several advantages for fiduciary investing. By comparison with common trust funds, mutual fund shares may be distributed in-kind when trust interests terminate, avoiding liquidation and the associated recognition of gain for tax purposes. Mutual funds commonly offer daily pricing, which gives trustees and beneficiaries better information about performance. Because mutual funds can combine fiduciary and nonfiduciary accounts, they can achieve larger size, which can enhance diversification and produce economies of scale that can lower investment costs.
>
> Mutual fund investment also has a number of potential disadvantages. It adds another layer of expense to the trust, and it causes the trustee to lose control over the nature and timing of transactions in the fund. Trustee investment in mutual funds sponsored by the trustee, its affiliate, or from which the trustee receives extra fees has given rise to litigation implicating the trustee's duty of loyalty, the duty to invest with prudence, and the right to receive only reasonable compensation. Because financial institution trustees ordinarily provide advisory services to and receive compensation from the very funds in which they invest trust assets, the contention is made that investing the assets of individual trusts in these funds is imprudent and motivated by the effort to generate additional fee income. Because the financial institution trustee often will also charge its regular fee for administering the trust, the contention is made that the financial institution trustee's total compensation, both direct and indirect, is excessive.
>
> Subsection (f) attempts to retain the advantages of mutual funds while at the same time making clear that such investments are subject to traditional fiduciary responsibilities. Nearly all of the States have enacted statutes authorizing trustees to invest in funds from which the trustee might derive additional compensation. Portions of subsection (f) are based on these statutes.
>
> Subsection (f) makes clear that such dual investment-fee arrangements are not automatically presumed to involve a conflict between the trustee's personal and fiduciary interests, but subsection (f) does not otherwise waive or lessen a trustee's fiduciary obligations. The trustee, in deciding whether to invest in a mutual fund, must not place its own interests ahead of those of the beneficiaries. The investment decision must also comply with the enacting jurisdiction's prudent investor rule. To obtain the protection afforded by

**Agent's Duty of Loyalty.** Unlike the trustee's strict duty of loyalty, in the context of principal agent relationships the duty of loyalty is a more relaxed standard of conduct. Conflicts of interest are not prohibited, but must be disclosed and consented to.

The Restatement of Agency, Third, provides in pertinent part:

> § 8.01 General Fiduciary Principle. An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.
>
> § 8.02 Material Benefit Arising Out Of Position. An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position.
>
> § 8.03 Acting As Or On Behalf Of An Adverse Party. An agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship.
>
> § 8.04 Competition. Throughout the duration of an agency relationship, an agent has a duty to refrain from competing with the principal and from taking action on behalf of or otherwise assisting the principal's competitors. During that time, an agent may take action, not otherwise wrongful, to prepare for competition following termination of the agency relationship.
>
> § 8.05 Use Of Principal's Property; Use Of Confidential Information. An agent has a duty (1) not to use property of the principal for the agent's own purposes or those of a third party; and (2) not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party.

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subsection (f), the trustee must disclose at least annually to the beneficiaries entitled to receive a copy of the trustee's annual report the rate and method by which the additional compensation was determined. Furthermore, the selection of a mutual fund, and the resulting delegation of certain of the trustee's functions, may be taken into account under Section 708 in setting the trustee's regular compensation. *See also* Uniform Prudent Investor Act Sections 7 and 9 and Comments; Restatement (Third) of Trusts: Prudent Investor Rule Section 227 cmt. m (1992).

Subsection (f) applies whether the services to the fund are provided directly by the trustee or by an affiliate. While the term "affiliate" is not used in subsection (c), the individuals and entities listed there are examples of affiliates. The term is also used in the regulations under ERISA. An "affiliate" of a fiduciary includes (1) any person who directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the fiduciary; (2) any officer, director, partner, employee, or relative of the fiduciary, and any corporation or partnership of which the fiduciary is an officer, director or partner. *See* 29 C.F.R. Section 2510.3-21(e).

[250] The FDIC notes the conflict of interest due to the "lucrative array of fees available under a mutual fund arrangement" and suggests that it must be "resolved in the favor of trust beneficiaries." FDIC Trust Examination Manual, Section 7 "Compliance–Pooled Investment Vehicles," at Section A.1 (3/21/2009), stating: "One of the incentives for converting a CIF to a proprietary mutual fund is purely financial. There is a lucrative array of fees available under a mutual fund arrangement that is not available from bank sponsored CIF's. However, the desire for increased revenue must not take precedence over the fiduciary responsibility of the bank. Such a conflict must be resolved in favor of the account beneficiaries. If the desire for financial reward is dominant, the conflict could become abusive."

Some of the states, in enacting authority for banks to use proprietary or affiliated mutual funds, have prohibited their use unless the bank or trust company rebates its management fees, while others just require that certain disclosures be made to trust beneficiaries and/or that total compensation be "reasonable." *See, e.g.,* Wisconsin Statutes Sect. 881.01(4) (1989), stating in part: "A bank or trust company may invest in these securities notwithstanding that the bank or trust company, or an affiliate of' the bank or trust company, provides investment services to the investment company or investment trust if the bank or trust company waives its fee as fiduciary for the assets that it invests in these securities or if the bank , trust company or affiliate waives its fees for providing investment services to the investment company or investment trust." However, Wisconsin no longer effectively mandates fee waivers of offsets in this situation, and like most other states only requires disclosure in writing of the compensation received for providing services to the mutual fund, etc.. *See* Wisconsin Statutes Sect. 881.015 (1007-8).

The Restatement of Agency, Third, further provides that the consent of the principal is sufficient to waive a breach of an agent's fiduciary duty of loyalty:

> § 8.06 Principal's Consent
>
> (1) Conduct by an agent that would otherwise constitute a breach of duty as stated in §§ 8.01, 8.02, 8.03, 8.04, and 8.05 does not constitute a breach of duty if the principal consents to the conduct, provided that
>
> (a) in obtaining the principal's consent, the agent
>
> (i) acts in good faith,
>
> (ii) discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and
>
> (iii) otherwise deals fairly with the principal; and
>
> (b) the principal's consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship.

As noted above, the principal's informed consent may be obtained, provided *in obtaining the principal's consent* full disclosure is made by the agent of all material facts, the agent acts in good faith, and the agent otherwise deals fairly with the principal.

The comments to the foregoing rule further outline the parameters of informed consent given by a principal:

> [A]lthough a person may empower another to take action without regard to the interest of the person who grants the power, the law applicable to relationships of agency … imposes mandatory limits on the circumstances under which an agent may be empowered to take disloyal action. These limits serve protective and cautionary purposes. Thus, an agreement that contains general or broad language purporting to release an agent in advance from the agent's general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent's fiduciary duty may not reflect an adequately informed judgment on the part of the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent's position in ways not foreseeable by the principal at the time the principal agreed to the release.
>
> In contrast, when a principal consents to specific transactions or to specified types of conduct by the agent, the principal has a focused opportunity to assess risks that are more readily identifiable.[251]

As noted previously in this letter, all broker dealers are fiduciaries as to the scope of their agency. Hence, even custodial agents nevertheless have a duty of loyalty to their customers which precludes undisclosed self-dealing with respect to their custodial functions.[252]

**The Lawyer's Stronger Duty of Loyalty to His or Her Client.** An attorney is a particular form of agent, acting in a professional[253] capacity. Due to the vast disparity of knowledge between an attorney

[251] Restatement of the Law, Third, Agency, §8.06, *cmt. b.*

[252] *See O'Malley v. Boris*, 2002 WL 453928 (Del. Ch. 2002) (Brokerage firm violated fiduciary duty to customers when it switched account cash sweep vehicle to mutual fund in which it had not fully disclosed its interest).

[253] Supreme Court Justice Louis M. Brandeis in his 1914 book, Business - A Profession, stated that, in his view, a profession has three characteristics. First, it is an occupation for which the necessary training is intellectual, involving knowledge and learning as distinguished from skill. Second, it is an occupation pursued largely for others. Third, it is an occupation in which the amount of financial return is not the accepted measure of success.

and a client,[254] attorney codes of conduct have generally enhanced the protections provided to the client, above and beyond those provided under the common law of agency.[255]

Model Rule 1.7(a) provides that "a concurrent conflict of interest exists (1) if the representation of one client will be directly adverse to another client; or (2) if there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer."[256] If a conflict exists, Model Rule 1.7(b) permits attorneys to represent a client despite an actual or potential concurrent conflict of interest as long as (1) the attorney reasonably believes that the attorney will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the attorney in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.

As indicated, the Model Rules require the *informed consent* of the client when a conflict of interest is waived. The Model Rules define informed consent as "the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."[257] In most jurisdictions, informed consent must also be confirmed in writing to the client.[258] Moreover, the lawyer is under a duty to affirmatively advise the client of the conflict of interest, all relevant facts pertaining thereto, and its ramifications, in a manner designed to ensure client understanding;[259] and attempts to infer consent are generally looked upon with disfavor by the courts.

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[254] *See* ALI-ABA publication, RED FLAGS: A LAWYER'S HANDBOOK ON LEGAL ETHICS, noting in Chapter 6, "Conflicts of Interest: The Loyalty Obligation" that the relationship between the lawyer and client is described in the context of the fiduciary duty of loyalty:

> Lawyers derive power from clients, but also have the ability to overpower client interests due to the lawyer's superior knowledge and skill. Loyalty imposes an obligation on lawyers to ensure effective client representation by providing the client with independent legal judgment, and to prevent client harm by recognizing and responding to any influences (conflicts of interest) that may interfere with the lawyer's obligation to act in the client's best interests, as defined by the client. Pursuing the best interests of a client requires lawyers to remain vigilant for conflicting interests that may arise or change throughout a representation.

[255] *See, e.g.,* Restatement of the Law, Third, Agency, §8.06, cmt. b., stating in part: "Other bodies of law, and law focused on particular types of agency relationships, may impose additional limitations on the efficacy of a principal's consent after-the-fact to conduct by an agent. *See* Restatement Third, The Law Governing Lawyers §54(3).

[256] American Bar Association (ABA) Model Rules of Professional Conduct, Model Rule 1.7(a).

[257] *See* ABA Model Rules of Professional Conduct, Rule 1.0(e).

[258] Again, the ABA Model Rules attempt to delineate what is required: "Confirmed in writing," when used in reference to the informed consent of a person, denotes informed consent that is given in writing by the person or a writing that a lawyer promptly transmits to the person confirming an oral informed consent. See paragraph (e) for the definition of "informed consent." If it is not feasible to obtain or transmit the writing at the time the person gives informed consent, then the lawyer must obtain or transmit it within a reasonable time thereafter.

[259] "Courts interpreting the ABA and Restatement rules have made it clear that it is not sufficient to leave the client to infer the full nature of a conflict from only bits and pieces of actual or constructive knowledge." XXXX As stated by the 6th Circuit:

> It is not sufficient that both parties be informed of the fact that the lawyer is undertaking to represent both of them … he must explain to them the nature of the conflict of interest in such detail so that they can understand the reasons [why] it may be desirable for each to have independent counsel, with undivided loyalty to the interests of each other.

However, attorneys must be aware of the limitations which may exist on clients' ability to provide informed consent, as well as the attorney's ability to subjectively judge his or her own ability to continue to represent the client in the face of a conflict of interest. As stated by one commentator:

> Some scholars have questioned whether an attorney can truly evaluate his or her ability to represent a client in light of a concurrent or potential conflict of interest." *See* Leonard E. Gross, *Are Differences Among the Attorney Conflict of Interest Rules Consistent with Principles of Behavioral Economics?* GEORGETOWN JOURNAL OF LEGAL ETHICS (Winter 2006) (arguing that attorneys will be improperly influenced by economic considerations to fully and properly advise their clients of potential conflicts). If presented with a large and complex representation, an attorney with doubts concerning representation under Model Rule 1.7 may advise a client to consult with an independent attorney regarding the representation, a practice recommended under Model Rule 1.8. Again, the purpose is to establish informed consent.[260]

Even with informed consent, as previously noted the lawyer must undertake a judgment that, even with informed consent, the lawyer's representation of the client will not be adversely affected. In other words, even with disclosure and informed consent, the lawyer must continue to act with the client's ends in mind, and in the client's best interests.

Certain conflicts of interest are subject to additional restrictions. For example, before lawyers enter into business arrangements with a client, the lawyer must ensure that:

> "(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner that can be reasonably understood by the client;
>
> (2) the client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
>
> (3) the client consents in writing thereto."[261]

Even then, the client's informed consent may be judged under the lens of the "harsh reality test"[262]. As the New Hampshire Bar Association Ethics Committee opined: "The Committee believes that the courts will feel a strong temptation to apply the harsh reality test, or some other strict test to the selling of life insurance. 'There are no transactions which courts will scrutinize with more jealousy than dealings between attorneys and their clients.'"[263]

Whether a lawyer's client may even consent to representation or continued representation when the lawyer possesses a material conflict of interest depends upon the circumstances. The ultimate determinant is the extent to which the interests are truly adverse.[264] In some instances the duty of loyalty

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*CenTra, Inc. v. Estrin*, 538 F.3d 402, 415-6 (6th Cir. 2008). The *CenTra* court noted that the Model Rules "specifically imposes upon an attorney the affirmative burden of providing disclosure and obtaining consent. clearly, full and effective disclosure of all the relevant facts must be made and brought home to the prospective client." *CenTra*, 538 F.3d at 416.

[260] Randall, Karen Painter, and Sayles, Andrew, "Informed Consent and Legal Malpractice," For the Defense (May 2009).

[261] ABA Model Rules of Professional Conduct, Rule 4-1.8(a).

[262] Under this test, a lawyer attempting to resolve such an issue should ask himself or herself whether, if a disinterested lawyer were to look back at the inception of this representation once something goes wrong, would that lawyer seriously question the wisdom of the first attorney's requesting the client's consent to this representation or question whether there had been full disclosure to the client prior to obtaining the consent.

[263] New Hampshire Bar Association Ethics Committee Formal Opinion #1998-99/14, Lawyers Selling Insurance to Their Clients (May 10, 2000), *citing Spilker v. Hankin*, 188 F.2d 35 (D.C. Cir. 1951).

[264] *CenTra,*, 538 F.3d at 413.

has been deemed too impaired by the lawyer's proposed conduct to the extent that a client's informed consent would be deemed *per se* invalid.[265]

In other instances the lawyer's proposed conduct violates other principles of professionalism, even if the conflict of interest is managed through informed consent. For example, in most jurisdictions lawyers cannot serve as "solicitors" for registered investment advisers, regardless of whether they meet federal or state securities law requirements.[266]

**The Investment Adviser's Duty of Loyalty: A Professional Standard Near That of the Sole Interests Standard.**

Is a registered investment adviser a mere "agent"? Or have the Courts and the Commission itself already imposed upon registered investment advisers a stricter version of the fiduciary duty of loyalty, akin to the loyalty required of another professional – the lawyer?

NAPFA first notes that the U.S. Securities and Exchange Commission has already received guidance from the U.S. Supreme Court, in dealing with a different type of fiduciary, that the Commission should not adopt "a lax view of fiduciary obligations."[267]

Next, the express language of the Dodd Frank Act informs the answer, as the legislation added Section 211(g) to the Advisers Act, providing in pertinent part that the Commission may promulgate rules to provide that the standard of conduct for "*<u>all</u> brokers, dealers and investment advisers* … shall be to act *in the <u>best interest</u> of the customer <u>without regard to the financial or other interest of the broker, dealer, or investment adviser</u> providing the advice.*" This language appears to move the standard much closer back to the "sole interests" standard of conduct, but without invalidating a transaction which might provide, directly or indirectly, third-party compensation to the adviser or broker.

Next, Section 211(g) provides: "*In accordance with* such rules, any material conflicts of interest *shall be disclosed* and *may be consented to* by the customer." In other words, provided the best interests of the client remain paramount, and provided there is disclosure of material conflicts of interest, then the client may provide (or choose not to provide) informed consent.

Then Section 211(g) provides this qualifier: "Such rules shall provide that *such standard of conduct shall be no less stringent than the standard applicable to investment advisers under sections 206(1) and (2) of this Act* when providing personalized investment advice about securities …." In other words, regardless of the prior language, under no circumstances should the Commission seek to lower the fiduciary standard of conduct already found in the Advisers Act. And this form of fiduciary duty is very similar in many respects to the high fiduciary standard of conduct imposed upon another form of professional – the lawyer.

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[265] For example, ABA Model Rules of Professional Conduct, Rule 1.7(b)(3) specifically prohibits a waiver for a lawyer to be on both sides of "the same litigation or other proceeding before a tribunal.

[266] *See* Rhoades, Ron A., "The Attorney as "Complete Advisor"—Fiduciary Ancillary Business Models," 79 Fla.B.J. 10 (March 2005), which surveys some of the ethics opinions in this area.

[267] Justice Frankfurter eloquently expressed the need of the courts and of the Commission to look beyond the rhetorical language surrounding the fiduciary standard, when in a decision attempting to ascertain the appropriate fiduciary standard to be applied by the Securities and Exchange Commission to officers and directors managing a holding company that was in the process of reorganization, he wrote: "We reject a lax view of fiduciary obligations and insist upon their scrupulous observance. But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?" *SEC v. Chenery Corp*., 318 U.S. 80, 85-86 (1943) (citations omitted).

Calls upon the Commission to adopt the fiduciary standard found in the general law of agency are misplaced and contrary to the express provisions of the Dodd Frank Act. Moreover, such an attempt to denigrate the Adviser Act's fiduciary standard fails to reflect the "delicate nature" of the fiduciary relationship between the investment adviser and the client, the vast disparity in knowledge between the entrustor and the fiduciary[268] (often not found in agency relationships of a general nature, where often the reverse is true), and the strong public policy which favors promoting relationships based upon trust as a means of promoting capital formation and economic growth.

In summary, we refer back to the prior sections of this comment letter, in which we set forth in detail the strictness of the application of the fiduciary standard of conduct under the Advisers Act, already. Given that the Dodd Frank Act calls for the fiduciary standard of conduct, when applied to brokers, to be "no less stringent," we call upon the Commission to adopt rules in furtherance of this express statutory requirement. In addition, as we have noted, there exists multiple and strong public policy reasons in favor of the imposition of the Advisers Act strict standard of conduct.

**6. Congressional Language and Intent. The "solely incidental" requirement for the broker-dealer exclusion to the definition of "investment adviser" should be defined in such a way as to follow the plain meaning of the words, as well as the intent of both the 1940 Congress and the 2010 Congress.**

While new section 211(g) of the Advisers Act[269] provides the Commission with authority to impose the Advisers Act's fiduciary standard of conduct upon broker-dealers, NAPFA suggests that the Commission could adopt a parallel track in rule-making, by restoring sense to the definition of redefining "solely incidental" as it pertains to the broker-dealer exclusion from the Advisers Act.

We do not believe that legal precedent is so clearly established that the Commission could not undertake a different track. Indeed, the U.S. Court of Appeals decision in *Financial Planning Association vs. SEC*, No. 04-1242 (D.C. Cir., March 30, 2007), possesses potentially far-reaching implications, as Three times in that decision the Court emphasized that the term "investment

[268] "Where self-help is effective, fiduciary constraints are relatively weak, and where self-help is weak, fiduciary constraints are relatively intense." Smith, D. Gordon, The Critical Resource Theory of Fiduciary Duty. Vanderbilt Law Review, Vol. 55, p. 1399. Available at SSRN: http://ssrn.com/abstract=339100. As we have previously noted, individual investors (and indeed, many persons working for institutional investors) possess not only a lack of knowledge regarding our complex modern capital markets system, but they possess behavioral bias which substantially limit the effectiveness of disclosures. Moreover, investment advisers and brokers are in a position to take advantage of this lack of knowledge and behavioral biases, and should a weak form of fiduciary standard be adopted many will undoubtedly do so, thereby destroying the essential trust which is so necessary to ensure the effectiveness of our capital markets to raise capital and thereby promote U.S. and world economic growth.

[269] New section 211(g) of the Investment Advisers Act of 1940 expressly provides the U.S. Securities and Exchange Commission with the authority to "promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities 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. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under sections 206(1) and (2) of this Act when providing personalized investment advice about securities … The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser."

adviser" was "broadly defined" by Congress and the Court stressed the remedial purposes of the Advisers Act.

There have already been advanced numerous arguments for the Commission's adoption of a definition for "solely incidental" which is in line with the plain meaning and Congressional intent, including NAPFA's comment letter of November 2, 2007, which we incorporate herein by reference.[270]

In NAPFA's April 15, 2008 letter to the SEC's Division of Investment Management, we also suggested a definition of "solely incidental" which could be adopted by SEC rule-making, and which could provide industry professionals with the guidance required to determine when they are subject to the fiduciary standards of the Advisers Act. We repeat that language here:

**PROPOSAL: A DEFINITION OF "SOLELY INCIDENTAL"**

1. Under the limited exclusion from the application of the Investment Advisers Act of 1940, broker-dealers and their registered representatives may provide investment advice only when it is *solely incidental* to a securities transaction and only when *no special compensation* is received for such investment advice. "Solely incidental" or "merely incidental" investment advice means only that advice in connection with the sale of a security, such as explaining the fees, costs and characteristics of a security and the risks of the security, so that the investment advice is discrete, minor, casual, and at all times subordinate to the sale process.
2. The following activities are illustrative of forms of advice which are not "solely incidental" to a securities transaction (this is not intended to be an exclusive listing):
    a. Strategic asset allocation - The division of assets within an investment portfolio with regards to the long term view of the risk and return profile of those asset classes
    b. Tactical asset allocation - modify their asset allocation according to the valuation of the markets in which they are invested or other valuation or economic factors
    c. Monitoring an investment portfolio for purposes of advising to switch investments between various securities, or even between sub-accounts of a variable annuity
    d. Any discretionary authority to effect a trade in a security (even if the discretion only relates to the timing of the trade, and not to the identity of the security)
    e. Preparing a financial plan addressing the extent, amount, or timing of withdrawals during retirement
    f. Preparing a financial plan advising as to the amount necessary to accumulate to reach any particular financial goal, such as retirement or educational expenses, or advising as to what type of account (i.e., traditional or Roth IRA or taxable account) to be utilized to effect retirement savings, which is followed by a recommendation or the sale of a security
    g. Preparing a financial plan which includes any one of more of the following: risk management issues (asset protection planning, whether through insurance or other means), estate planning, and/or tax planning , which is followed by a recommendation or the sale of a security
    h. Regular or periodic reviews of a client's investment portfolio, with the goal of determining whether to rebalance the investment portfolio or otherwise address risk levels of the portfolio.

[270] Nov. 2, 2007 letter of Tom Orecchio, Chair, and Ellen Turf, CEO, National Association of Personal Financial Advisors, Arlington Heights, Illinois, available at http://sec.gov/comments/s7-22-07/s72207-8.pdf. We also take note of the excellent comments provided in the comment letter of November 2, 2007 submitted by Barbara Roper, Director, Investor Protection, Consumer Federation of America, and Mercer Bullard, Founder and President, Fund Democracy, available at http://sec.gov/comments/s7-22-07/s72207-9.pdf, and the prior letter from CFA Director of Investor Protection Barbara Roper to SEC Secretary Jonathan Katz, dated February 7, 2005, and the letter of the same date from CFA, Fund Democracy, Consumers Union, Consumer Action, also to Secretary Jonathan Katz.

3. Once investment advice has been provided to a client which is subject to the Advisers Act and its imposition of fiduciary duties, further investment advice always remains subject to the Advisers Act and cannot be considered "solely incidental." Section 215 of the Advisers Act does not permit a client to waive the protections of the broad fiduciary duties of due care, loyalty, and utmost good faith imposed by the Advisers Act.

Accordingly, we submit that the Commission should exercise its authority to define "solely incidental" in a manner which reflects Congressional intent that the Advisers Act be broadly applied, through the broader application by the Commission of the definition of "investment adviser." Both 1940 and 2010 Congressional histories support such a broad application of the term "investment adviser," and point to the narrowness of the broker-dealer exclusion.

## **7. The Use of Titles Which Connote An Advisory Relationship Should Be Prohibited, if The Fiduciary Standard of Conduct Is Inapplicable; The Importance of Effective Disclosures of the Nature of the Relationship.**

We suggest to the Commission some specific rules which would serve to reduce consumer confusion and promote trust in those who adhere to the fiduciary standard of conduct:

(a) The terms "financial advisor" and "wealth manager," and similar terms, must be preserved for use by fiduciary advisors.

(b) The term "fee-only" should be reserved to those financial advisors who meet the definition of "fee-only" as set forth in the CFP Board's Rules of Professional Conduct.

(c) The term "fee-based" – when used by dual registrants charging both fees and commissions, is inherently misleading and should be prohibited.

(d) Attempts to circumvent the fiduciary requirement by denoting an account as a "brokerage account" even though advisory services are provided should be prohibited. We note that, even with contract language and clear disclosure that the role is not a fiduciary one, fiduciary duties may be applied under the common law, as the nature of the relationship is determined by the application of the law to the facts, not by contract of the parties. Moreover, it is a basic principle, embodied in Section 215 of the Advisers Act, that no client may sign away, or waive, all of his or her fiduciary obligations.

(e) It is important that disclosure of the nature of the relationship, if it is to have any chance of being effective to accomplish the purposes for which it is intended, be much more than "casual disclosure" utilizing vague language to describe the distinctions between investment advisers and brokers. As previously alluded to, even Commissioner Walter opined that she believed it doubtful that consumers would have understood the disclosures crafted relative to fee-based brokerage accounts. Disclosures must inform consumers not only of the circumstances into which they find themselves, but the *consequences* or *ramifications* of those circumstances.

With regard to the last suggestion, it is important that disclosures provide, in plain English, consumers with the ability to understand when they are in an arms-length relationship (and thereby needing to be self-protective of their own interests) or in a fiduciary relationship (the only time the consumer can rely upon the advice of their financial advisor as being objective and in the consumer's best interest).

In NAPFA's April 15, 2008 correspondence to the Division of Investment Management, relative to the Rand Corporation report, we suggested language which we believe could form an adequate disclosure to consumers of the differences between investment advisers and brokers. We offer this language, again, as an illustration of the meaningful disclosure to which consumers should receive when entering into a relationship with an investment adviser or broker:

> **UNDERSTANDING WHO WE ARE.** Investment services providers fall into two categories: (1) investment advisers; and (2) brokers. Key differences exist as to the types of services offered, the fees and costs associated with such services, and the different federal and state regulatory requirements and the resulting different legal obligations to their clients or customers. Important distinctions – including whether the provider has a clear obligation to act in your best interests or disclose conflicts of interest – depend on which legal category the provider falls into under our securities laws. *Following is some basic information you can use to find an investment services provider who is right for you – one who offers the services you want on terms you understand and accept.*
>
> **Investment Advisers -** The term investment adviser is a legal term that describes a broad range of people who are in the business of giving advice about securities (the term "securities" includes stocks, bonds, mutual funds, annuities, and other types of investments). They may use a variety of titles in addition to investment adviser, such as financial planner, financial advisor, financial consultant, investment manager, investment counsel, asset manager, wealth manager, or portfolio manager.
>
> *Services Provided.* Investment advisers provide ongoing management of investments based on the client's objectives. The client of an investment adviser may, or may not, give the adviser authority to make investment decisions without having to get prior approval from the client for each transaction (called "discretionary authority").
>
> *Compensation.* Most investment advisers charge fees for their services which clients pay directly to the provider. They may be hourly fees or a flat fee or retainer fee for a particular service or range of services. In some instances they may also include a performance fee based on how well the client's account performs.
>
> *Legal Duties to You, the Client.* Investment advisers are subject to broad fiduciary duties of due care, loyalty, and utmost good faith to their clients. That means they have to put your best interests ahead of theirs at all times by providing advice and recommending investments that they view as being the best for you. Investment advisers also are required to provide up-front disclosures about their qualifications, what services they provide, how they are compensated, possible conflicts of interest, and whether they have any record of disciplinary actions against them. You should ask for, and receive, a copy of the investment adviser's disclosure brochure (SEC Form ADV, Part 2, or its equivalent), which contains detailed information about the investment adviser, investment philosophies, fees, conflicts of interest, and how such conflicts of interest are managed to keep your best interests paramount at all time. Investment advisers are regulated directly by the U.S. Securities and Exchange Commission (SEC) or by state securities regulators, depending on the amount of assets they have under management. You can find out whether a person or firm is registered or licensed as an investment adviser by calling your state securities regulator using the contact information on the NASAA website: www.nasaa.org or by visiting: www.adviserinfo.sec.gov.
>
> **Brokers -** The terms broker and broker-dealer are legal terms that refer to people who are in the business of buying and selling securities (called trading) for customers. Individual salespeople employed by brokerage firms are often called stockbrokers and are officially referred to as *registered representatives* of the brokerage firm.
>
> *Products Provided.* Brokers engage in the buying and selling of securities, including stocks, bonds, CDs, mutual funds, annuities, and other types of securities. Brokers sell products, and any investment advice they provide must only be solely incidental to the sale of the product or security.
>
> *Compensation.* Brokers typically receive their compensation based on commissions clients pay each time they buy or sell a security, and through principal trading (mark-ups and mark-downs on bond prices, selling or purchasing stocks or other securities from or to the broker-dealer firm's own inventory). Other compensation may be paid to a brokerage firm (or, indirectly, to the broker) resulting from the sale of a product, such as 12b-1 fees, soft dollar compensation, bid-ask spreads (including payment for order flow to market makers), and other indirect payments. Commission-based compensation can be an affordable option for customers who expect to trade only rarely, but the payment of commissions and other indirect compensation to brokers by product manufacturers and others may expose customers to potential conflicts of interest, such as creating an incentive to recommend frequent trades or particular investment products.

*Legal Duty to Their Customers.* Brokers are generally not considered to have a broad fiduciary duty to their customers, although this standard may apply in certain limited circumstances. Instead, brokers are required: to know your financial situation well enough to understand your financial needs, and to recommend investments that are suitable for you (mainly as to risk, as applied to your situation) based on that knowledge. They are not required to provide up-front disclosure of the type provided by investment advisers. In addition to being regulated directly by the SEC and by state securities regulators, brokers are subject to regulation by an industry self-regulatory organization, the Financial Industry Regulatory Authority (FINRA). You can find out whether a person or firm is registered or licensed as a broker and check out their disciplinary record by calling your state securities regulator using the contact information on the NASAA website: www.nasaa.org, or by using FINRA's "BrokerCheck" at www.finra.org.

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**Date: ___________, 20____ Client or Customer Name:___________________**

**I confirm to you that in my relationship with you I am acting as (check one):**

**____ an investment adviser**

**____ a broker**

**___________________________ (signature)**

**8. Concluding Thoughts.** We close with several concluding thoughts, on issues which may be presented to the Commission by other commenters.

a. Despite Industry Claims to the Contrary, Many Registered Investment Advisers (and NAPFA Members) Provide Services to the "Middle Market" and to "Small Investors". And they are profitable in doing so. Moreover, adhering to the fiduciary standard of care does not limit the fiduciary advisor's ability to provide clients with appropriate services and products.

b. Despite Claims to the Contrary, Imposition of Fiduciary Status Does Not Result in More Liability. Rather, acting as a fiduciary, seeking to minimize conflicts of interest which may exist with clients, and ensuring any remaining conflicts of interest are properly managed, while exercising due care with respect to the investment advice being provided, results in less fear of customer claims. It is only when the fiduciary standard is applied, but not followed by the financial advisor or his or her firm, that a failure to adhere to fiduciary obligations results. We encourage the Commission to explore the nature and extent of the claims against the various participants in the financial services industry. We believe the Commission will find that fiduciary-only advisers possess, relative to similarly situated non-fiduciary actors, substantially lower claims, and pay substantially lower insurance premiums.

c. Inspections of Registered Investment Advisers Should Be Frequent, Robust, and Focused. The SEC possesses an important role in verifying holdings of client assets, as a means of deterring fraud and, should fraud occur, preventing its growth to Madoff-type levels. We believe that examinations by securities regulators should be supplemented by periodic peer reviews, under the auspices of a professional regulatory organization. FINRA's long opposition to the true fiduciary standard of conduct and its application, lack of a fiduciary culture, inability to raise the standards of conduct of its members over seven decades, and inherent conflicts of interest in representing the commercial interests of mostly large broker-dealer firms (and their affiliated product manufacturing arms), all render FINRA incapable of properly applying, preserving, and enhancing the fiduciary standard of conduct. We believe a professional regulatory organization, composed of individual professionals (not dominated by the commercial interests of firms), akin to a Bar Association but on a national level, should serve as the model for the regulation of professionals who deliver investment advice, and should provide the platform upon which to erect peer review structures.

d. The Commission Should Not Seek, by Regulation, to Preserve a Business Model Which Consumers Do Not Desire. The product sales method for the delivery of "incidental advice" is outdated in today's modern and complex financial world. Consumers need and want comprehensive financial advice. Product salespeople, posing as trusted advisors but not accepting fiduciary obligations, undermine consumer trust in our capital markets system, which in turn hinders capital formation. The Securities and Exchange Commission, under the leadership of Chairman Mary L. Schapiro, possesses the opportunity to give birth to a new era in which trust in financial advisors, and thereby in our capital markets system, is substantially increased. This will foster much-needed economic growth for America, enable Americans to receive the guidance required to increase their personal savings and make good financial and investment decisions, and better enable the long-term financial health of Americans, the Federal Government, and the state governments.

e. Despite Broker-Dealer Industry Claims to the Contrary, Application of the Fiduciary Standard Results in a General Lowering of Intermediation Costs for Retail Investors. This is because fiduciary advisors possess a duty to ensure that fees and costs paid by their clients are reasonable. As the many different types and numbers of investment vehicles proliferate, investors are challenged to discern an investment product's true "total" fees and costs. Even "disclosed" costs are often unknown to individual investors. This is seen in the Rand Report, which found that over thirty percent (75 of 246) consumers who responded to the Rand survey indicated that they paid nothing for investment advisory services or for brokerage services![271] This observation challenges the broker-dealer industry's repeated assertion that the Rand survey clearly indicates that consumers are satisfied with the services of their registered representatives; if these consumers knew all of the costs of intermediation imposed, and the consequences of the imposition of so many layers of fees and costs, it is far more likely that the vast majority of the customers of broker-dealers would be wholly dissatisfied.[272]

**In Conclusion.**

NAPFA urges the Commission to maintain the current fiduciary standard of conduct found in the Advisers Act, and also applied by state common law, to the activities of those engaged in providing investment advice, and that the Commission correct the present situation through imposition of the same fiduciary standard upon all of the investment advisory activities of broker dealers. NAPFA further recommends that the Commission explore rules which are consistent with the "no profit" and "no conflict" rules embedded within the Advisers Act.

NAPFA also urges the Commission to explore how a new professional regulatory organization, possessing a fiduciary culture and whose members are individual professionals, might assist federal and/or state regulators in the enforcement of professional standards of conduct, such as through peer review of either a proactive or reactive nature.

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[271] Rand Report at p.108.

[272] Moreover, given that the Rand survey was conduct near the end of a 4-year bull market, it is likely that the results would be quite different today.

The National Association of Personal Financial Advisors (NAPFA), which for over 26 years has led the way in setting high standards for registered investment advisers, and whose members adhere strictly to its fiduciary oath, is available to provide further information as requested, and to discuss the comments set forth herein.

Respectfully submitted,

William T. Baldwin, CFP® Ellen Turf Susan MacMichael John, CFP®
Chair, NAPFA CEO, NAPFA Chair, Industry Issues Committee
Incoming Chair, NAPFA

NAPFA acknowledges the assistance of the incoming Chair of its Industry Issues Committee, Ron A. Rhoades, JD, CFP®, in the preparation of these comments.

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## National Association of Personal Financial Advisors' Fiduciary Oath

- The advisor shall exercise his/her best efforts to act in good faith and in the best interests of the client.
- The advisor shall provide written disclosure to the client prior to the engagement of the advisor, and thereafter throughout the term of the engagement, of any conflicts of interest, which will or reasonably may compromise the impartiality or independence of the advisor.
- The advisor, or any party in which the advisor has a financial interest, does not receive any compensation or other remuneration that is contingent on any client's purchase or sale of a financial product.
- The advisor does not receive a fee or other compensation from another party based on the referral of a client or the client's business.

## NAPFA Code of Ethics

**Objectivity:** NAPFA members strive to be as unbiased as possible in providing advice to clients and NAPFA members practice on a fee-only basis.

**Confidentiality:** NAPFA members shall keep all client data private unless authorization is received from the client to share it. NAPFA members shall treat all documents with care and take care when disposing of them. Relations with clients shall be kept private.

**Competence:** NAPFA members shall strive to maintain a high level of knowledge and ability. Members shall attain continuing education at least at the minimum level required by NAPFA. Members shall not provide advice in areas where they are not capable.

**Fairness & Suitability:** Dealings and recommendation with clients will always be in the client's best interests. NAPFA members put their clients first.

**Integrity & Honesty:** NAPFA members will endeavor to always take the high road and to be ever mindful of the potential for misunderstanding that can accrue in normal human interactions. NAPFA members will be diligent to keep actions and reactions so far above board that a thinking client, or other professional, would not doubt intentions. In all actions, NAPFA members should be mindful that in addition to serving our clients, we are about the business of building a profession and our actions should reflect this.

**Regulatory Compliance:** NAPFA members will strive to maintain conformity with legal regulations.

**Full Disclosure:** NAPFA members shall fully describe method of compensation and potential conflicts of interest to clients and also specify the total cost of investments.

**Professionalism:** NAPFA members shall conduct themselves in a way that would be a credit to NAPFA at all times. NAPFA membership involves integrity, honest treatment of clients, and treating people with respect.