July 5, 2013

The Honorable Mary Jo White
Chairman
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number 4-606 Duties of Brokers, Dealers, and Investment Advisers

Dear Chairman White:

The Committee for the Fiduciary Standard congratulates you on your appointment as Chair of the U.S. Securities and Exchange Commission (SEC). We suggest that a critical opportunity exists for you, and the Commission, to improve investor protections for, and the financial security of, all of our fellow Americans by raising the standard of conduct for broker-dealers providing personalized investment advice to retail investors. In so doing capital formation will be promoted, along with U.S. economic growth, resulting in lower burdens upon the federal and state governments in future years and lower tax rates for all Americans.

This comment letter is submitted by the Steering Group[i] of THE COMMITTEE FOR THE FIDUCIARY STANDARD (www.thefiduciarystandard.org). The Committee, consisting of over 1,100 members via LinkedIn, is led by a volunteer Steering Group of practitioners and financial and investment experts, seeks to inform and nurture a public discussion on the bona fide fiduciary standard of conduct as applied to the delivery of investment and financial advice.[ii]

Our response is to the SEC's Request for Information (RFI) published in March 2013, and our comments are designed to inform rulemaking with respect to fiduciary standards of conduct.

KEY POINTS

- We suggest that some of the assumptions made in the RFI would, if adopted, not conform to the requirement under the Dodd Frank Act that the fiduciary standard be as stringent as that found under the Advisers Act. For example, the heavy emphasis in the SEC's RFI on disclosure, when a conflict of interest is present, is misplaced. Under the jurisprudence of the Advisers Act, disclosure does not discharge a fiduciary's continued obligation to act in the client's best interest; much more is required of the fiduciary advisor.
- A further elicitation of fiduciary standards of conduct can, and should be, provided to all those who provide personalized investment advice. We further suggest the formation of a "Fiduciary Board of Standards" for purposes of aiding the SEC, DOL, OCC and state securities regulators in the application of fiduciary standards.
- Significant public policy and economic rationale exists for the imposition of fiduciary standards upon all of those who provide personalized investment advice.

- Having transformed their businesses to incorporate the delivery of financial and investment advice, brokers and their registered representatives should be willing to assume the duties and obligations which flow as a result of fiduciary status. As the fiduciary standard operates as a restraint on conduct, certain business practices of brokers should be modified.

A. Our Five Core Principles.

The Committee for the Fiduciary Standard posits that the fiduciary standard as currently applied under the Advisers Act can be summarily articulated as a set of five core principles:

- Put the client's best interests first;
- Act with prudence, that is, with the skill, care, diligence and good judgment of a professional;
- Do not mislead clients--provide conspicuous, full and fair disclosure of all important facts;
- Avoid conflicts of interest;
- Fully disclose and fairly manage, in the client's favor, unavoidable conflicts.

These five principles in turn flow from the broad fiduciary standard of conduct applied to investment advisers, which is commonly set forth in the United States as a triad of broad fiduciary duties – due care, loyalty, and utmost good faith.[iii] As we suggest in Part C of this letter, below, from these five core principles can be further discerned additional specific principles in applying the fiduciary standard which can serve to guide both fiduciaries and their clients.

B. Disclosure Does Not Discharge the Fiduciary's Duty of Loyalty.

In this comment letter we initially focus upon the duty of loyalty, including the duties to avoid[iv] certain conflicts of interest, and the duty to properly manage remaining conflicts of interest in the client's favor. We emphasize that, in the situation where a fiduciary possesses a conflict of interest with a client, while disclosure of conflicts of interest is important, disclosure is but one aspect of the fiduciary duty of loyalty under the Advisers Act. Disclosure of a conflict of interest and mere consent of the client thereto does not discharge the fiduciary's obligations.[v]

Rather, substantial additional duties exist upon the fiduciary. We suggest that the "duty of no conflict" and the "duty of no profit"[vi] found under the common law are firmly embedded in the jurisprudence[vii] of the Advisers Act creating such a federal fiduciary duty of loyalty.[viii] We further explore these duties in Section C of this letter, below.

We also suggest that commentators who suggest that court precedent exists for the proposition that disclosure, alone, is all that is required, are either engaging in wishful thinking or are mistaken. Such commentators often rely upon language found in *SEC vs. Capital Gains Research Bureau.* For a detailed discussion of how *SEC vs. Capital Gains Research Bureau* is often misconstrued, as to the scope of the fiduciary's obligations under the Advisers Act in the context of disclosure, we refer you to Appendix A to this letter.

C. Proposed Specific Principles to Apply Fiduciary Standards to Those Who Provide Personalized Investment Advice.

We suggest the following language for SEC rule-making efforts, which elaborates upon our five core principles in a manner designed to provide guidance to regulators, practitioners, and clients alike. In the notes to our recommended standards of professional conduct, we cite to judicial decisions and administrative decisions applying the Advisers Act; we also provide additional commentary on the rationale behind a rule, where appropriate.

We propose the following specific principles be adopted in the SEC's rule-making effort, to adequately inform advisors and their clients of the obligations arising under a fiduciary standard of conduct, applying the jurisprudence of the Advisers Act:

PROFESSIONAL STANDARDS OF CONDUCT

Any statement which merely describes a security, without more,[ix] shall not be construed as personalized investment advice. However, any statement by an investment adviser or broker or their representatives which expresses whether a security is appropriate for a retail client or which constitutes a recommendation[x] for the purchase or sale of a security by a specific retail client shall be considered the delivery of personalized investment advice.

Investment advisers and brokers, and their representatives, are professionals[xi] providing personalized investment advice are given the highest degree of trust and confidence[xii] by their clients. They are fiduciaries in the broadest sense, and accordingly possess broad fiduciary duties of undivided loyalty, due care, and utmost good faith to the client. Accordingly, but not by way of limitation,[xiii] investment advisers and brokers providing personalized investment advice and their representatives shall:

1) *act in the best interests[xiv] of the client;*
2) *be obedient to the client's instructions;*
3) *act with the utmost good faith,[xv] honestly, and without intimidation;*
4) *use reasonable care[xvi] to avoid making any misrepresentations to their clients;[xvii]*
5) *use reasonable care and judgment to achieve and maintain independence[xviii] and to provide independent,[xix] objective advice;*
6) *reasonably act to avoid[xx] conflicts of interest;*
7) *not offer, solicit, or accept any gift, benefit, compensation, or consideration[xxi] that reasonably could be expected to compromise their independence and objectivity;*
8) *fully disclose[xxii] all material[xxiii] facts to their clients[xxiv] affirmatively[xxv] and in a timely[xxvi] manner, including but not limited to conflicts of interest which are not reasonably avoided, in a manner in which client understanding[xxvii] is assured;*
9) *properly manage any remaining conflicts of interest in order to secure the client's informed consent[xxviii] to a transaction which remains substantively fair to the client, in order that that the client's best interests remain paramount[xxix] above the interests of the broker or adviser[xxx];*

10) *reasonably seek to not favor the interests of any one client over the interest of another client;*

11) *act with the due care,*[xxxi] *applying the requisite knowledge, experience and attention to the engagement expected of a professional providing personalized investment advice;*[xxxii]

12) *ensure that the total fees and costs paid by the client in connection with personalized investment advice and the investments selected are reasonable under the circumstances;*

13) *reasonably consider and recommend to the client such strategies and investment products which may reduce the tax burdens imposed upon the client over time;*

14) *keep all information about clients (including prospective clients and former clients) in strict confidence, including the client's identity, the client's financial circumstances, the client's security holdings, and advice furnished to the client by the firm, unless the client consents otherwise;*

15) *shall be subject to the foregoing fiduciary standards with respect to all of the investment and financial advisory activities provided to the client;*

16) *shall not seek to have any client waive*[xxxiii] *the adviser's core duties of loyalty, due care, and utmost good faith, including but not limited to the duties to ensure all fees and costs incurred by the client are reasonable and that tax reduction strategies are properly employed; however, within reasonable boundaries the scope of the client's engagement of the investment adviser may be limited in writing;*

17) *shall not seek to change*[xxxiv] *the fiduciary-client relationship to an arms-length relationship,*[xxxv] *unless:*

    a. *the client seeks only trade execution services with no further personalized investment advice (including no references back to any prior investment advice provided); <u>and</u>*

    b. *the broker or adviser provides the client, in a single writing wholly separate and apart from any other contract or disclosure, of the following statement in bold all-caps print of a minimum 12-point font:*

    YOU HAVE REQUESTED A CHANGE IN OUR RELATIONSHIP FROM AN ADVISORY RELATIONSHIP TO ONE OF TRADE EXECUTION SERVICES ONLY.

    AS SUCH, WE WILL NO LONGER BE PROVIDING PERSONALIZED INVESTMENT ADVICE TO YOU.

    YOU ARE NO LONGER ENTITLED RELY UPON ANY STATEMENTS MADE BY THIS FIRM OR ITS REPRESENTATIVES AS "ADVICE." NO STATEMENT MADE BY THIS FIRM OR ITS REPRESENTATIVES, IN FURNISHING INFORMATION REGARDING A SECURITY OR INVESTMENT PRODUCT, SHOULD BE CONSTRUED BY YOU AS ADVICE.

YOU NOW BEAR SOLE RESPONSIBILITY TO EVALUATE ANY INVESTMENT PRODUCT OR SECURITY.

WE ARE NO LONGER REQUIRED TO ACT IN YOUR BEST INTEREST. ACCORDINGLY, WE MAY CHOOSE TO FAVOR OUR INTERESTS OVER YOUR INTERESTS.

YOU ARE NOW SOLELY RESPONSIBLE FOR YOUR OWN PROTECTION.

and

c. *the client provides informed consent thereto, in writing.*

18) *shall not utilize the title which combines the words "investment," "financial," "wealth," or similar terms with "adviser," "advisor," "counsel," "counselor," "manager," or similar terms, unless the firm and/or its representatives accept that, as to any and all clients (including prospective clients) who may have received a communication of such title(s), the firm and/or its representatives act as fiduciaries at all time with respect to such client(s), and without exception.*[xxxvi]

D. Public Policies Compel the Application of Fiduciary Status Upon Those Providing Personalized Investment Advice.

Even a more detailed listing of fiduciary principles derived from the jurisprudence of the Advisors Act, as set forth in Section C above, will fail to accomplish its desired results if both regulators and those who provide personalized investment advice do not fully understand the substantial public policy rationale behind the application of fiduciary status upon professionals. These public policy reasons include, but are not limited to, the following.

Consumers' Lack of Desire to Expend 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 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."[xxxvii]

The Shifting of Monitoring Costs to Government

In service provider relationships which arise to the level of fiduciary relations, it is highly costly for the client to monitor, verify and ensure that the fiduciary will abide by the fiduciary's promise and deal with 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, by enabling trust to be placed in the advisor by the client.

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 imposing costs of enforcement actions upon firms and individuals found to be violating rules of conduct, may shift monitoring costs back to the fiduciaries which are regulated.

Consumers' Difficulty in Tying Performance to Results

The results of the services provided by a fiduciary advisor are not always related to the honesty of the fiduciary or the quality of the services. For example, an investment adviser may be both honest and diligent, but the value of the client's portfolio may fall as the result of market events. Indeed, rare is the instance in which an investment adviser provides substantial positive returns for each incremental period over long periods of time – and in such instances the honesty of the investment adviser should be suspect.

Consumers' Difficulty in Identifying and Understanding Conflicts Of Interest

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

Survey after survey (including the Rand Report commissioned by the SEC) has concluded that consumers place a very high degree of trust and confidence in their investment adviser, stockbroker, or financial planner. These consumers deal with their advisors on unequal terms, and often are unable to identify the conflicts of interest their "financial consultants" possess. As evidence of the lack of knowledge possessed by consumers, the Rand Report noted that 30% of investors believed that they did not pay their financial consultant any fees! This calls into substantial question the conclusion derived from the Rand Report's survey that most customers of brokers are happy with their financial consultant; if these customers knew of all of the fees and costs that they were paying, and of the amount of compensation received by their financial consultant, it is highly doubtful that any of them would be "happy."

Transparency is important, but even when compensation is fully disclosed, few individual investors realize the impact high fees and costs can possess on their long-term investment returns; often individual investors believe that a more expensive product will possess higher returns.[xxxviii]

For Fiduciaries the Cost of Proving Trustworthiness Is Quite High

How does one prove one to be "honest" and "loyal"? The cost to a fiduciary in proving that the advisor is trustworthy could be extremely high – so high as to exceed the compensation gained from the relationships with the advisors' clients.

In his influential article discussing the creation of the federal securities acts, and in particular their moral purpose, John Walsh (of the SEC's OCIE) 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.
>
> 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.

> 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 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."[xxxix]

This is why it is important to fiduciary advisors to be able to distinguish themselves from non-fiduciaries. A recent example of the problems faced by investment advisers was the "fee-based brokerage accounts" final rule adopted by the SEC in 2005, which would have permitted brokers to provide the same functional investment advisory services as investment advisers but without application of fiduciary standards of conduct. This would have negated to a large degree economic incentives[xl] for persons to become investment advisers and be subject to the higher standard of conduct. The SEC's fee-based accounts rule was overturned in *Financial Planning Ass'n v. S.E.C.*, 482 F.3d 481 (D.C. Cir., 2007).

Monitoring and Reputational Threats are Largely Ineffective

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

Public Policy Encourages Specialization, Which Necessitates Fiduciary Duties

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

Public Policy Encourages Participation in our Capital Markets

Investment advisory services encourage participation by investors in our capital markets system, which in turn promotes economic growth. 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[xlii] 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.[xliii]

Public Policy Encourages Saving and Proper Investing

As stated in a 2002 white paper authored by Professor Macy: "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."[xliv]

E. The Economic Rationale for the Application of Fiduciary Standards.

American business is the robust engine that drives the growth of our economy and delivers prosperity for all. An important component of the fuel for this engine is monetary capital. Yet, this monetary capital is not efficiently delivered to the engine of business … it's as if the engine is stuck using an outdated, clogged carburetor, in the form of substantial intermediation costs by current investment banking firm practices.

More importantly, the transmission system of our economic vehicle is failing, leading to far less progress in our path toward personal and U.S. economic growth. The transmission system is large, heavy and unwieldy; its sheer weight slows down our vehicle's progress. Through costly investment products and hidden fees and costs, this transmission system unnecessarily diverts much of the power delivered by American business' economic engine to Wall Street, rather than deliver it to the investors (our fellow Americans) who provide the monetary capital.

The ramifications of this inefficient vehicle, with its clogged carburetor and faulty transmission, are both numerous and severe. The cost of capital to business is much higher than it should be, due to the exorbitant intermediation costs Wall Street imposes during the raising of capital and its diversion of the returns of capital away from individual investors.

In fact, Wall Street currently diverts away from investors a third or more of the profits generated by American publicly traded companies. As Simon Johnson, former chief economist of the International Monetary Fund, observed in his seminal May 2009 article "The Quiet Coup" appearing in *The Atlantic*, wrote: "From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits … In 1986, that figure reached 19 percent. In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period. This decade, it reached 41 percent."[xlv] More recently the financial services sector's bite into corporate profits has been estimated at one-third or higher.[xlvi]

Investor Distrust = Less Capital

The siphoning of profits by Wall Street, away from the hands of individual investors, has led to a high level of individual investor distrust in our system of financial services and in our capital markets. In fact, many individual investors, upset after finally discovering the high intermediation costs present, flee the capital markets altogether. (Many more would flee if they discovered all of the fees and costs they were paying, and realized the substantial effect such had on the growth or preservations of their nest eggs.)

The effects of greed in the financial services industry can be profound and extremely harmful to America and its citizens. Participation in the capital markets fails when consumers deal with financial intermediaries who cannot be trusted.

As a result of the growth of investor distrust in financial intermediaries, the capital markets are further deprived of the capital that fuels American business and economic expansion, and the cost of capital rises yet again. Indeed, as high levels of distrust of financial services continue,[xlvii] the long-term viability of adequate capital formation within the United States is threatened, leading to greater reliance on infusions of capital from abroad. In essence, by not investing ourselves in our own economy, we are selling our bonds, corporate and other assets to investors abroad.[xlviii]

Less Capital Formation = Reduced Economic Growth

It is well documented that public trust is positively correlated with economic growth.[xlix]

Moreover, public trust is also correlated with participation by individual investors in the stock market.[l] This is especially true for individual investors with low financial capabilities – those who in our society are in most need of financial advice; policies that affect trust in financial advice seem to be particularly effective for these investors.[li]

The lack of trust in our financial system has potential long-range and severe adverse consequences for our capital markets and our economy. As recently stated by Prof. Ronald J. Columbo: "Trust is a critical, if not the critical, ingredient to the success of the capital markets (and of the free market economy in general). As Alan Greenspan once remarked: '[O]ur market system depends critically on trust-trust in the word of our colleagues and trust in the word of those with whom we do business.' From the inception of federal securities legislation in the 1930s, to the Sarbanes-Oxley Act of 2002, to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, it has long been understood that in the face of economic calamity, the restoration and/or preservation of trust – especially investor trust – is paramount in our financial institutions and markets."[lii]

There is no doubt that "[t]rust is a critically important ingredient in the recipes for a successful economy and a well-functioning financial services industry. Due to scandals ranging in nature from massive incompetence to massive irresponsibility to massive fraud; investor trust is in shorter supply today than just a couple of years ago. This is troubling, and commentators, policymakers, and industry leaders have all recognized the need for trust's restoration …."[liii]

Less Trust = Less Use of Financial Advisors

The issue of investor trust in financial intermediaries does not just concern asset managers and Wall Street's broker-dealer firms; it affects all investment advisers and financial advisors to individual clients. As Tamar Frankel, a leading scholar on U.S. fiduciary law, once observed: "I doubt whether investors will commit their valuable attention and time to judge the difference between honest and dishonest … financial intermediaries. I doubt whether investors will rely on advisors to make the distinction, once investors lose their trust in the market intermediaries. From the investor's point of view, it is more efficient to withdraw their savings from the market."[liv]

Harmful Impact on Americans' Retirement Security

Even more severe are the long-term impacts of the high intermediation costs imposed by Wall Street firms on individual investors themselves. Individual investors, now largely charged with saving and investing for their own financial futures through 401(k) and other defined contribution retirement plans and IRA accounts, reap far less a portion of the returns of the capital markets than they should. These substantially lower returns from the capital invested, due to Wall Street's diversion of profits, result in lower reinvestment of the returns by individual investors; this in turn also leads to even lower levels of capital formation for American business.

It must be remembered that, fundamentally, an economy is based upon trust and faith. Continued betrayal of that trust by those who profess to "advise" upon qualified retirement plans and IRA accounts, while doing so under an inherently weak standard of conduct, only serves to destroy the essential trust required for capital formation, thereby undermining the very foundations of our modern economy.

Greater Burdens Placed Upon Governments – and Taxpayers

As individual Americans' retirement security is not adequately provided through their own investment portfolios, saddled with such high intermediation costs, burdens will shift to governments – federal, state and local – to provide for the essential needs of our senior citizens in future years. These burdens will likely become extraordinary, resulting in far greater government expenditures on social services than would otherwise be necessary, precisely at the time when our governments can ill afford further burdens and cannot solve these burdens through the issuance of debt.

Consequentially, higher tax rates become inevitable, for both American business and individual citizens alike. This in turn consumes a greater share of our economy, leading to further economic stagnation, and perhaps to the permanent decline of America in the 21st Century and beyond.

The Fiscal and Talent Drains by Wall Street

In essence, American business has become Wall Street's servant, rather than its master. The excessive rents extracted at multiple levels by Wall Street fuels excessive bonuses paid, in large part, to young investment bankers.

Wall Street also drains some of the best talent away from productive businesses, as well. Far too many of our graduates of math and engineering programs make their way to Wall Street, and even more pursue finance majors rather than pursue studies in the STEM (science, technology, engineering, math) disciplines. This further distorts the labor market, as shortages of talent in our important information technology and engineering sectors continue.

Consequently, Wall Street has become a huge drain on American business and the U.S. economy. It derives excessive rents at the expense of corporations and individuals. The financial services sector, rather than providing the grease for American's economic engine, instead has become a very thick sludge.

F. Effect on Application of the Fiduciary Standard on the Current Business Practices of Brokers (Also, the Fiduciary Standard Has Long Been Applied to Brokers Providing Personalized Investment Advice.)

Fundamentally, the fiduciary standard operates as a restriction on greed, and hence certain types of business practices can, and should, be prohibited under the fiduciary standard of conduct. It is beyond reason for broker-dealer firms to argue that the application of fiduciary standards to their advisory activities be undertaken in a manner which does not disrupt, in any way or fashion, their current business practices.

The need for brokers to adapt their business practices arises because brokers have changed the nature of their business to provide personalized investment advice and to form relationships of trust and confidence with their customers. During the course of the 20^{th} Century brokers have shifted from the role of merchandizer, in which they used the terms "registered representative" or "sales representative" to describe themselves, to the role of trusted advisor using titles[lv] denoting relationships of trust and confidence and employing trust-based sales techniques.[lvi] Having transformed their businesses to incorporate the delivery of financial[lvii] and investment advice, they should be willing to assume the duties and obligations which flow as a result of fiduciary status.

We note, however, that the application of fiduciary standards of conduct to the personalized investment advisory activities of brokers is not new; it preceded the enactment of the Securities Exchange Act of 1934, and continued thereafter. Moreover, the Investment Advisers Act of 1940 never stated that brokers were *not* fiduciaries; it only provided an exemption from registration as an investment adviser. *See* Exhibit B hereto, "Shhh!!! Brokers Are (Already) Fiduciaries … Part 1: The Early Days."

With respect to the application of the Dodd-Frank Act's specific provisions relating to the business practices of brokers, we provide the following suggestions for consideration by the SEC during its rule-making efforts, with regard to variable compensation practices. We agree that charging a retail customer on a commission basis, in and of itself, is not inconsistent with a strong and uniform fiduciary standard of conduct. The Dodd-Frank Act and the SEC staff study make it clear that a commission-based pricing model can be consistent with a fiduciary standard. However, to the extent a firm or investment professional chooses to use a commission-based pricing model, it must recognize that it creates inherent conflicts of interest that are not present in asset-based, fixed-fee or hourly-fee based pricing models.

Additionally, there exist conflicts of interest when variable, or differential, compensation flows as a result of recommending one investment product over another. We suggest that variable and differential compensation, such as that arising from different levels of commissions, payment for order flow, sales contests, and soft dollar[lviii] compensation, present such insidious conflicts of interest that such practices should be banned. In other words, consistent with the fiduciary principle, and regardless of the form of compensation of the broker and its registered representative, the broker's customer should agree to a reasonable method and amount of compensation to be paid in advance of any specific recommendation, and any additional compensation should be avoided. We acknowledge that the imposition of this avoidance of variable compensation will require changes in the asset management industry, but we believe that variable or differential compensation poses a substantial threat to the integrity of fiduciaries, and that higher compensation received for the sale of one product over a similar product with lower compensation to the advisor can rarely be justified.[lix] It is a far better practice for the advisor to establish the compensation to be paid in advance of any investment recommendations, and then to undertake recommendations which do not result in additional compensation and self-dealing.

If a firm offers both commission-based and asset-based pricing models, the firm and the investment professional have the obligation to recommend to the retail customer the pricing model that is in the customer's best interest, and to monitor regularly to assure that the customer remains in the account structure that is in the customer's best interest.

<u>G. Further Development of Standards of Conduct: Advisory Board.</u>

One of the problems of securities regulation today is its focus on disclosure; in part, this is because securities examiners can test adherence to disclosure obligations fairly easily. Yet, evaluation of a professional advisor's proper adherence to the full extent of the fiduciary's duty of loyalty, and many aspects of a professional advisor's adherence to the fiduciary's duty of due care, will often require the judgment of professionals with substantial experience.

Hence, we suggest that the SEC form a "Fiduciary Board of Standards," composed only of those individual professionals fully committed to a bona fide fiduciary standard of conduct, along with representatives of consumer organizations, to advise the SEC, DOL, Office of Comptroller of the Currency (OCC), and state securities regulators on the further development and application of the rules of conduct suggested above. Practitioners and regulators (such as state securities regulators) should be permitted to seek advisory opinions from such Board, as a means of understanding how the fiduciary duties are applied to real-life situations. Through such Board's issuance of advisory opinions and commentary on any adopted rules of conduct, the jurisprudence of the fiduciary standard can properly further develop over time.

In making this recommendation, we emphasize that the members of such a panel should be chosen for their commitment to a bona fide fiduciary standard of conduct and the interests of consumers. Otherwise, commercial self-interests could result in an evisceration of the true fiduciary standard of conduct.

H. Conclusion.

We have directed our comments to the fiduciary duty of loyalty, out of concern that the SEC's Request for Information of March 2013 is inconsistent with the Dodd-Frank Act's requirement that the fiduciary standard of conduct, if imposed upon brokers, be "no less stringent" than that found under the Advisers Act. We reject the assumption that broad and/or core fiduciary duties for those investment advisers and brokers who provide personalized investment advice are somehow waivable by the client. We suggest that a *bona fide* fiduciary standard will, first and foremost, fully explore the existing jurisprudence of the Advisers Act, as well as state common law which continues to inform the development of the Advisers Act federal fiduciary standard.

We appreciate the opportunity to submit this comment letter. Our Steering Group members are available to provide further information to the Commission, and to meet to review these recommendations, as may be requested.

Thank you.

Steering Group
The Committee for the Fiduciary Standard

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<u>APPENDIX A:</u> THE FIDUCIARY ADVISOR AND CONFLICTS OF INTEREST: THE TRUE MEANING OF *SEC vs. CAPITAL GAINS RESEACH BUREAU* – IT IS <u>NOT</u> JUST DISCLOSURE

It has been written[lx] by some in the securities bar that the U.S. Supreme Court's landmark decision in *SEC v. Capital Gains* provided a road map for an investment adviser's handling of conflicts of interest, in that disclosure of a conflict of interest would be sufficient to comply with the fiduciary's duty of loyalty. Is this true, or did the U.S. Supreme Court intend something altogether different? In essence, the questions should be asked:

> Have some securities law attorneys misconstrued *SEC vs. Capital Gains*? - Yes.
>
> Does there exist, for investment advisers, a duty to avoid certain insidious conflicts of interest? - Yes.
>
> For permitted conflicts of interest which are disclosed and for which informed consent is provided, does there exist a continuing duty to properly manage such conflicts of interest? – Yes.

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.'[lxi] [*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 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.'[lxii] [*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."[lxiii] 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. *We need not go that far in this case, since here the Commission seeks only disclosure of a conflict of interests with significantly greater potential for abuse than in the situation described above*.[lxiv] [*Emphasis added*.]

In other words, it was not necessary to the U.S. Supreme Court decision, as it was before the Court, for the Court to find that the Advisers Act outlawed significant conflicts of interest between investment advisers and their clients. The SEC in the underlying action only sought an injunction pertaining to disclosure; given that this was the only relief requested, the Court did not need to address the other parameters of the fiduciary duty of loyalty.

Despite this factual limitation, the U.S. 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, while 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 which form foundations of the fiduciary duty of loyalty in English common law 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.

Furthermore, some key aspects of the legislative history underlying the Advisers Act were 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. In the decision, the U.S. Supreme Court stated:

> 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.'[lxv]
>
> 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*.]

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 in order to avoid conflicts of interest and the deviation of profits away from the client (except as to profits derived from compensation paid directly by the client, which has been previously agreed to by the client).

A philosophy of full disclosure is not the Advisors Act's only purpose. 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 *only* purpose was to require disclosure; it was merely one means by which Congress sought to protect clients of investment advisers.

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.

Yet, again, this reading of the decision is far too narrow. While certainly disclosure is one means by which the intent of Congress was effected, the *avoidance* of conflicts of interest is another fundamental purpose of the Advisers Act. As the U.S. Supreme Court stated in its own footnote to the passage set forth above:

> 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 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....

Furthermore, the Supreme Court near the end of its majority opinion stated: "The statute, in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested. To insure this it empowers the courts to require disclosure of material facts." But, again, this is but one requirement of the Advisers Act. The avoidance of investment adviser conflicts of interest, and profit-taking resulting from actions of investment advisers, are additional purposes of the Advisers Act.

Why did the Supreme Court not go further, and hold in the *Capital Gains* decision that the investment adviser's secret purchase of shares of a particular security shortly before recommending it to clients (and thereby profiting from the increase in market price which occurred as a result of the recommendation, by selling the shares) was prohibited? As mentioned above, the SEC's request for an injunction was limited to requiring disclosure, and not more. Hence, it should not be inferred from this language that investment advisers are only required to undertake disclosures of conflicts of interest, as opposed to avoiding them.

Think about it … If disclosure was effective as a means of consumer protection, there would be no need for the fiduciary standard of conduct!

The Advisers Act imposes, in situations where a conflict of interest is not avoided, substantial additional burdens upon the fiduciary adviser, beyond mere disclosure. We have suggested the boundaries of these additional duties in our suggested rules for adoption, above.

APPENDIX B:

Shhh!!! Brokers Are (Already) Fiduciaries ... Part 1: The Early Days

By Ron A. Rhoades, JD, CFP®*

> *"The relationship between a customer and the financial practitioner should govern the nature of their mutual ethical obligations. Where the fundamental nature of the relationship is one in which customer depends on the practitioner to craft solutions for the customer's financial problems, the ethical standard should be a fiduciary one that the advice is in the best interest of the customer. To do otherwise – to give biased advice with the aura of advice in the customer's best interest – is fraud. This standard should apply regardless of whether the advice givers call themselves advisors, advisers, brokers, consultants, managers or planners."*[lxvi]

> *"The duty of loyalty requires an adviser to serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own."*[lxvii]

On March 1, 2013 the U.S. Securities and Exchange Commission issued a request for data and information regarding the "Duties of Brokers, Dealers, and Investment Advisors."[lxviii] The SEC desires this information to inform its rule-making processes under Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[lxix] ("Dodd-Frank Act"), specifically as to whether and how to impose fiduciary standards upon brokers (i.e., registered representatives of broker-dealer firms). However, often lost in this debate is the fact that brokers providing personalized investment advice are *already* fiduciaries, possessing broad duties of due care, loyalty and utmost good faith to their clients, and it has been this way for over a century. This paper explores this topic, as to the jurisprudence and understandings which developed largely during the first half of the 20th Century.

The delivery of investment advice in the United States primarily occurs through broker-dealers or investment advisers.[lxx] It is generally believed that registered investment advisers[lxxi] and their investment adviser representatives (hereafter collectively referred to as "RIAs" or "investment advisers") are subject to a higher standard of conduct (fiduciary standard of conduct) than broker-dealers and their registered representatives (hereafter collectively referred to as "brokers") (subject to the lower "suitability" standard and certain other specific rules) when engaging in activities involving the furnishing of investment recommendations and advice to clients.[lxxii]

Yet, often lost in the "debate" regarding whether brokerage firms and their registered representatives should be required to be fiduciaries to their individual customers is the fact that – for nearly a century - courts across the country have found brokers to be fiduciaries through the application of state common law. Moreover, early statements from both the SEC and the National Association of Securities Dealers (NASD), now known as the Financial Industry National Regulatory Authority (FINRA), embraced the view that brokers – when providing personalized investment advice – were fiduciaries to their clients.

The Investment Advisers Act of 1940 (Advisers Act) was widely believed, at the time of its enactment and thereafter, to apply broad fiduciary standards upon investment advisers. However, the Advisers Act provides for an exemption of brokers from the definition of "investment adviser"[lxxiii] provided the advice provided by brokers is "solely incidental" to the conduct of the broker's activities and no "special compensation"[lxxiv] is received. Yet, the Advisers Act, while providing a limited exception from the application of its registration requirements for brokers,[lxxv] did not negate the potential status of brokers[lxxvi] as fiduciaries under state common law.[lxxvii]

This paper explores cases arising under state common law in which brokers and their registered representatives are held to broad fiduciary standards of conduct similar to those applicable to investment advisers,[lxxviii] and not the lower standard of suitability,[lxxix] arising due to the nature of the advisory activities undertaken.

As a result of regulatory missteps over many decades, substantial consumer confusion now abounds as to the standard of conduct consumers can expect from their providers of investment advice.[lxxx] Section 913 of the Dodd-Frank Act provides the SEC with the legal authority to correct this situation through the imposition of fiduciary standards upon broker-dealers.

A. **When Does a "Confidential Relation" Exist, Thereby Meriting the Imposition of Fiduciary Status?**

> *"A fiduciary relationship may exist under a great variety of circumstances. Reliance may engender a duty of loyalty. Where the confidence and trust of another is accepted and is the basis for the guidance of another's affairs, a duty of loyalty is required. A disloyal adviser could have and should have declined to give advice."*[lxxxi]

The fiduciary principle has its roots in antiquity. It is clearly reflected in the provisions of the Code of Hammurabi nearly four millennia ago, which set forth the rules governing the behavior of agents entrusted with property.[lxxxii] Ethical norms arising from relationships of trust and confidence also existed in Judeo-Christian traditions,[lxxxiii] in Chinese law,[lxxxiv] and in Greek[lxxxv] and Roman[lxxxvi] eras.

Time and again our courts have enumerated the fiduciary maxim: "No man can serve two masters."[lxxxvii] As stated early on by the U.S. Supreme Court, "The two characters of buyer and seller are inconsistent: Emptor emit quam minimo potest, venditor vendit quam maximo potest."[lxxxviii] As the U.S. Supreme Court has also opined, "the rule … includes within its purpose the removal of any temptation to violate them…."[lxxxix]

Through elaboration in English law and U.S. law, fiduciary law has evolved over the centuries to refer to a wide range of situations in which courts have imposed duties on persons acting in particular situations that exceed those required by the common law duties of ordinary care and fair dealing which exist in arms-length relationships.[xc] Fiduciary duties find their origin in a mix of the laws of trust law, tort law, contract law, and agency law. And, through the gradual expansion of the situations in which fiduciary duties are required as our society evolves,[xci] today fiduciary status attaches to many different situations.

The fact that control of property (as would exist in a trustee-beneficiary relationship) or the management of property (as in the grant of discretion over securities) is nonexistent does not mean that fiduciary status does not attach. There has long been recognition that the mere provision of advice may result in a fiduciary relationship.[xcii]

It is curious that so many financial intermediaries today are unaware of their fiduciary status, or those situations in which it might attach. The many paths to fiduciary status include: (1) common law fiduciary status arising from a relationship of "trust and confidence" between the financial advisor and client; (2) application of the Investment Advisers Act of 1940 ("IAA"); (3) application of

ERISA[xciii]; (4) limited fiduciary duties imposed upon brokers under agency law, relating to best execution and safeguarding of custodied assets, for brokerage accounts; (6) discretionary accounts, now leading to the application of the Investment Advisers Act of 1940 and its imposition of broad fiduciary duties; (5) *de facto* "control" amounting to "discretion" over a brokerage account, also leading to the imposition of broad fiduciary duties; (6) state statutory law and regulations in a few states (including those stating that financial planners are investment advisers); (7) express acceptance of fiduciary duties through contractual terms; (8) service as trustee, custodian; guardian, or conservator; and (9) acting as attorney-in-fact.

Agency law dictates that agents are subject to certain limited fiduciary duties to act on behalf of their principals. It is under agency law that many of the early cases find fiduciary obligations pertinent to the broker's duty of best execution or holding the client's funds as a custodian.

However, the broad fiduciary duties of a broker toward his or her customer are more likely to be found by courts when a *confidential relation* exists, as may occur when personalized investment advice is provided. In the United States, our state courts have long applied broad fiduciary duties upon those in relationships of "trust and confidence" with entrustors. As stated by one early 20th Century court:

> In equity the court looks to the relationship of the parties -- the reliance, the dependence of one upon the other. Where a relationship of confidence is shown to exist, where trust is justifiably reposed, equity scrutinizes the transaction with a jealous eye; it exacts the utmost good faith in the dealings between the parties, and is ever alert to guard against unfair advantage being taken by the one trusted.[xciv]

But what is this "relationship of trust and confidence," sometimes referred to as a "confidential relation," which merits the imposition of the fiduciary standard of conduct? First, let us examine what a "confidential relation" under the law is not; we should not confuse the existence of a longstanding friendship or an intimate relationship with a "relationship of trust and confidence" under the law sufficient to impose fiduciary status upon one of the actors in such a relationship:

> Friendly relations or even intimacy of relationship present an entirely different question from what is understood as a confidential relation in law. One may have confidence in another's integrity and honesty of purpose, and likewise believe that he will live up to any of his contracts, without having any confidential relations with such person that would void any agreement or transactions entered into between them, on the theory of constructive fraud or undue influence. We think the record shows that the Harrises did have confidence in the honesty and integrity of the Jacksons, and believed that the Jacksons would comply with any agreements into which they entered; but there is absolutely no testimony showing anything further, or that there were any confidential business relationships, or relationships existing between the Jacksons and the Harrises which would constitute a basis for a charge of constructive fraud. There must be something further than mere confidence in another's honesty and integrity to sustain the presumption of constructive fraud.[xcv]

For a "confidential relation" to occur under the law, there is typically the placement of trust by one person in another, often the result of asymmetric information or disparate skill. One court described the situation in which parties deal with each other from substantially different positions, resulting in the possibility of abuse of the superior position:

> Confidential relation is not confined to any specific association of the parties; it is one wherein a party is bound to act for the benefit of another, and can take no advantage to himself. It appears when the circumstances make it certain the parties do not deal on equal terms, but, on the one side, there is an overmastering influence, or, on the other, weakness, dependence, or trust, justifiably reposed; in both an unfair advantage is possible.[xcvi]

However, placement of trust in another, by a person in an inferior position, is not sufficient to impose fiduciary status. We trust most men with whom we deal. Trust must be *justifiably reposed* – *i.e.,* there must be something *reciprocal* in the relationship before the rule applying fiduciary status can be invoked. In other words, it is not just the placement of trust, but the *acceptance* of that trust *by either words or conduct or both*, which form the basis of the fiduciary relation. As stated by a federal court applying California law:

> It is true that one party cannot create a legal obligation or status by pleading ignorance and inexperience to an opposing party in a business transaction. Those who have in the law's view been strangers remain such, unless both consent by word or deed to an alteration of that status. The communicated desire or intention of one to impose upon the other a different status, involving greater obligations, is ineffective, *unless the other consents to the changed relation*. It is true that *consent may find expression in acts as readily as in words*. But *such consent cannot be implied from a bare procedure with the transaction, after one party has declared his or her inexperience and reliance upon the other*. The knowledge of this state of mind in a party may be an important consideration in determining the existence of fraud, as indicating what effect might be anticipated from statements made; but it cannot establish a confidential legal status.[xcvii] [*Emphasis added.*]

The 1933 case of *Hancock v. Anderson*[xcviii] illustrates this principle of acceptance or consent to the fiduciary relation, in the situation where the customer of a banker was advised to enter into an extension and renewal of a first mortgage held by the customer. Subsequently the banker acquired an adverse interest by representing the holder of the second mortgage on the same property. While there had been a history of advice provided by the banker to the customer over the years with respect to the purchase of bonds, with respect to a later transaction involving a suggestion to reduce the principal amount of the customer's first mortgage, the banker stated to the customer, "I am not in a position to advise you."[xcix] The banker advised the customer to seek advice from another businessman with respect to the particular transaction at hand.[c] The court stated:

> Trust alone, however, is not sufficient. We trust most men with whom we deal. *There must be something reciprocal in the relationship before the rule can be invoked*. Before liability can be fastened upon one *there must have been something in the course of dealings for which he was in part responsible that induced another to lean upon him, and from which it can be inferred that the ordinary right to contract had been surrendered*. If this were not true a reputation for fair dealing would be a liability and an unsavory one an asset. A sale of bonds made by the Bank of England can be set aside no more quickly than a sale made by a "bucket-shop" …
>
> In Pomeroy's Eq. (3d ed.) section 902, it is said that when a contract is not in its nature essentially fiduciary, a trust, to be established, must be *expressly* reposed or *necessarily* implied …

> It is said that a man cannot be at once agent for a buyer and seller, that loyalty to his trust is an elementary duty, and that where confidential personal relations exist a full and fair disclosure is imperative …
>
> The presumption is that people who deal with each other, grown men and women, deal with each other as such, and this presumption is not destroyed by disparity in age nor by the ties of blood ….[ci] [*Emphasis in original*.]

In other words, a provider of investment advice must "consent to be bound" – by *words* or *conduct* – for fiduciary status to attach under state common law. In the sections which follow are explored the types of words, representations, or conduct which merit the imposition of broad fiduciary obligations upon brokers. It will be demonstrated that holding out as a trusted advisor, such as through the use of the title "financial advisor," or by means of an invitation to accept and/or follow "objective" advice, is sufficient conduct to provide such "consent to be bound."

B. Early Authorities: Brokers as Fiduciaries

Federal courts look to state common law to determine whether brokers should be deemed fiduciaries and the scope of the fiduciary duties thereby imposed.[cii] Indeed, it is from state common law that fiduciary principles arose. State common law, derived from judicial opinions over hundreds of years, melds together the state common law of trust law,[ciii] agency law,[civ] some aspects of contract law, [cv] and tort law[cvi] to define fiduciary relationships and to explore the duties that arose therefrom.

In early England, the term "brokers" was used by persons who engaged in the then-disreputable pawnbroker's business.[cvii] "It was not until the latter part of the 17th century, when the East India Company came prominently before the public, that trading in stock became an established business in England."[cviii] This new breed of brokers became known as "stockbrokers."[cix]

Early evidence of fiduciary-like prohibitions imposed upon stockbrokers in England can be found in the fiduciary-like restriction imposed upon brokers in 1697 by the English Parliament in An Act to Restrain the Number and Ill Practice of Brokers and Stock Jobbers.[cx] The statute, enacted in response to "unjust practices" which had evolved in the selling of stock,[cxi] was in existence for a little over ten years,[cxii] required brokerage firms and their employees to take a verbal oath to comply with the law, which required brokers to eschew compensation not permitted under the Act.[cxiii]

At the beginning of the 20th Century, in "the United States the business of buying and selling stocks and other securities [was] generally transacted by Brokers for a commission agreed upon or regulated by the usages of" a stock exchange."[cxiv] Indicative of the known distinctions between brokers and dealers, an early Indiana law provided for the licensing of brokers but not for "persons dealing in stocks, etc., on their own account."[cxv]

Moreover, stockbrokers were known to possess duties akin to those of trustees, including the duty of utmost good faith and the avoidance of receipt of hidden forms of compensation. As stated in the 1905 edition of an early treatise:

> He is a Broker because he has no interest in the transaction, except to the extent of his commissions; he is a pledgee, in that he holds the stock, etc. as security for the repayment of the money he advances in its purchase; so he is a trustee, for the law

> charges him with the utmost honesty and good faith in his transactions; and whatever benefit arises therefrom enures to the *cestui que trust*.[cxvi]

By the early 1930's, the fiduciary duties of brokers (as opposed to dealers[cxvii]) were widely known. As summarized by Cheryl Goss Weiss, in contrasting the duties of an broker vis-à-vis a dealer:

> By the early twentieth century, the body of common law governing brokers as agents was well developed. *The broker, acting as an agent, was held to a fiduciary standard* and was prohibited from self-dealing, acting for conflicting interests, bucketing orders, trading against customer orders, obtaining secret profits, and hypothecating customers' securities in excessive amounts -- all familiar concepts under modern securities law. Under common law, however, a broker acting as principal for his own account, such as a dealer or other vendor, was by definition not an agent and owed no fiduciary duty to the customer. The parties, acting principal to principal as buyer and seller, were regarded as being in an adverse contractual relationship in which agency principles did not apply.[cxviii] [*Emphasis added.*]

The non-imposition of fiduciary duties upon dealers was further explained by Matthew P. Allen:

> At the time the '34 Act was passed, broker-dealers performed clearly defined functions, which are defined under the Act: a 'broker' 'effected transactions in securities for the accounts of others,' while a 'dealer' bought and sold securities for his own account. Brokers filled a customer's buy order by going into the market and purchasing designated securities 'from an exchange specialist or an over-the-counter marketmaker.' As such, *courts treated brokers as agents of their principal customers before enactment of the '34 Act, and thus applied fiduciary principles to impose duties of care and loyalty on stockbrokers*. But 'dealers' filled a customer's order by selling the customer securities from the dealer's own inventory of securities. Thus a dealer and customer are acting at arm's-length as buyer and seller, or principal to principal, and 'were regarded as being in an adverse contractual relationship in which agency principles did not apply.' So a dealer, acting as a principal rather than an agent, owed only ordinary duties of care to the customer, not fiduciary duties.[cxix] [*Emphasis added.*]

The fact that stockbrokers were known to be fiduciaries at an early time in the history of the securities industry (when acting as brokers and not acting as dealers) should not come as a surprise. To a degree it is simply an extension of the laws of agency. One might then surmise that, if the broker provides personalized investment advice, then a logical extension of the principles of agency dictates that the fiduciary duties of the agent also extend to those advisory functions, as the scope of the agency has been thus expanded.[cxx]

Yet, not all early commentators agreed that the fiduciary duties of brokers extended to their advisory functions. As Professor Arthur B. Laby recently observed:

> One would expect a broker acting as an agent to be held to a fiduciary standard. According to both the Restatement (First) of Agency from 1933 and the Restatement (Second) from 1958, an agency relationship is a fiduciary relationship. Many early cases stated that broker-dealers owed fiduciary duties not because they served in an advisory capacity, but rather because they were entrusted as agents with the customer's cash or securities and owed a duty to carry out the customer's instructions in good faith and with due diligence. An influential study from this era entitled *The Security Markets* – prepared by a team of thirty economists and associates

> of the Twentieth Century Fund [in 1938] – stated that a broker acts as a fiduciary to a customer account when the broker has custody of the funds or securities in the account. Otherwise, a broker's liability is limited to the proper execution of the customer's orders.[cxxi]

However, on this point this author disagrees with the foregoing conclusion. *The Securities Markets* study, in fact, recognized that a broker "exercises, to some extent, the function of an investment counsel" and recommended that "a condition should be created where the conflict of interest between broker and customer is reduced to a minimum."[cxxii]

Indeed, there are numerous cases which apply fiduciary duties upon brokers due to their custody of customer's cash or securities[cxxiii] or the existence of discretion over a customer's account, either *de jure* discretion or through the exercise of "control" (*de facto* discretion). These types of cases, however, are not the primary focus of this article. Rather, this inquiry seeks out those decisions which impose fiduciary status upon brokers due, at least in part, to the advice which is provided and the resulting relationship of trust and confidence which thereby exists.

Yet, some modern commentators have stated that the mere furnishing of advice by a broker, without more, does not give rise to a fiduciary relationship between a broker and its customer. As stated by one treatise:

> The prevailing view is that the mere rendering of advice by a broker-dealer that is excluded from the definition of an investment advisers is not by itself sufficient to establish a fiduciary relationship with its customer. Most of the decisions hold that, in addition to the giving of advice, some other element must be present to establish a fiduciary relationship, such as discretionary authority, control of the account by the broker, or *the reposing of trust and confidence in the broker by the customer*. A fiduciary relationship is formed where a brokerage firm holds itself to its customer out as a fiduciary.[cxxiv]

When does, under state common law, an arms-length relationship between a broker and his or her customer become transformed into a fiduciary relationship? The answer requires an examination of the history of the stock brokerage function and early statutes and cases in which the fiduciary status of brokers was considered, when advice was provided.

In the 1934 case of *Birch v. Arnold*,[cxxv] in a case which did not appear to involve the exercise of discretion by a broker, the relationship between a client and her stockbroker was found to be a fiduciary relationship, as it was one of trust and confidence. As the court stated:

> She had great confidence in his honesty, business ability, skill and experience in investments, and his general business capacity; that she trusted him; that he had influence with her in advising her as to investments; that she was ignorant of the commercial value of the securities he talked to her about; and that she had come to believe that he was very friendly with her and interested in helping her. He expected and invited her to have absolute confidence in him, and gave her to understand that she might safely apply to him for advice and counsel as to investments … She unquestionably had it in her power to give orders to the defendants which the defendants would have had to obey. In fact, however, **every investment and every sale she made was made by her in reliance on the statements and advice of Arnold** and she really exercised no independent judgment whatever. She relied wholly on

him.[cxxvi] [**Emphasis added.**]

The Massachusetts Supreme Court held that, in these circumstances, facts "conclusively show that the relationship was one of trust and confidence"[cxxvii] and therefore the broker could not make a secret profit from the transactions for which the advice was provided.

The *Birch* decision therefore rests not upon the finding of discretion (real or *de* facto) over the account, but rather results from the finding that advice was provide in a relationship in which trust and confidence was reposed. In the 2000 case of *Patsos v. First Albany Corp.*, the Massachusetts Supreme Court discussed further the 1934 *Birch* case and other Massachusetts cases, noting that: "Read together, *Vogelaar*, *Berenson*, and *Birch* recognize that in Massachusetts a relationship between a stockbroker and a customer may be either a fiduciary or an ordinary business relationship, depending on whether the customer provides sufficient evidence to prove 'a full relation of principal and broker.'"[cxxviii] The *Patsos* court then went on discuss the decisions of other state courts, and to contrast discretionary and non-discretionary accounts:

> Courts in other States have not been of single mind whether fiduciary duties adhere in every relationship between a stockbroker and his customer … Other courts have suggested that a broker always owes his customer some fiduciary obligations …. because the relationship between a customer and stockbroker is that of principal and agent, the broker, as agent, has a fiduciary duty to carry out the customer's instructions promptly and accurately … There is general agreement, however, that the scope of a stockbroker's fiduciary duties in a particular case is a factual issue that turns on the manner in which investment decisions have been reached and transactions executed for the account …
>
> Where the account is 'non-discretionary,' meaning that the customer makes the investment decisions and the stockbroker merely receives and executes a customer's orders, the relationship generally does not give rise to general fiduciary duties … For nondiscretionary accounts, each transaction is viewed singly, the broker is bound to act in the customer's interest when transacting business for the account, but all duties to the customer cease 'when the transaction is closed' … Conversely, where the account is 'discretionary,' meaning that the customer entrusts the broker to select and execute most if not all of the transactions without necessarily obtaining prior approval for each transaction, the broker assumes broad fiduciary obligations that extend beyond individual transactions.[cxxix]

The *Patsos* court then went on to state that an account termed "non-discretionary (by written or oral agreement)" could become subject to the *control* of the stockbroker later, in which case the "trier of fact may still find that the broker assumed the fiduciary obligations associated with a discretionary account."[cxxx] This would be the equivalent of *de facto* discretion over an account, one way of finding broad fiduciary duties to exist. Then the *Patsos* court went on to explain when an advisory relationship, not involving actual nor *de facto* discretion (i.e., control over the account) may result in the assumption of broad fiduciary duties:

> **Other factors may also support a finding that a stockbroker has assumed general fiduciary obligations to a customer**. A customer's lack of investment acumen may be an important consideration, where other factors are present. *See, e.g., Broomfield v. Kosow*, 349 Mass. 749, 755, 212 N.E.2d 556 (1965); *Birch v. Arnold & Sears, Inc.*, 288 Mass. 125, 129, 136, 192 N.E. 591 (1934); *Romano v. Merrill Lynch, Pierce, Fenner &*

> *Smith,* 834 F.2d at 530, *citing Clayton Brokerage Co. v. Commodity Futures Trading Comm'n*, 794 F.2d 573, 582 (11th Cir. 1986) (trier of fact must consider "the degree of trust placed in the broker and the intelligence and personality of the customer"); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., 461 F. Supp. at 953, 954 (where customer is particularly young, old, or naive with regard to financial matters, courts are "likely" to find that broker assumed control over account). **An inexperienced or naive investor is likely to repose special trust in his stockbroker because he lacks the sophistication to question or criticize the broker's advice or judgment.** *Paine, Webber, Jackson & Curtis, Inc. v. Adams*, supra at 517. **This may be particularly true where the broker holds himself out as an expert in a field in which the customer is unsophisticated**. *See, e.g., Burdett v. Miller, 957 F.2d 1375* (7th Cir. 1992); *Paine, Webber, Jackson & Curtis, Inc. v. Adams*, supra at 517, *citing Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck*, 127 Wis. 2d 127, 145-146, 377 N.W.2d 605 (1985) (Abrahamson, J., concurring) ("**By gaining the trust of a relatively uninformed customer and purporting to advise that person and to act on that person's behalf, a broker accepts greater responsibility to that customer**"). Social or personal ties between a stockbroker and customer may also be a consideration because the relationship may be based on a special level of trust and confidence. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., 461 F. Supp. at 954.[cxxxi] [**Emphasis added.**]

The Court therefore explained the Birch holding, noting that even in cases of non-discretionary (*de jure* or *de facto*) brokerage accounts, "other factors" may lead to broad fiduciary duties imposed upon a broker. However, the *Patsos* Court noted that fiduciary duties in such instances are not imposed by courts lightly:

> **"[A] business relationship between a broker and customer does not become a general fiduciary relationship merely because an uninformed customer reposes trust in a broker who is aware of the customer's lack of sophistication**. *Cf. Broomfield v. Kosow, supra* at 755 (**catalyst in transformation of business relationship into fiduciary relationship is defendant's knowledge of plaintiff's reliance upon him**). In this respect, as others, our law is consistent with other States. *See, e.g., Hill v. Bache Halsey Stuart Shields, Inc., supra* at 824 ("A fiduciary duty . . . cannot be defined by asking the jury to determine simply whether the principal reposed 'trust and confidence' in the agent")."[cxxxii] [**Emphasis added.**]

Another 1935 judicial decision pointed out that brokers possess fiduciary obligations – which were not possessed, in contrast, by dealers in securities. "[A] stock broker may also become a stock dealer toward his customer in any one transaction, even though he has acted as broker in other transactions … **Where the course of dealings between the parties has established a relationship of customer and broker, the customer is justified in assuming that that relationship will continue, and will not become one of buyer and seller, unless he is notified by the broker of the latter's intention to change the relationship** … A broker, on the other hand, must confirm the purchase or sale to his customer at the exact price at which he himself buys or sells. He is not permitted by law to make a secret profit; nor is he permitted to supply his own stock in fulfillment of a purchase made for a customer, or take for his own account stock which he has sold for a customer … In the instant case the plaintiff was a layman, and was not fully acquainted with all the technicalities of the street or dealings on the exchange. She had a right to assume that the relationship of customer and broker, a fiduciary, would protect her, to the end that in acting for her, they would do all in their power to protect her account with them, and that in so doing she would get the full advantage of the knowledge of the defendants as such brokers in the management and care of the account. This she had a right to assume, and this she was entitled to … The law is well settled that the fiduciary relationship between the customer and broker requires full faith and confidence be given to the acts of the brokers in the belief that they would at all times be acting for their customer in all his dealings, and the plaintiff had a right to assume and to rely upon the fact that they were acting for her benefit at all times during the existence of such relationship."[cxxxiii]

In another early case, from 1938, the customer, "untrained in business – she had been a domestic servant for years – was susceptible to the defendant's influence, trusted him implicitly …." The court stated: "We are persuaded from the facts of the case that a trust relationship existed between the parties … The [broker] argues that he was not a trustee but a broker only. This argument finds little to support it in the testimony. **He assumed the role of financial guide and the law imposed upon him the duty to deal fairly with the complainant even to the point of subordinating his own interest to hers.** This he did not do. He risked the money she entrusted to him in making a market for hazardous securities. He failed to inform her of material facts affecting her interest regarding the securities purchased. He consciously violated his agreement to maintain her income, and all the while profited personally at the complainant's expense. Even as agent he could not gain advantage for himself to the detriment of his principal."[cxxxiv]

In a 1940 case, arising from a time when banks often acted as the sellers of securities, the facts – which so often are paralleled in modern-day broker-customer relationships, are informative. "Following the death of her husband and the receipt of his insurance money, she went to respondent bank, where she and her husband had done business. She went there for the purpose of investing the insurance money that she had received. She trusted respondent Boly, the cashier of the bank, whom she had known over a period of years, to advise and assist her in making the desired investments so that, as she said, she and her son might have some income upon which to live. Subsequently, when the investments defaulted in payment of interest, she went back to the bank to inquire the reason therefor. While the occurrence of such defaults might prompt her to question the soundness of respondent Boly's judgment, surely it was no ground for her to question the integrity of the same. She inquired the reason for the defaults in the payment of interest, and respondents, still concealing from her the fact that they had sold her bonds at par when the same were upon the market at prices much less than par, informed her both in conversations and by letter that the failure of the corporation did not necessarily mean she would lose her money, and that these reorganization plans were due entirely to the business depression. That appellant relied upon respondents' representations and believed in the integrity thereof is indicated by the fact that she continued to apply to respondent Boly for advice and continued to keep her account in the bank until … 1936 … We hold that the evidence in this case is reasonably susceptible of the conclusion that there existed a continuing confidential and fiduciary relationship between the parties …."[cxxxv]

Hence, while under the Securities Exchange Act of 1934 and FINRA rules broker-dealers are not subject to an explicit fiduciary standard, in private litigation between customers and brokers and in some arbitrations fiduciary standards are applied when a relationship of trust and confidence is found. As noted in a recent law review article, "Notwithstanding the absence of an explicit fiduciary standard, broker-dealers are subject to substantially similar requirements when they act as more than mere order takers for their customers' transactions."[cxxxvi] This appears in accord with the original intent of Franklin D. Roosevelt and the United State Congress: "Roosevelt and Congress used the 1934 Exchange Act to raise the standard of professional conduct in the securities industry from the standardless principle of caveat emptor to a 'clearer understanding of the ancient truth' that brokers managing 'other people's money' should be subject to professional trustee duties."[cxxxvii]

C. **Early Statements and Actions by the U.S. Securities and Exchange Commission**

In its 1940 Annual Report, the U.S. Securities and Exchange Commission noted: "If the transaction is in reality an arm's-length transaction between the securities house and its customer, then the securities house is not subject' to 'fiduciary duty. However, the necessity for a transaction to be really at arm's-length in order to escape fiduciary obligations, has been well stated by the United States. Court of Appeals for the District of Columbia in a recently decided case:

> '[T]he old line should be held fast which marks off the obligation of confidence and conscience from the temptation induced by self-interest. He who would deal at arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector. He cannot commingle his trusteeship with merchandizing on his own account…'"[cxxxviii]

In 1941, the SEC opined in its Seventh Annual Report:

> The preceding case [*Hope & Co.*] is one of a series of cases involving revocation of registration ordered by the Commission during the year in which fraud, arisirig out of an abuse of a fiduciary duty, has been alleged. Other cases were: *In the Matter of Commonwealth Securities, Inc.*; *In the Matter of Securities Distributors Corporation*; *In the Matter of Equitable Securities Company of Illinois*; and *In the Matter of Geo. W. Byron &: Co*. In some of these cases, including *Commonwealth Securities, Inc.* and *Securities Distributors Corporation*, the registered broker or dealer had attempted to avoid fiduciary responsibility by use of words on the confirmation intend to indicate that in the particular transaction it had not acted in a fiduciary capacity, but, in such cases, the Commission held that the form of confirmation could not alter the fiduciary character of the relationship where this was clearly established from the other facts and circumstances surrounding the transaction. The case of *Geo. W. Byron &: Co.* involved transactions in which the firm acted as agent for both parties to the transaction and accepted commissions from each without the other's knowledge and consent, which constituted an abuse of thc fiduciary responsibility to which an agent is subject. *In the Matter of Securities Distributors Corporation* involved failure of a securities firm, while acting as a fiduciary, to disclose information in its possession which the customer would wish to have in deciding whether to enter into the transaction. *In the Matter of Equitable Securities Company oj Illinois* involved a fiduciary obligation arising from a relation of trust and confidence between the customer and the securities company. In the decision in *In the Matter of Hope & Company* the Commission held:
>
> > 'A broker-dealer exercising supervision over a discretionary account is; Of course, an agent and under the principles already discussed these transactions constitute a violation of the statutory provisions cited …'
>
> and further held:
>
> > 'A broker is an agent and it is, of course, a general principle of law that an agent may not, in the absence of consent of the person whom he purports to represent, deal with such person as a principal. This is so irrespective of any

> injury or loss to the principal. It follows that when a broker-dealer represents to a customer that he is effecting a transaction as broker, and, without the knowledge or consent of the customer buys from or sell to the customer as a principal, he is making a misrepresentation of a material fact and is engaging in a fraudulent practice which violates Section 17(a) of the Securities Act, Section 15(c) of the Securities Exchange Act and Rule X-15Cl-2 thereunder.'

In this opinion the Commission quoted the following statement of the law by the Supreme Judicial Court of Massachusetts in *Hall v. Paine* [224 Mass. 62, 112 N. E. 153.]:

> 'A broker's obligation to his principal requires him to secure the highest price obtainable, while his self-interest prompts him to buy at the lowest possible price … The law does not trust human nature to be exposed to the temptations likely: to arise out of such antagonistic duty and influence. This rule applies even though the sale may be at auction and in fact free from any actual attempts to overreach or secure personal advantage, and where the full market price has been paid and no harm resulted * * *'"[cxxxix]

The SEC also summarized a court decision finding that the furnishing of investment advice by a broker was a "fiduciary function." The SEC stated: "In the *Stelmack* case the evidence showed that the firm obtained lists of holdings from certain customers and then sent to these customers analyses of their securities with recommendations listing securities to be retained, to be disposed of, and to be acquired … The [U.S. Securities and Exchange] Commission held that the conduct of the customers in soliciting the advice of the firm, their obvious expectation that it would act in their best interests, their reliance on its recommendations, and the conduct of the firm in making its advice and services available to them and in soliciting their confidence, pointed strongly to an agency relationship and that the very function of furnishing investment counsel constitutes a fiduciary function."[cxl]

The SEC also "has held that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship exists, imposing a particular duty to act in the customer's best interests and to disclose any interest the broker-dealer may have in transactions he effects for his customer … [BD advertising] may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business … Where the relationship between the customer and broker is such that the former relies in whole or in part on the advice and recommendations of the latter, the salesman is, in effect, an investment adviser, and some of the aspects of a fiduciary relationship arise between the parties." 1963 SEC Study, citing various SEC Releases.

The SEC has also opined: "[T]he merchandising emphasis of the securities business in general, and its system of compensation in particular, frequently impose a severe strain on the legal and ethical restraints."[cxli]

D. **Early FINRA (formerly known as NASD) Statements**

Prior to FINRA's creation the necessity for high standards of conduct for brokers was noted in the courts: "The ethical standards of the exchange are perforce the ethical standards of its members. Its standards rise no higher and sink no lower than their standards. It is the member who must create and maintain high standards if he would permanently succeed, because his is a fiduciary relation to his customers. So that if the practices of any proposed customer are distasteful to the broker member he must correct such practices, not the exchange."[cxlii]

In 1938 the Maloney Act authorized the creation of the self-regulatory organization for broker-dealers. The SEC clearly understood that the goal of the Maloney Act was to create a true profession, bound by fiduciary standards … in 1938, the Assistant General Counsel of the SEC stated that the "Commission has concluded that the next stage in the job – *the job of raising the standards of those on the edge to the level of the standards of the best* – can best be handled … by placing the primarily responsibility on the organized associations of securities dealers throughout the country."[cxliii] [*Emphasis added.*]

The theme of continually raising the standards of the industry was repeated in a speech by SEC Commissioner George C. Matthews, shortly after the Maloney Act was passed in Congress, in which he stated, "Ideally, the industry should eventually play the predominant role in its own regulation and development ... It should in the largest possible measure achieve that ideal under democratic institutions which Josiah Royce described as the forestalling of restraint by self-restraint … I wish to re-emphasize the evolutionary character of the program provided for in the [Maloney] Act … it is our hope … that the work of construction [of regulation] will continue through the years until there shall finally have been erected a professional edifice commensurate with the importance of the investment banking and over-the-counter securities businesses in our national economy."[cxliv]

Even Senator Francis Maloney, for whom the Maloney Act of 1938 was named, stated that the Maloney Act had, as its purpose, "the promotion of truly professional standards of character and competence."[cxlv]

By 1940 the NASD had been formed. In an opinion issued by this self-regulatory organization for broker-dealers, in only its second newsletter to members, the NASD unequivocally pronounced that brokers were fiduciaries: "Essentially, a broker or agent is a fiduciary and he thus stands in a position of trust and confidence with respect to his customer or principal. He must at all times, therefore, think and act as a fiduciary. He owest his customer or principal complete obedience, complete loyalty, and the exercise of his unbiased interest. The law will not permit a broker or agent to put himself in a position where he can be influenced by any considerations other than those to the best interests of his customer or principal … A broker may not in any way, nor in any amount, make a secret profit … his commission, if any, for services rendered … under the Rules of the Association must be a fair commission under all the relevant circumstances."[cxlvi]

In a later newsletter, the NASD, in discussing the decisions of two cases, the NASD wrote that it was "worth quoting" statements from the opinions: "In relation to the question of the capacity in which a broker-dealer acts, the opinion quotes from the Restatement of the law of Agency: 'The understanding that one is to act primarily for the benefit of another is often the determinative feature in distinguishing the agency relationship from others. *** The name which the parties give the relationship is not determinative.' And again: 'An agency may, of course, arise out of correspondence and a course of conduct between the parties, despite a subsequent allegation that the parties acted as principals.'"[cxlvii]

The self-regulatory association for broker-deaers has also noted that a *dealer* in securities was not a fiduciary, but rather a merchant, stating: "A member when acting as a dealer or principal in a transaction with a customer is acting essentially as a merchant, buying or selling securities for himeself, for his own account, and like all merchants, hoping to make a profit of the difference between the price at which he buys or has bought for himself and the price at which he sells for himself. A member when acting as a dealer or principal is thus not subject to the common law principles of agency which apply to a broker, but a dealer must at all times make it clear to his customer that he is acting as a dealer or principal, if that is the fact. *He must be ever careful in such transactions not to make misrepresentations, directly or indirectly, with respect to the particular security being purchased or sold*, and he must buy from or sell to his customer at a price which is fair…."[cxlviii]

When Chairman Benjamin Howell Griswold, Jr., called to order the first meeting of the NASD Board of Governors, he described the Association as a "worthwhile experiment" that would succeed only through "coordinated effort, careful study, good will, and hard thinking." "If you do succeed," he told the Board, "then both the Securities and Exchange Commission and yourselves are entitled to the credit for the development of a plan that may tend more than anything else to restore confidence, remove the legal obstacles that now alarm you, and re-establish the capital issues market of this country."[cxlix]

E. **Impact of the Investment Advisors Act of 1940**

In the 1930's, investment advisers (often called "investment counselors" at the time) were "viewed as providing investment advice and counsel to what were perceived as largely less knowledgeable retail customers. Investment advisers therefore were envisioned as having superior knowledge than, and thus greater responsibility for, their customers."[cl]

When the Investment Advisers Act of 1940 was enacted, early cases and speeches from the U.S. Securities and Exchange Commission (SEC) clearly stated the SEC's belief that the new legislation imposed fiduciary status upon all those required to register as investment advisers (or representatives thereof).

In the seminal case 1963 of *SEC v. Capital Gains* the U.S. Supreme Court confirmed this longstanding understanding, when it construed Advisers Act Sections 206(1) and (2) as establishing a federal fiduciary standard governing the conduct of advisers.[cli]

More recently, the SEC has expressed its view that Sections 206(1) and (2) of the Investment Advisers Act of 1940 sections 206(1) and (2) incorporate the common law principles of fiduciary duties.[clii]

The clear application of fiduciary duties has important implications for investment advisers. While investment advisors governed by the Investment Advisers Act of 1940 are not subject to the strict "sole interests" fiduciary standard imposed by trust law[cliii] and by ERISA (when investment advisers are not subject to ERISA's provisions), they are required by the courts to act in the "best interests" of their advisory clients. Under the "best interest" fiduciary standard, an adviser may possess certain conflicts of interest and thereby benefit from a transaction with or by a client, but the transaction must be fully disclosed in a manner which ensures client understanding, and client must provide informed consent to the proposed transaction, and even then the transaction must remain substatively fair to the client (i.e., the client should not be harmed). In addition, a broad range of other fiduciary duties are imposed upon investment advisers.

However, it should be emphasized that the Advisers Act, while providing an exemption from the application of the Advisers Act to broker-dealers in certain circumstances, did <u>not</u> overturn state common law principles which had already held that brokers (and their registered representatives), when in a relationship of trust and confidence with their client, are also fiduciaries. Brokers may have been exempted under the Advisers Act from *registration* as investment advisers; but this exemption did not, either expressly or by inference, negate the fiduciary status of brokers when they developed relationships of trust and confidence with their clients.

It should also be noted that the federal securities acts of the 1930's and 1940 did not preempt state common law. In fact, it should be noted that that breach of fiduciary duty arising under state common law is now the most commonly asserted complaint by consumers in arbitration proceedings against brokers and dual registrants, and has been for the past five years. Hence, brokers are subject to state law fiduciary claims, at least in many of the various states.

F. **Conclusion**

In many of the states, brokers have long been in a fiduciary relationship with their clients, when providing personalized investment advice. Many early and recent judicial decisions (not explored herein) support this conclusion.

Yet there remain differences among the states as to when fiduciary duties are applied. The beauty of the Dodd Frank Act is its provision of authority to the SEC to ensure uniform application of the fiduciary standard, upon brokers, when they are in relationships of trust and confidence with their clients – i.e., while they are providing personalized investment advice. The beauty of Dodd Frank Act lies in the grant of authority to the SEC to return all brokers, when providing personalized investment advice, to be bound by a clear elicitation of the "best interests" fiduciary standard of conduct.

In so doing, the SEC can accomplish the establishment of a true profession.

END NOTES:

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[i] **Current members of the Steering Group of THE COMMITTEE FOR THE FIDUCIARY STANDARD include:**

(Chair) **Ron A. Rhoades, JD, CFP®**, Program Director for the Financial Planning Program at Alfred State College, Alfred, New York, where he teaches financial planning and investment courses as well as business law. He is also the President of ScholarFi, Inc., an investment advisory firm. He served as Reporter for the Financial Planning Association's (FPA's) Fiduciary Task Force and its Standards of Conduct Task Force. Rhoades previously served on the Board of Directors for the National Association of Personal Financial Advisors (NAPFA), where he also chaired its Ethics Committee. In 2013 he was named as one of the "30 Most Influential" persons in NAPFA's 30-year history. Frequently quoted in the national media, Rhoades is the author of several books and many articles on investment theory, portfolio construction, tax and estate planning, and fiduciary law.

Blaine Aikin, AIFA®, CFA, CFP® is President and CEO of fi360, whose mission is to provide training, tools, and resources to support and promote a culture of fiduciary responsibility. He is the author of the monthly "Fiduciary Corner" column in *InvestmentNews* magazine. Aiken has held leadership positions in public and private sector financial management, including as Budget Officer for Prince William County, VA, Chief Investment Officer of Allegiance Financial Advisors, and Senior Vice President and Director of Product Development and Management for PNC Advisors. He holds the AIFA, CFA, and CFP® professional designations and a Masters of Public Policy and Management from Carnegie-Mellon University.

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[ii] The Committee for the Fiduciary Standard's sole objectives are to ensure that any financial reform regarding the fiduciary standard: (1) meets the requirements of the authentic fiduciary standard, as presently established in the Investment Advisers Act of 1940; and (2) covers all professionals who provide investment and financial advice or who hold themselves out as providing financial or investment advice, without exceptions and without exemptions. The Committee is composed solely of volunteers, and plans to disband following the current implementation of rule-

making relating to the fiduciary standard of conduct by the SEC under the Dodd Frank Act and by the U.S. Dept. of Labor under ERISA.

[iii] U.S. courts have in large part adopted the view of fiduciary obligations as resting upon "the triads of their fiduciary duty—good faith, loyalty or due care." *See In re Alh Holdings LLC*, 675 F.Supp.2d 462, 477 (D. Del., 2009).

[iv] 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:

> 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. [*Emphasis added*.]

[v] Disclosure, in and of itself, does not negate a fiduciary's duties to his or her client. As stated in an 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*." *Rocky Mountain Financial Planning, Inc*. (pub. avail. March 28, 1983). [*Emphasis added*.] *See also* Exhibit A to our comment letter, discussing *SEC vs. Capital Gains Research Bureau* and how the language of that decision, with respect to disclosure, has often been misconstrued.

[vi] "Alexander Hamilton once said: 'The best security for the fidelity of men, is to make interest coincide with duty.' A fiduciary is not allowed to put himself in a position where his interest and his duty conflict. Accordingly, a fiduciary is disentitled from making a profit out of his position. The concept is that powers are a species of property, which can be owned beneficially by one person, while exercised by another on his behalf. Any profits gained through the use of those powers are deemed to accrue to the beneficial owner." Cheryl Goss Weiss, A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty, 23 Iowa J. Corp. L. 65, 69 (1997).

[vii] The Advisers Act's jurisprudence has developed, over time, a federal fiduciary standard, in order to effect a uniform application of its requirements throughout the States. Advisers Act §206 establishes "federal fiduciary standards" to govern the conduct of investment advisers, *Transamerica Mortgage Advisors, Inc. v. Lewis,* 444 U.S. 11; 100 S. Ct. 242; 62 L. Ed. 2d 146; 1979 U.S. LEXIS 150; Fed. Sec. L. Rep. (CCH) P97,163; *Santa Fe Industries, Inc. v. Green*, supra, at 471, n. 11; Burks v. Lasker, 441 U.S. 471, 481-482, n. 10; *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192.

[viii] "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, to the extent not in conflict therewith, the analysis of fiduciary principles continues to be informed by state common law. *See, e.g., U.S. v. Brennan, 938 F.Supp. 1111 (E.D.N.Y., 1996) , citing 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*

The 3rd Circuit recently opined further on the interrelationship between federal and state law, in applying the federal fiduciary standard:

> "Because of the federal fiduciary standard, some courts dealing with private causes of action alleging fiduciary breach by investment advisers have relied on federal, rather than state, common law. *See Laird v. Integrated Res., Inc.*, 897 F.2d 826, 837 (5th Cir. 1990) ("The Supreme Court has recognized the investment advisers' fiduciary status. Courts may refer to [its] cases instead of state analogies in deciding whether this

status prohibits particular conduct."); *see also id*. ("[C]oncerning entanglement with state law, because our holding encompasses a developed federal standard, it does not require reference to state corporate and securities law or the state law of fiduciary relationships."); *State ex rel. Udall v. Colonial Penn Ins. Co*., 112 N.M. 123, 812 P.2d 777, 785 (N.M. 1991) (citing Capital Gains Research, and applying the standard set forth therein, in ruling on a state law claim for breach of fiduciary duty against an investment adviser); *cf. Douglass v. Beakley*, ___ F. Supp.2d ___, 2012 U.S. Dist. LEXIS 152765, 2012 WL 5250566, *11 & n.16 (N.D.Tex., Oct. 24, 2012) (citing Texas law for breach of fiduciary duty claims, but noting that the Supreme Court in *Transamerica* recognized "that Section 206 of the IAA "establishes federal fiduciary standards to govern the conduct of investment advisers" (citing Transamerica, 444 U.S. at 17)); *but cf. In the Matter of O'Brien Partners, Inc*., S.E.C. Release No. 7594, 88 S.E.C. Docket 615, 1998 SEC LEXIS 2318, 1998 WL 744085, *9 n.20 (Oct. 27, 1998) (noting that respondent "owed a fiduciary duty to its clients, both as a financial advisor and as an investment adviser[,]" and adding by footnote that "[i]n addition to its duties under the Advisers Act, relevant state law also imposed a fiduciary duty on [respondent]," with citations to Wisconsin and California law). Among other benefits, following the federal fiduciary standard has as the particular virtue that, "because state law is not considered, uniformity is promoted." *Laird*, 897 F.2d at 837.

Belmont v. MB Inv. Partners, Inc., 708 F.3d 470 (3RD Cir. 2013); 2013 U.S. App. LEXIS 3732; Fed. Sec. L. Rep. (CCH) P97, 297.

[ix] See comment letter of Harold Evensky, Evensky & Katz Wealth Management, dated March 8, 2013, available at http://www.sec.gov/comments/4-606/4606-2984.pdf, stating in part:

> I would suggest that the Commission consider, in conjunction with any other criteria and guidelines it may develop, requiring anyone providing personalized investment advice to commit to a simple "mom-and-pop" statement describing the adviser's responsibility. The criterion for determining when this statement would be required is also simple; it is the "you" standard.
>
> > ***The 'You' Standard***
> >
> > If a prospective client calls an adviser and says "I would like to buy xx shares of YYY". No problem, the adviser would be subject to a suitability standard.
> >
> > If a prospective client calls an adviser and says "I'm thinking of buying YYY, what does your firm think of the stock?" Again, no problem, the adviser would be subject to a suitability standard.
> >
> > However, if the prospect then says "That sounds good, do you think I should buy YYY?" and the adviser responds "yes, I think YYY would be a good investment for YOU," he or she would then be held to a fiduciary standard and required to provide the client with the Mom-and-Pop commitment.
>
> The obvious point is, as soon as an adviser uses the term "you" in a recommendation, he or she is no longer acting under a suitability standard. Trust is absolute; therefore, once a relationship of trust has been established and personalized advice has been provided; all subsequent business would be under a fiduciary standard.

At all times the relationship between the describer of the investment security and the customer should remain an impersonal one and no formation of a relationship of trust and confidence, and no overreaching, should occur. *See, e.g., Lowe v. SEC*, 472 U.S. 181 (1985) ("The dangers of fraud, deception, or overreaching that motivated the enactment of the [Advisers Act] are present in personalized communications … As long as the communications between petitioners and their subscribers remain entirely impersonal and do not develop into the kind of fiduciary, person-to-person relationships that were discussed at length in the legislative history of the Act and that are characteristic of investment adviser-client relationships, we believe the publications are, at least presumptively, within the exclusion and thus not subject to registration under the Act.") *Id*. at 210.

[x] In the SEC Staff's January 2011 study, the SEC staff noted that "Minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor." SEC Staff Study at p.vii.

We do not suggest that providing stock analyst research reports or a list of all buy and sell recommendations made by a firm to a broad group of clients would constitute personalized investment advice. However, if a broker or its registered representative undertakes a personal, one-on-one communication to a client with a purchase or sale recommendation, such would constitute personalized investment advice.

[xi] Generally, the investment adviser is a professional, and as such accepts restraint on his, her or its conduct as a result of acceding to fiduciary status. As stated early on by Adam Smith, the founder of modern capitalism: "Our

continual observations upon the conduct of others insensibly lead us to form to ourselves certain general rules concerning what is fit and proper either to be done or to be avoided." Adam Smith, of Moral Sentiments 229 (E.G. West ed. 1969). The domain of the investment counselor has previously been described as the "investment advisory profession. *Lowe v. SEC*, 472 U.S. 181, 229 (1985) (White, J., dissenting opinion). 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. *Id*. Early on, 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." *Lowe v. SEC*, 472 U.S. 181 (1985), fn. 38. [*Emphasis added*.] Moreover, the U.S. Securities and Commission's report which led to the adoption of the Advisers Act "stressed the need to improve the *professionalism* of the industry, both by eliminating tipsters and other scam artists and by emphasizing the importance of unbiased advice, which spokespersons for investment counsel saw as distinguishing their profession from investment bankers and brokers." SEC Staff, "Study on Investment Advisers and Broker Dealers" (Jan. 21, 2011), citing Investment Trusts and Investment Companies: Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 477 at 27-30 (1939). [*Emphasis added*.]

[xii] The U.S. Securities and Exchange Commission's early comments regarding the necessity for imposition of fiduciary duties on those who provide investment advice upon learning the details of a client's financial affairs should not go unnoticed: "The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice 'in almost every instance.' This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients." *In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

[xiii] The SEC has acknowledged that the Advisers Act is a "principles-based" regulatory regime, rather than one based upon rules. In 2008, the Director of the SEC's Division of Investment Management, who is responsible for implementation of the provisions of the Investment Advisers Act, noted, for example: "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, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Keynote Address at the 9th Annual International Conference on Private Investment Funds (Mar. 10, 2008), available at http://www.sec.gov/news/speech/2008/spch031008adj.htm. Hence, while certain aspects of these proposed rules seek to elicit the parameters of the fiduciary obligation, for the guidance and benefit of both fiduciaries and their clients, the setting forth of specific principles should not be interpreted to limit, in any way, the broad fiduciary principles which continue to apply to those investment advisers and brokers, and their representatives, who provide personalized investment advice.

[xiv] "The duty of loyalty requires an adviser to serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.22 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.), *citing Transamerica Mortgage Advisors, Inc*., 444 U.S. 11, 17 (1979).

See also Amendments to Form ADV, Release No. IA-3060 (July 28, 2010) (ADV Release) at 3: "Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients…." See also Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Release Nos. 34-58264; IC-28345 (July 30, 2008) (2008 Proposed Director Guidance on Soft Dollars), at n. 64: "Under sections 206(1) and (2), in particular, an adviser must discharge its duties in the best interest of its clients…."

"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).

[xv] *See SEC vs. Capital Gains Research Bureau*, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963) ("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 clients." *Id.* at 194.)

"Duty to Act in Good Faith: An adviser must –

Act honestly toward clients with candor and utmost good faith.

Examples of this might include –

- being truthful and accurate in all communications and disclosures
- being forthright about issues, mistakes and conflicts of interest
- providing fund directors with all information in the adviser's possession that reasonably bears on a board decision, particularly where the adviser has a personal interest in the outcome or similar conflict of interest

Treat clients fairly.

Examples of this might include –

- avoiding favoritism of one client or group of clients over another in handling investment opportunities and trade allocations
- adopting investment opportunity and trade allocation procedures and applying them consistently over time so that no client or group of clients is systematically disadvantaged
- allocating shared costs across accounts using a rational methodology applied consistently over time
- seeking a fair and prompt resolution of all legitimate client complaints"

Lorna A. Schnase, An Investment Adviser's Fiduciary Duty (Aug. 1, 2010), at p.5, available at http://www.40actlawyer.com/Articles/Link3-Adviser-Fiduciary-Duty-Paper.pdf.

In the corporate context, one court explained: "A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient." *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006) at text surrounding footnote 26 (footnote omitted). This same court concluded that the duty of good faith is essentially a subset of the duty of loyalty.

[xvi] *See SEC vs. Capital Gains Research Bureau*, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963) ("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 clients." *Id.* at 194.)

[xvii] "[I]nvestment advisers are prohibited under Advisers Act Sections 206(1) and (2) from making any communications to clients that are misleading." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.30 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

See also SEC vs. Capital Gains Research Bureau, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963) ("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 clients." *Id.* at 194.)

[xviii] In *Bayer v. Beran*, 49 N.Y.S.2d 2, Mr. Justice Shientag said: "The fiduciary has two paramount obligations: responsibility and loyalty. * * * They lie at the very foundation of our whole system of free private enterprise and are as fresh and significant today as when they were formulated decades ago. * * * While there is a high moral purpose implicit in this transcendent fiduciary principle of undivided loyalty, it has back of it a profound understanding of human nature and of its frailties. It actually accomplishes a practical, beneficent purpose. It tends to prevent a clouded conception of fidelity that blurs the vision. It preserves the free exercise of judgment uncontaminated by the dross of divided allegiance or self-interest. It prevents the operation of an influence that may be indirect but that is all the more potent for that reason."

[xix] "[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).

[xx] *See In the Matter of Dawson-Samberg Capital Management, Inc., Now Known as Dawson-Giammalva Capital Management, Inc. and Judith A. Mack*, Advisers Act Release No. 1889 (August 3, 2000), *citing SEC vs. Capital Gains Research Bureau*, 375 U.S. at 191-92.

"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 Research Bureau* at 187.

In its recent Study, the SEC Staff recommended that the "Commission should consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.118 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

"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). As Professor Cain has more recently stated in a public appearance, "It does not appear that sunlight is the best disinfectant, after all." (Fiduciary Forum, Washington, D.C., Sept. 2010).

"Disclosure forms the central focus of most of the federal securities laws … From a behavioral perspective, however, disclosure risks confusing investors already suffering from bounded rationality, availability and hindsight." Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC (2003), at pp. 69-70.

In recognition of the extreme conflicts of interest present, and the potential for abuse, the SEC generally prohibits "performance fees" being charged by registered investment advisers. "Generally, investment advisers that are registered or required to be registered with the Commission are prohibited by Advisers Act Section 205(a)(1) from entering into a contract with any client that provides for compensation based on a share of the capital gains or appreciation of a client's funds, i.e., a performance fee. Section 205(a)(1) is designed, among other things, to eliminate 'profit sharing contracts [that] are nothing more than 'heads I win, tails you lose' arrangements,' and that 'encourage advisers to take undue risks with the funds of clients,' to speculate, or to overtrade. There are several exceptions to the prohibition, mostly applicable to advisory contracts with institutions and high net worth clients."
SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.41-2 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

"The federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest. For example, FINRA rules generally prohibit a member with certain 'conflicts of interest' from participating in a public offering, unless certain requirements are met. FINRA members also may not provide gifts or gratuities to an employee of another person to influence the award of the employer's securities business. FINRA rules also generally prohibit a member's registered representatives from borrowing money from or lending money to any customer, unless the firm has written procedures allowing such borrowing or lending arrangements and certain other conditions are met. Moreover, the Commission's Regulation M generally precludes persons having an interest in an offering (such as an underwriter or broker-dealer and other distribution participants) from engaging in specified market activities during a securities distribution. These rules are intended to prevent such persons from artificially influencing or manipulating the market price for the offered security in order to facilitate a distribution." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.58-9 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) (Citations omitted.) "FINRA rules also establish restrictions on the use of non-cash compensation in connection with the sale and distribution of mutual funds, variable annuities, direct participation program securities, public offerings of debt and equity securities, and real estate investment trust programs. These rules generally limit the manner in which members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible." *Id.* at p.68.

See also Thorp v. McCullum, 1 Gilman (6 Ill.) 614, 626 (1844) ("The temptation of self interest is too powerful and insinuating to be trusted. Man cannot serve two masters; he will foresake the one and cleave to the other. Between two conflicting interests, 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.")

[xxi] "FINRA rules also establish restrictions on the use of non-cash compensation in connection with the sale and distribution of mutual funds, variable annuities, direct participation program securities, public offerings of debt and equity securities, and real estate investment trust programs. These rules generally limit the manner in which members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p. 68 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) (Citations omitted.)

[xxii] "[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) (a case involving a conflict of interest arising out of principal trading). *See also, e.g.,* General Instructions for Part 2 of Form ADV: "Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship." *Id., at* #3. In fact, the SEC requires registered investment advisers to undertake a broad variety of affirmative disclosures, well beyond disclosures of conflicts of interest, and many of these disclosures are required to be found in Form ADV, Parts 1 and 2A and 2B. Part 2A requires information about the adviser's range of fees, methods of analysis, investment strategies and risk of loss, brokerage (including trade aggregation policies and directed brokerage practices, as well as use of soft dollars), review of accounts, client referrals and other compensation, disciplinary history, and financial information, among other matters.

SEC Staff recently noted that under the "antifraud provisions of the Advisers Act, an investment adviser must disclose material facts to its clients and prospective clients whenever the failure to do so would defraud or operate as a fraud or deceit upon any such person. The adviser's fiduciary duty of disclosure is a broad one, and delivery of the adviser's brochure alone may not fully satisfy the adviser's disclosure obligations." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.23 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

Disclosure must be full and frank: "If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all its start significance." *See* "Will the Investment Company and Investment Advisory Industry Win an Academy Award?" remarks of Kathryn B. McGrath, Director of the SEC Division of Investment Management, at the 1987 Mutual Funds and Investment Management Conference, citing Scott, The Fiduciary Principle, 37 Calif. L. Rev. 539, 544 (1949).

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

A material fact is "anything which might affect the (client's) decision whether or how to act." *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 227 Va. 441 (Va., 1984). 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).

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.

The standard of materiality is whether a reasonable client or prospective client would have considered the information important in deciding whether to invest with the adviser. *See SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992).

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

See also RESTATEMENT (THIRD) OF AGENCY, §8.06(1):

(1) Conduct by an agent that would otherwise constitute a breach of duty … 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 reasonabley affect the principal's judgment …

(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.

[xxiv] *See SEC vs. Capital Gains Research Bureau*, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963) ("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 clients." *Id.* at 194.)

[xxv] The duty to disclose is an affirmative one and rests with the advisor alone. Clients do not generally possess a duty of inquiry. *See, e.g.,* SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.117 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) "The [SEC} Staff believes that it is the firm's responsibility—not the customers'—to reasonably ensure that any material conflicts of interest are fully, fairly and clearly disclosed so that investors may fully understand them."

As stated in an early case applying the Advisers Act: "It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge material facts to the ones whose interests she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure. The statutes and rules discussed above make it unlawful to omit to state material facts irrespective of alleged (or proven) willingness or readiness to supply that which has been omitted." *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir., 1949).

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

"The adviser's fiduciary duty of disclosure is a broad one, and delivery of the adviser's brochure alone may not fully satisfy the adviser's disclosure obligations." SEC Staff Study (Jan. 2011), p.23, *citing see* Instruction 3 of General Instructions for Part 2 of Form ADV; Advisers Act Rule 204-3(f); *also citing see also* Release IA-3060.

Disclosures of fees, costs, risks and other material facts, far in advance of specific investment recommendations, such as those found upon the initial delivery of Form ADV, Part 2A, would not meet the requirement of undertaking affirmative disclosure in a manner designed to ensure client understanding. We suggest that the Commission re-explore the delivery of point-of-recommendation disclosures, for recommendations of pooled investment vehicles of any form, in order to provide all fiduciary advisors with the benefit of a provisional safe harbor for disclosures. However, to be meaningful and operable as a full disclosure of all material facts, such a disclosure form, if adopted, should incorporate an estimate of all of the fees and costs attendant to pooled investment vehicles, such as brokerage commissions and other transactional costs within the fund which are not included in the fund's annual expense ratio.

We also recommend that the SEC's Division of Investment Management replace the currently misleading computational method of "portfolio turnover" within a fund, in which funds are permitted to report the lesser of purchases or sales of securities in relation to the fund's net assets, to a more accurate method in which purchases and sales of securities within a fund are averaged; it is currently conceivable that a fund with significant inflows or outflows report a "zero" portfolio turnover in its filings, when in fact substantial purchases and sales within a fund exist.

[xxvii] 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.*] *In re the Matter of Arleen Hughes*, SEC Release No. 4048 (1948).

The extent of the disclosure required is made clear by cases applying the fiduciary standard of conduct in related professional advisory contexts, such as the duties imposed upon an attorney with respect to his or her client: "The fact that the client knows of a conflict is not enough to satisfy the attorney's duty of full disclosure." *In re Src Holding Corp*., 364 B.R. 1 (D. Minn., 2007). "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]*.") *Florida Ins. Guar. Ass'n Inc. v. Carey Canada, Inc*., 749 F.Supp. 255, 259 (S.D.Fla.1990) [*emphasis added*], *quoting Unified Sewerage Agency, Etc. v. Jeko, Inc*., 646 F.2d 1339, 1345-46 (9th Cir.1981)); "*[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*." *In re Src Holding Corp*., 364 B.R. 1, 48 (D. Minn., 2007) [*emphasis added*].

The burden of affirmative disclosure rests with the professional advisor; constructive notice is insufficient. *See also British Airways, PLC v. Port Authority of N.Y. and N.J*., 862 F.Supp. 889, 900 (E.D.N.Y.1994) (stating that the burden is on the client's attorney to fully inform and obtain consent from the client); *Kabi Pharmacia AB v. Alcon Surgical, Inc*., 803 F.Supp. 957, 963 (D.Del.1992) (stating that evidence of the client's constructive knowledge of a conflict would not be sufficient to satisfy the attorney's consultation duty); *Manoir-Electroalloys Corp. v. Amalloy Corp*., 711 F.Supp. 188, 195 (D.N.J.1989) ("Constructive notice of the pertinent facts is not sufficient."). A client of a fiduciary is not responsible for recognizing the conflict and stating his or her lack of consent in order to avoid waiver. *Manoir-Electroalloys*, 711 F.Supp. at 195.

[xxviii] 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." Frankel, Tamar, Fiduciary Law, 71 Calif. L. Rev. 795 (1983). [*Emphasis added.*].

[xxix] "The duty of loyalty requires an adviser to serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own." SEC Staff Study, January 2011, at p.22, *citing see, e.g.,* Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106 (Jan. 31, 2003 ("Release 2106"); *also citing* Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) ("Release 3060").

[xxx] The Commission recently characterized this as an adviser's obligation "not to subrogate clients' interests to its own." ADV Release, at 3. *See also* "Without Fiduciary Protections, It's 'Buyer Beware' for Investors," Press Release issued by the Investment Adviser Association, et al., June 15, 2010, available at: http://www.financialplanningcoalition.com/docs/assets/3C7AB96C-1D09-67A1-7A3E526346D7A128/JointFOFPressRelease-ConferenceCommitteeFINAL6-15-10.pdf.

[xxxi] While a broader elicitation of the duty of due care could be undertaken, the focus of this comment letter is on a fiduciary's duties of loyalty and utmost good faith, given that these are the distinguishing characteristics of the fiduciary relationship. Nevertheless, we relate some general guidance as to the duty of due care, hereafter.

Under the Advisers Act, the SEC Staff recently interpreted the fiduciary duty of care to require the investment adviser to "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.22 and p.27 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.), *citing*, *see*, Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052 (July 14, 2010) ("Release 3052") at 119.

However, we note that SEC Staff has recommended that more guidance be provided in this area:

> "The [SEC] Staff believes that the Commission, through rulemaking, guidance, or both, should specify the minimum professional obligations of investment advisers and broker-dealers under the duty of care. In evaluating the regulation of investment advisers and broker-dealers, the Staff believes that it could be useful to develop rules or guidance on the minimum requirements that are fundamental to a duty of care under the uniform fiduciary standard." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.122 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

> "Professional standards under the duty of care could be developed regarding the nature and level of review and analysis that broker-dealers and investment advisers should undertake when making recommendations or otherwise providing advice to retail customers. The Commission could articulate and harmonize any such standards, by referring to and expanding upon, as appropriate, the explicit minimum standards of conduct relating to the duty of care currently applicable to broker-dealers (e.g., suitability (including product-specific suitability), best execution, and fair pricing and compensation requirements) under Commission and SRO rules." *Id.* "Any such rules or guidance could take into account long-held Advisers Act fiduciary principles, such as the duty to provide suitable investment advice (e.g., with respect to specific recommendations and the client's portfolio as a whole) and to seek best execution. Detailed guidance in this area has not been a traditional focus of the investment adviser regulatory regime." *Id.* at 123.

We suggest that the duty of due care has been articulated in similar fiduciary contexts, such as those arising under ERISA and under the Prudent Investor Rule applicable to trustees.

While the articulation of the duty of due care under the Advisers Act has not been elicited to a large degree by the courts or through administrative decisions or rules, we suggest that the SEC could look to the duty of due care as it is similarly applied under ERISA. While the duty of loyalty under ERISA is a "sole interests" standard (rather than the "best interests" standard applicable under the Advisers Act), it is possible to maintain consistency between the DOL and SEC regulatory regimes by adopting a common duty of due care. We refer the SEC to the following summary of the duty of due care found under ERISA:

> The duty of prudence mandated by § 1104(a)(1)(B) "is measured according to the objective prudent person standard developed in the common law of trusts." *LaScala v. Scrufari*, 479 F.3d 213, 219 (2d Cir. 2007) (quotation marks omitted). Under that common-law standard, and consistent with ERISA's instruction that fiduciaries act in a prudent manner "under the circumstances then prevailing," 29 U.S.C. § 1104(a)(1)(B), "[w]e judge a fiduciary's actions based upon information available to the fiduciary at the time of each investment decision and not from the vantage point of hindsight," *In re Citigroup*, 662 F.3d at 140 (internal quotation marks omitted). Accordingly, "[w]e cannot rely, after the fact, on the magnitude of the decrease in the [relevant investment's] price; rather, we must consider the extent to which plan fiduciaries at a given point in time reasonably could have predicted the outcome that followed." Id. In other words, as the Court of Appeals for the Third Circuit has nicely summarized, this standard "focus[es] on a fiduciary's conduct in arriving at an investment decision, not on its results, and ask[s] whether a fiduciary employed the appropriate methods to investigate and determine the merits of a particular investment." *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 434 (3d Cir. 1996). In short, ERISA's "fiduciary duty of care . . . requires prudence, not prescience." *DeBruyne v. Equitable Life Assurance Soc'y of the U.S.*, 920 F.2d 457, 465 (7th Cir. 1990) (internal quotation marks omitted).
>
> Pursuant to ERISA implementing regulations, promulgated by the Secretary of Labor, a fiduciary's compliance with the prudent-man standard requires that the fiduciary give "appropriate consideration" to whether an investment "is reasonably designed, as part of the portfolio . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment." 29 C.F.R. § 2550.404a-1(b)(2)(i).14 Accordingly, the prudence of each investment is not assessed in isolation but, rather, as the investment relates to the portfolio as a whole. *See Cal. Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036, 1043 (9th Cir. 2001); *Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 322 (5th Cir. 1999). An ERISA fiduciary's investment decisions also must account for changed circumstances, and "[a] trustee who simply ignores changed circumstances that have increased the risk of loss to the trust's beneficiaries is imprudent." *Armstrong v. LaSalle Bank Nat'l Assoc.*, 446 F.3d 728, 734 (7th Cir. 2006).

Pension Benefit Guar. Corp. v. Morgan Stanley Inv. Mgmt., 712 F.3d 705; 2013 U.S. App. LEXIS 6710 (2013).

The duty of due care has been considered to involve both process and substance. That is, in reviewing the conduct of an investment adviser in adherence to the investment adviser's fiduciary duty of due care, a court would likely review whether the decision made by the investment adviser was informed (procedural due care) as well as the substance of the transaction or advice given (substantive due care). Procedural due care is often met through the application of an appropriate decision-making process, and judged under the standard, not (necessarily) by the end result. Substantive due care pertains to the standard of care and the standard of culpability for the imposition of liability for a breach of the duty of care.

Under the Investment Advisers Act of 1940, the duty of due care is measured by the ordinary negligence standard, and it is anticipated that the duty of due care imposed by this rule would likewise be measured by the same ordinary negligence standard. However, the standard of prudence is relational, and it follows that the standard of care for investment advisers is the standard of a prudent investment adviser. By way of explanation, the standard of care for professionals is that of prudent professionals; for amateurs, it is the standard of prudent amateurs. For example, Restatement of Trusts 2d § 174 (1959) provides: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing itself to be expert or professional. *See* Annot., "Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill", 91 A.L.R. 3d 904 (1979) & 1992 Supp. at 48-49.

Note, however, that the courts recognize that it is simply not possible for a fiduciary to be aware of every piece of relevant information before making a decision on behalf of the principal, and a fiduciary cannot guarantee that a correct judgment will be made in all cases. Due to the difficulty of evaluating the behavior of fiduciaries, most often courts turn to an analysis not of the advice that was given but rather to the process by which the advice was derived. Nevertheless, while adherence to a proper process is also necessary, at each step along the process the investment adviser is required to act prudently with the care of the prudent investment adviser. In other words, the investment adviser must at all times exercise good judgment, applying his or her education, skills, and expertise to the financial planning issue before the investment adviser. Simply following a prudent process is not enough if prudent good judgment (and the investment adviser's requisite knowledge, expertise and experience) is not applied as well.

One must evaluate the duty of care, unlike the duty of loyalty, by the process the fiduciary undertakes in performing his functions and not the outcome achieved. The very word "care" connotes a process. One associates caring with a condition, state of mind, manner of mental attention, a feeling, regard, or liking for something. How else may one determine whether an investment adviser who regularly achieves below average returns, or an attorney who loses most cases, has performed his duty of care? It is only through evaluating the steps the fiduciary took while doing his job, and not whether they resulted in success, that one may judge whether the fiduciary has breached his duty.

Additionally, the suitability standard applicable to broker-dealers has been implied to apply to investment advisers, although by no means is suitability the standard by which an investment adviser's due care should be judged; suitability remains only a small part of an investment adviser's fiduciary obligation of due care. Certainly investment advisers owe their clients the duty to provide suitable investment advice. *See* SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.27-8 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.), *quoting* Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994) (proposing a rule under the Advisers Act Section 206(4)'s antifraud provisions that would expressly require advisers to give clients only suitable advice; the rule would have codified existing suitability obligations of advisers). However, the due diligence burdens on an investment adviser can extend much further.

[xxxii] There are a variety of organizations which already promulgate professional standards of conduct for those who provide personalized investment advice. *See, e.g.,* Certified Financial Planner Board of Standards, Inc.'s Standards of Professional Conduct," available at http://www.cfp.net/for-cfp-professionals/professional-standards-enforcement; AICPA Exposure Draft, "Proposed Statement on Standards in Personal Financial Planning Services" (June 11, 2013); CFA Institute's "Code of Ethics and Standards of Professional Conduct," available at http://www.cfainstitute.org/ethics/codes/Pages/index.aspx. Other standards of conduct for financial planning and/or investment advisory services are promulgated by other organizations. International standards have also been promulgated for adoption in various countries. *See* ISO 22222 (2005).

[xxxiii] Estoppel and waiver possess a place in anti-fraud law, generally. However, in a fiduciary legal environment estoppel and waiver operate differently than that found in purely commercial relationships. Core fiduciary duties cannot be waived. Nor can clients be expected to contract away their core fiduciary rights. Estoppel has a different role in the context of "actual fraud," as opposed to its limited role when dealing with "constructive fraud." For example, for estoppel to make unactionable a breach of a fiduciary obligation due to the presence of a conflict, it is required that the fiduciary undertake a series of measures, far beyond undertaking mere disclosure of the conflict of interest.

By way of further explanation, in the context of arms-length relationships, disclosure and consent creates estoppel, as customers generally possess responsibility for their own actions. This is fundamental to anti-fraud law, as applicable to arms-length relationships ("actual fraud") . Prosser and Keeton wrote that it is a "fundamental principle of the common law that *volenti non fit injuria*—to one who is willing, no wrong is done."

Yet, the doctrine of estoppel springs from equitable principles, and it is designed to aid in the administration of justice where, without its aid, injustice might result. *Levin v. Levin*, 645 N.E.2d 601, 604 (Ind. 1994). And a breach of the fiduciary standard is "constructive fraud," not actual fraud. To prove a breach of fiduciary duty, a plaintiff must only show that he or she and the defendant had a fiduciary relationship, that the defendant breached its fiduciary duty to the plaintiff, and that this resulted in an injury to the plaintiff or a benefit to the defendant. It is not necessary for the plaintiff to prove causation to prevail on claims of certain breaches of fiduciary duty. It is the agent's disloyalty, not any resulting harm, which violates the fiduciary relationship. Comment b to section 874 of the RESTATEMENT (SECOND) OF TORTS recognizes that a plaintiff may be entitled to "restitutionary recovery," to capture "profits that result to the fiduciary from his breach of duty and to be the beneficiary of a constructive trust in the profits." In some circumstances, the plaintiff may recover "what the fiduciary should have made in the prosecution of his duties." RESTATEMENT (SECOND) OF TORTS § 874 cmt. b (1979); see also 2 DAN B. DOBBS, THE LAW OF REMEDIES 670 (2d ed. 1993) (noting that a fiduciary who wrongfully takes an opportunity, if "treated as a fiduciary for the profits as well as for the initial opportunity," would "owe a duty to maximize their productiveness within the limits of prudent management and might be liable for failing to do so").

Hence, the role of estoppel in fiduciary law is different in fiduciary relationships than in its application to arms-length relationships in in which *caveat emptor* (even when aided by disclosure obligations under the '33 Act and '34 Act) plays a role. Mere consent by a client in writing to a breach of the fiduciary obligation is not, in itself, sufficient to create estoppel. If this were the case, fiduciary obligations – even core obligations of the fiduciary – would be easily subject to waiver. Instead, to create an estoppel situation, the fiduciary is required to undertake a series of steps :

(1) Disclosure of all material facts to the client must occur. [Even in arms-length relationships, a ratification or waiver defense may fail if the customer proves that he did not have all the material facts relating to the trade at issue. *E.g., Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1213 (8th Cir. 1990); *Huppman v. Tighe*, 100 Md. App. 655, 642 A.2d 309, 314-315 (1994). In contrast, in fiduciary relationships the failure to disclose material facts while seeking a release has been held to be actionable, as fraudulent concealment. *See, e.g., Pacelli Bros. Transp. v. Pacelli*, 456 A.2d 325, 328 (Conn. 1982) ('the intentional withholding of information for the purpose of inducing action has been regarded ... as equivalent to a fraudulent misrepresentation.'); *Rosebud Sioux Tribe v. Strain*, 432 N.W. 2d 259, 263 (S.D. 1988) ('The mere silence by one under such a [fiduciary] duty to disclose is fraudulent concealment.')" (*Id.*)]

(2) The disclosure must be affirmatively made (the "duty of inquiry" and the "duty to read" are limited in fiduciary relationships) and must be timely made – i.e., in advance of the contemplated transaction. ["Where a fiduciary relationship exists, facts which ordinarily require investigation may not incite suspicion (*see, e.g., Bennett v. Hibernia Bank,* 164 Cal.App.3d 202, 47 Cal.2d 540, 560, 305 P.2d 20 (1956), and do not give rise to a duty of inquiry (id., at p. 563, 305 P.2d 20). Where there is a fiduciary relationship, the usual duty of diligence to discover facts does not exist. *United States Liab. Ins. Co. v. Haidinger-Hayes, Inc.*, 1 Cal.3d 586, 598, 83 Cal.Rptr. 418, 463 P.2d 770 (1970), *Hobbs v. Bateman Eichler, Hill Richards, Inc.*, 210 Cal.Rptr. 387, 164 Cal.App.3d 174 (Cal. App. 2 Dist., 1974).)

(3) The disclosure must lead to the client's understanding – and the fiduciary must be aware of the client's capacity to understand, and match the extent and form of the disclosure to the client's knowledge base and cognitive abilities.

(4) The informed consent (which is not coerced by the fiduciary in any manner) of the client must be affirmatively secured (and silence is not consent). [There must be no coercion for the informed consent to be effective. The "voluntariness of an apparent consent to an unfair transaction could be a lingering suspicion that generally, when entrustors consent to waive fiduciary duties (especially if they do not receive value in return) the transformation to a contract mode from a fiduciary mode was not fully achieved. Entrustors, like all people, are not always quick to recognize role changes, and they may continue to rely on their fiduciaries, even if warned not to do so." Tamar Frankel, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209.]

and

(5) At all times, the transaction must be substantively fair to the client – if an alternative exists which would result in a more favorable outcome to the client, this would be a material fact which would be required to be disclosed, and a client who truly understands the situation would likely never gratuitously make a gift to the advisor where the client would be, in essence, harmed. [In the absence of integrity and fairness in a

transaction between a fiduciary and the client or beneficiary, it will be set aside or held invalid. *Matter of Gordon v. Bialystoker Center and Bikur Cholim*, 45 N.Y. 2d 692, 698 (1978) (2006 WL 3016952 at *29). As stated by Professor Frankel, "if the bargain is highly unfair and unreasonable, the consent of the disadvantaged party is highly suspect. Experience demonstrates that people rarely agree to terms that are unfair and unreasonable with respect to their interests." Frankel, Tamar, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209.]

It should also be noted that attempts to waive core fiduciary duties of an advisor may violate Section 215(a) of the Advisers Act. As stated by SEC Staff in its Jan. 2011 Study: "Advisers Act Section 215(a) voids any provision of a contract that purports to waive compliance with any provision of the Advisers Act. The Commission staff has taken the position that an adviser that includes any such provision (such as a provision disclaiming liability for ordinary negligence or a "hedge clause") in a contract that makes the client believe that he or she has given up legal rights and is foreclosed from a remedy that he or she might otherwise either have at common law or under Commission statutes is void under Advisers Act Section 215(a) and violates Advisers Act Sections 206(1) and (2). The Commission staff has stated that the issue of whether an adviser that uses a hedge clause would violate the Advisers Act turns on 'the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client.' The Commission has brought enforcement actions against advisers alleging that the advisers included hedge clauses that violated Advisers Act Sections 206(1) and (2) in client contracts." SEC Staff Study (Jan. 2011), p.43. [Citations omitted.]

[xxxiv] Within the legal community there has existed a long discussion relating to whether fiduciary duties are "default rules" and contractual in nature, or whether certain core fiduciary duties are non-waivable. We suggest that the answer lies in the disparity of knowledge and ability of the fiduciary vis-à-vis the other party. For example, in the law of partnerships and limited liability companies, the partners or members are usually on relatively equal footing and hence can alter many (but not all) of the fiduciary obligations they possess toward one another. In contrast, stricter rules are imposed in attorney-client relationships, in which attorneys are prohibited from entering into transactions with clients unless the client is clearly advised to seek independent legal counsel, and even then the business transaction must be substantively fair to the client. *See* ABA Model Rules of Professional Conduct 1.8(a), stating: Rule 1.8 Conflict Of Interest: Current Clients: Specific Rules. (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless: (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 in a manner that can be reasonably understood by the client; (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and (3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

We suggest to the SEC that the "contractual nature" of fiduciary obligations is not yet accepted by many parts of the legal community, and even if accepted in limited circumstances the theory is wholly inapplicable to a fiduciary-client relationship in which such a great disparity of knowledge exists, as exists in the complex world of securities. Individual investors are simply unable to effectively "bargain" for protection from fraud.

Academic research exploring the nature of individual investors' behavioral biases, as a limitation on the efficacy of disclosure and consent, also strongly suggests that client waivers of fiduciary duties are not effectively made. In a paper exploring the limitations of disclosure on clients of stockbrokers, Professor Robert Prentice explained several behavioral biases which combine to render disclosures ineffective: (1) Bounded Rationality and Rational Ignorance; (2) Overoptimism and Overconfidence; (3) The False Consensus Effect; (4) Insensitivity to the Source of Information; (5) Oral Versus Written Communications; (6) Anchoring; and (7) Other Heuristics and Biases. Moreover, as Professor Prentice observed: "Securities professionals are well aware of this tendency of investors, even sophisticated investors, and take advantage of it." Robert Prentice, Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future, 51 Duke L.J. 1397 (available at http://www.law.duke.edu/shell/cite.pl?51+Duke+L.+J.+1397#H2N5). Much other academic research into the behavioral biases faced by individual investors has been undertaken, in demonstrating the substantial challenges faced by individual investors in dealing with those providing financial advice in a conflict of interest situation.

Financial advisors also utilize clients' behavioral biases to their own advantage, if not restricted by appropriate rules of conduct. As stated by Professor Prentice, "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." *Id. See also* Stephen J. Choi and A.C. Pritchard, "Behavioral Economics and the SEC" (2003), at p.18. Practice management consultants train financial and investment advisors to take advantage of the behavioral biases of consumers. The instruction involves actions to build a relationship of trust and confidence with the client first, far before any discussion of the service to be provided or the fees for such services. It is well known among marketing consultants that once a relationship of trust and confidence is established, clients and customers will agree to most anything in reliance upon the bond of trust which has been formed.

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

Lastly, we must ask, what individual investor would ever permit a fiduciary to contract away its fiduciary obligations? Any truly knowledgeable individual investor would recognize the immense protections provided by the fiduciary standard of conduct, and would not permit the financial or investment adviser to contract out of fiduciary obligations.

See also discussion in the prior endnote regarding waiver and estoppel and its limited application to fiduciaries.

[xxxv] We note that it is suspect whether the rendering of any information regarding investment securities should be considered given in an arms-length relationship, but rather should be given only in a fiduciary relationship. The U.S. Supreme Court stated that there is a "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." *Capital Gains*, 375 U.S. at 194.

However, we do not suggest that the SEC proceed so far. Rather, the SEC should permit direct sales of securities, and sales of securities through intermediaries, provided that the seller not hold out in any fashion as an advisor, and provided further that only a description of the product is provided; any suggestion by a seller that the security is right "for you" (*i.e.,* for the client) crosses the threshold of advice, and hence would be subject to the fiduciary standard of conduct, for – as the Supreme Court has stated – standards covering arms-length transactions are ill-suited to the delivery of advice regarding securities. It should be noted that, in adopting the Advisers Act, "Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels." *Capital Gains*, 375 U.S. at 195.

[xxxvi] Common among insurance agents and brokers are two disturbing practices. First, they hold themselves out as "advisors." Second, they all talk of the importance of gaining the trust and confidence of the clients.

In its 1940 Annual Report, the U.S. Securities and Exchange Commission noted: "If the transaction is in reality an arm's-length transaction between the securities house and its customer, then the securities house is not subject' to 'fiduciary duty. However, the necessity for a transaction to be really at arm's-length in order to escape fiduciary obligations, has been well stated by the United States. Court of Appeals for the District of Columbia in a recently decided case: '[T]he old line should be held fast which marks off the obligation of confidence and conscience from the temptation induced by self-interest. He who would deal at arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector. He cannot commingle his trusteeship with merchandizing on his own account…'" Seventh Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1941, at p. 158, *citing Earll v. Picken* (1940) 113 F. 2d 150.

In 1963, in its Special Report on the securities industry, the SEC also noted that it "has held that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship exists, imposing a particular duty to act in the customer's best interests and to disclose any interest the broker-dealer may have in transactions he effects for his customer … [BD advertising] may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business … Where the relationship between the customer and broker is such that the former relies in whole or in part on the advice and recommendations of the latter, the salesman is, in effect, an investment adviser, and some of the aspects of a fiduciary relationship arise between the parties." 1963 SEC Special Study.

There exists a fundamental truth that "to provide biased advice, with the aura of advice in the customer's best interest, is fraud." [Angel, James J. and McCabe, Douglas M., Ethical Standards for Stockbrokers: Fiduciary or Suitability? (September 30, 2010), at p.23. Available at SSRN: http://ssrn.com/abstract=1686756.] Those who use titles and designations, such as "financial advisor" or "CFP" or "ChFC" or "financial consultant" - and who then don't adhere to the fiduciary obligations attendant to such representations - in essence commit intentional misrepresentation. Let's call it for what it is - "fraud" - plain and simple. We should not live in a society in which pervasive fraud - i.e., holding out as trusted advisors, and then failing to adhere to the duties imposed from the resulting fiduciary relationship - is continued to be permitted to occur. There is a simple maxim expressed by a state securities commissioner nearly a decade ago at a conference, and repeated many times since: "Do not lie, cheat or steal. Say what you do. And do what you say."

[xxxvii] 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.

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

[xxxix] 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).

[xl] One might reasonably ask why "honest investment advisers" (to use the language of the U.S. Supreme Court in *SEC vs. Capital Gains*) had to be protected by the Advisers Act. Was it not enough to just protect consumers? The answer can be found in economic principles, as set forth in the classic thesis for which George Akerlof won a Nobel Prize:

> There are many markets in which buyers use some market statistic to judge the quality of prospective purchases. In this case there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group whose statistic is affected rather than to the individual seller. As a result there tends to be a reduction in the average quality of goods and also in the size of the market.

George A. Akerloff, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, The Quarterly Journal of Economics, Vol. 84, No. 3. (Aug., 1970), p.488. George Akerloff demonstrated "how in situations of asymmetric information (where the seller has information about product quality unavailable to the buyer), 'dishonest dealings tend to drive honest dealings out of the market.' Beyond the unfairness of the dishonesty that can occur, this process results in less overall dealing and less efficient market transactions." Frank B. Cross and Robert A. Prentice, The Economic Value of Securities Regulation, 28 Cardoza L.Rev. 334, 366 (2006). As George Akerloff explained: "[T]he presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence." Akerloff at p. 495

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

[xlii] "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 Investment advisers (NAPFA) dated March 12, 2008 to David Blass, Assistant Director, Division of Investment Management, SEC re: Rand Study.

[xliii] "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.

[xliv] 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.

[xlv] Simon Johnson's complete article is available at http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/307364/?single_page=true. *See also* Simon Johnson, 2011, 3 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN, Vintage Press.

[xlvi] "Finance, which accounts for only about 8% of GDP, reaps about a third of all profits." Noah Smith, http://noahpinionblog.blogspot.com/2013/02/finance-has-always-been-more-profitable.html.

See also James Kwak, Why Is Finance So Big? (Feb. 29, 2012): "Many people have noted that the financial sector has been getting bigger over the past thirty years, whether you look at its share of GDP or of profits. The common defense of the financial sector is that this is a good thing: if finance is becoming a larger part of the economy, that's because the rest of the economy is demanding financial services, and hence growth in finance helps overall economic growth. But is that true? … the per-unit cost of financial intermediation has been going up for the past few decades: that is, the financial sector is becoming less efficient rather than more." Available at http://baselinescenario.com/2012/02/29/why-is-finance-so-big/.

[xlvii] The consulting firm Edelman Berland publishes a "Trust Barometer" each year that surveys various issues dealing with trust in both the U.S. and globally. One question posed is, "How much do you trust businesses in each of the following industries to do what is right?" Globally, the two industries listed at the bottom of the list are "Financial services" and "Banks" - both at 50% in the 2013 survey. 2013 *Edelman Trust Barometer Executive Summary*, available at http://trust.edelman.com/trust-download/executive-summary/.

[xlviii] "Foreign investors now hold slightly less than 55% of the publicly held and publicly traded U.S. Treasury securities, 26% of corporate bonds, and about 12% of U.S. corporate stocks.1 The large foreign accumulation of U.S. securities has spurred some observers to argue that this foreign presence in U.S. financial markets increases the risk of a financial crisis, whether as a result of the uncoordinated actions of market participants or by a coordinated withdrawal from U.S. financial markets by foreign investors for economic or political reasons." James K. Jackson, "Foreign Ownership of U.S. Financial Assets: Implications of a Withdrawal" (Congressional Research Service, April 8, 2013), p.1.

[xlix] 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, 1997, "Trust in Large Organizations," American Economic Review, 87, 333-338. In an influential paper, Knack and Keefer found that a country's level of

trust is indeed correlated with its rate of growth. Knack, S. and Keefer, P. (1996). "Does social capital have an economic payoff?: A cross country investigation," The Quarterly Journal of Economics, vol 112, p.p 1251. See also Zak, P., and S. Knack, 2001, "Trust and Growth," The Economic Journal, 111, 295-321.

Guiso, L., P. Sapienza, and L. Zingales, 2007, "Trusting the Stock Market," Working Paper, University of Chicago.

[li] Georgarakos, Dimitris and Inderst, Roman, Financial Advice and Stock Market Participation (February 14, 2011). ECB Working Paper No. 1296. Available at SSRN: http://ssrn.com/abstract=1761486.

[lii] Ronald J. Colombo, Trust and the Reform of Securities Regulation, 35 Del. J. Corp. L. 829 (2010).

[liii] *Id.* at 875. Prof. Colombo further observed: "Increased regulation of broker-dealers is likely to do little harm, as it is unclear whether sufficient room for high-quality, affective/generalized trust exists here in the first place. And if, in the twenty- first century, the brokerage industry relies upon primarily cognitive and specific trust (due to increased movement toward the discount-broker business model), such increased regulation could be beneficial." *Id.* at 876. Prof. Colombo explained the concept of cognitive trust: "Reliance and voluntary exposure to vulnerability stemming from cognitive trust is not based upon emotions or norms, but rather 'upon a cost-benefit analysis of the act of trusting someone.' For this reason, Williamson rejects even calling such reliance 'trust.' To him, such reliance is a form of calculativeness, which serves to economize on the scarcity of one's mental energies and time. The potential vulnerabilities accepted are not due to 'trust,' but to rational risk management-to the fact that 'the expected gain from placing oneself at risk to another is positive.' *Id.* at 836.

[liv] Tamar Frankel, "Regulation and Investors' Trust In The Securities Markets," 68 Brook. L. Rev. 439, 448 (2002).

[lv] In recent years massive marketing campaigns by Wall Street firms have touted their "objective advice" from "financial consultants" who attended their client's soccer games and made so many believe that the "advice" received would result in the ability to afford that second home on the beach. Even long-respected firms like Goldman Sachs have been perceived, at least at times and by some, to "throw clients under the bus" [see http://theweekinethics.wordpress.com/2012/03/22/the-week-in-ethics-goldman-sachs-2012-problem-with-culture/], apparently in violation of their adopted Code of Business Conduct and Ethics in which the firm commits "to conduct our business in accordance with … the highest ethical standards."

Slowly the clients of broker-dealer firms have realized the harm to which they have been subjected. Not quickly, and not all the time, of course. "[I]ndividuals continue to trust beyond the point where evidence points to the contrary. Eventually, however, the accumulated weight of evidence turns them towards distrust, which is equally reinforcing." [Anand, Kartik, Gai, Prasanna and Marsili, Matteo, Financial Crises and the Evaporation of Trust (November 16, 2009). Available at SSRN: http://ssrn.com/abstract=1507196.]

However, in recent years some courageous journalists have noted that many conflicts of interests exist between product salespersons (however disguised they might be by the use of titles). They have noted that "financial consultants" and "wealth managers" are seldom in a "fiduciary relationship" with their customers, even though most customers believe they can "trust" their advisor. Many studies confirm consumer confusion.

In essence, the use of common titles, and the high fees received by those operating under a conflict-ridden standard of conduct, which in turn funds marketing efforts which suggest a relationship of trust with those advisors who operate under the old product-sales business model, results in the inability by consumers to distinguish higher-quality advisors.

[lvi] Someone forgot to tell financial advisors that the use of trust-based sales techniques results in the application of fiduciary standards of conduct.

In the latter half of the 20th Century, sales techniques evolved, as did salespersons' view of themselves. Codes of ethics were developed, high-pressure sales techniques sometimes disavowed, and needs-based selling became a new paradigm. This evolved into "trust-based selling" and substantial changes in the sales process, with trust as a focus:

> In the past few years, many authors have recognized that in the "relational era" there have been radical changes in sales-force activities and sales management practices (Darmon, 1997; Marshall, Moncrief and Lassk, 1999; Wotruba, 1996). In brief, salesmen are expected to become value creators (De Vincentis and Rackham, 1996), customer partners and sales team managers (Weitz and Bradford, 1999), market analysts and planners (Wilson, 1993), and to rapidly shift from a hard selling to a smart selling approach (Sujan, Weitz and Kumar, 1994; Kohli, Shervani and Challagalla, 1998) … trust is a focal construct in the analysis of relationship marketing (see for example Blois, 1996; Doney and Cannon, 1997; Kumar, 1996; Morgan and Hunt, 1994).

Paulo Guenzi, "Sales-Force Activities and Customer Trust."

Where do we stand today? In the 2nd edition of the textbook, SELL (Cengage Learning, 2012), Professors Ingram, LaForge et. al. state that trust, when used as a sales technique, answers these questions:

"1. Do you know what you are talking about? – competence; expertise

2. Will you recommend what is best for me? – customer orientation

3. Are you truthful? – honesty; candor

4. Can you and your company back up your promises? – dependability

5. Will you safeguard confidential information that I share with you? – customer orientation; dependability."

(SELL, p.27).

In looking closely at this list, it appears that questions 1, 3 and 5 are closely associated with the fiduciary duty of care. Question 2 is close to the proposition of "acting in the client's best interests" – one of the major aspects of the fiduciary duty of loyalty. And Question 3, acting with honesty and candor, translate into the fiduciary duty of utmost good faith.

Of course, as any experienced financial advisor knows, trust-based selling is not just taught from books. Many (if not nearly all) practice consultants extoll the virtues of a "consultative approach" as a means to not only secure the sale, but also to generate referrals. Financial advisors are taught techniques such as the "Discovery Conference," where exploring the personal details of clients' lives results in building the foundations of trust for a long-term relationship. Having experienced one of these workshops myself (which this author found to be extremely valuable in building his own financial planning practice), the stress is upon getting to know the clients, and their goals and values, extremely well, through a process designed to build trust and confidence – prior to any discussion by the financial advisor of a product or service.

There is nothing inherently wrong with a trust-based sales process. In fact, one might applaud the depth of relationships between financial advisor and client that results from a trust-based, relationship-cultivation process.

Yet, under the law, there are two types of commercial relationships. One is the arms-length relationship, in which seller and buyer negotiate with each other over the terms of the transaction at hand. It is an adverse relationship, and as to the customer the doctrine of caveat emptor ("buyer beware") applies.

The other type of relationship is the fiduciary-entrustor relationship. In this type of relationship the provider of services (either management of assets, or the provision of advice) adopts a wholly different role. The fiduciary becomes bound by fiduciary duties of due care, loyalty and utmost good faith to the entrustor (the "client" in our context of investment or financial advice). The fiduciary, in essence, "steps into the shoes" of the client, and makes the decisions (or provides the advice) as if the fiduciary was the client. In other words, the fiduciary is bound to act in the sole or best interests of the client. As explained by Professor Laby, "What generally sets the fiduciary apart from other agents or service providers is a core duty, when acting on the principal's behalf, to adopt the objectives or ends of the principal as the fiduciary's own." [Arthur B. Laby, SEC v. Capital Gains Research Bureau and the Investment Advisers Act Of 1940, 91 Boston Univ. L.Rev. 1051, 1055 (2011).]

Somewhere along the way, the academics and practice consultants have often omitted to tell the financial advisors that "trust-based selling," designed to achieve a relationship of trust and confidence, results in fiduciary status attaching. This is true regardless of how the financial advisor is licensed or regulated (whether as a registered representative of a broker-dealer firm, investment adviser representative of a registered investment adviser firm, dual registrant, or even life insurance agent.

[lvii] The use of financial planning services as a means to sell securities in order to generate profits by brokers was criticized early on by the SEC:

> Between May 1960 and June 1964, registrant, together with or willfully aided and abetted by Hodgdon, Haight, Carr, Adam, Harper, Kitain, Davis and Kibler, engaged in a scheme to defraud customers who utilized registrant's financial planning services in the purchase and sale of securities, in willful violation of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c)(l) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder. The record shows that the gist of the scheme was respondents' holding themselves out as financial planners who would exercise their talents to make the best choices for their clients from all available securities, when in fact their efforts were directed at liquidating clients' portfolios and utilizing the proceeds and their clients' other assets to purchase securities which would yield respondents the greatest profits, in some instances in complete disregard of their clients' stated investment

objectives. This scheme was implemented by, among other things, registrant's advertising and by its training course for salesmen …

> It is abundantly clear from this record that under the guise of comprehensive "financial planning" encompassing the purchase of varied securities, including listed securities, the above respondents induced customers, who were generally inexperienced and unsophisticated, to believe that their best interests would be served by following the investment program designed for them by respondents. In fact, such programs were designed to sell securities that would provide the greatest gain to respondents, rather than to promote the customers' interests; indeed, in some instances, the recommendations were directly contrary to the customers' expressed investment needs and objectives.

In the Matter of Haight & Company, Inc. (Feb. 19, 1972)

[lviii] IA Release No. 1889, *In the Matter of Dawson-Samberg Capital Management, Inc. Now Known As Dawson-Giammalva Capital Management, Inc. and Judith A. Mack* (2000), stating:

> Soft dollar arrangements are material because of the potential conflict of interest arising from an adviser's receipt of some benefit in exchange for directing brokerage on behalf of client accounts. *See Renaissance Capital Advisers, Inc*., Advisers Act Rel. No. 1688, 66 SEC Docket 564, 567 (December 22, 1997); *Oakwood,* 63 SEC Docket at 2488; S *Squared Technology Corp*., Advisers Act Rel. No. 1575, 62 SEC Docket 1560, 1564 (August 7, 1996); Kingsley, *Jennison, McNulty & Morse, Inc*., Advisers Act Rel. No. 1396, 55 SEC Docket 2434, 2441-42 (Dec. 23, 1993) (Opinion of the Commission) ("Kingsley Opinion"); 1986 Interpretive Release, 35 SEC Docket at 909. Because the advisory clients' commission dollars generate soft dollar credits, soft dollar benefits are the assets of the clients. *See Republic New York Securities Corp*., Advisers Act Rel. No. 1789, 1999 SEC LEXIS 278 (February 10, 1999).

[lix] *See, e.g.*, Mercer Bullard, "Protecting Investors – Establishing the SEC Fiduciary Duty Standard" (AARP Public Policy Institute, Sept. 2011) stating that Dodd-Frank Act's requirement that brokers act in the best interests of their customers "without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice" likely requires that brokers should not be "unduly motivated or influenced by the camount of the compensation the broker-dealer receives in connection with the advice," and further stating:

> [B]roker-dealers that receive differential compensation, such as revenue-sharing payments from mutual funds, that varies depending on which investment they recommend, may be more vulnerable to claims that their advice was not given "without regard to the financial or other interests of the broker" than brokers that unbundle their fees and charge the same fee regardless of the investment selected …
>
> > [FN34. This unbundling incentive is also reflected in the SEC's proposed 12b-1 fee reforms. See Mutual Fund Distribution Fees; Confirmations, Exchange Act Rel. No. 62544 (July 21, 2010), pp. 244–45. The issue is analogous to the debate regarding proposed rules that implement the Employee Retirement Income Security Act of 1974 (ERISA) requirement that certain advisers' fees not be affected by the recommendations that they make to plan beneficiaries. See, generally, Investment Advice—Participants and Beneficiaries, 75 F.R. 9360 (Mar. 2, 2010) ….]
>
> The Section 913 Study does not indicate what practices should be examined pursuant to this mandate. The most likely candidates for prohibition may be compensation practices that create financial incentives for financial professionals to favor one course of action or investment product over another, regardless of which is in the client's best interests. This would be consistent with Section 913's mandate that the fiduciary standard require a broker-dealer or investment adviser to act in the customer's best interest "without regard to [its] financial or other interest."

Id. at pp.12, 15.

[lx] *See* Barbash, Barry P., and Massari, Jai, "The Investment Advisers Act of 1940: Regulation by Accretion," 39 Rutgers L.J. 627, stating: "[T]he Court in *Capital Gains* … provided investment advisers with clear guidance on fulfilling their obligations under the Act: appropriate disclosure can cure a conflict of interest. As the Court said, an adviser may "make full and frank disclosure" of the conduct in question to address the concerns raised by the Commission under the Advisers Act. The disclosure, the Court went on to say, would serve the purposes of the Act's anti-fraud provisions by allowing clients to evaluate 'overlapping motivations' …. in deciding whether an adviser is serving 'two masters' [i.e., the client and its own economic self-interest] or only one … Capital Gains both expanded the scope of the duties owed by an investment adviser to its client as a fiduciary and, consistent with the Advisers Act's approach, found disclosure an effective tool in curing conflicts of interest faced by an adviser..") Id. at 631, 633-4. *See also* Jennifer L. Klass, "Investment Adviser Conflicts of Interest Disclosures" (Outline for IAA Annual Compliance Workshop, Oct. 27, 2008), stating: "[T]he Advisers Act, like the other federal securities laws, is based on the

fundamental principal of "full disclosure.' In this regard, the Advisers Act reflects the "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."

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

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

[lxiii] Id. at p.___.

[lxiv] Id. at p.___.

[lxv] *Capital Gains*, 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.

[lxvi] James J. Angel, Ph.D., CFA and Douglas McCabe Ph.D., *Ethical Standards for Stockbrokers: Fiduciary or Suitability?* (Sept. 30, 2010).

[lxvii] Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011) (hereafter "SEC Staff 2011 Study"), available at www.sec.gov/news/studies/2011/913studyfinal.pdf, at p. 22.

[lxviii] SEC Release No. 34-69013; IA-3558; File No. 4-606, Duties of Brokers, Dealers, and Investment Advisers (March 1, 2013), available at http://www.sec.gov/rules/other/2013/34-69013.pdf.

[lxix] Section 913 of the Dodd–Frank Wall Street Reform and Consumer Protection Act. Pub. L. 111-203, 124 Stat. 1376 (2010). Specifically, the SEC may extend the fiduciary standard to broker-dealers in situations involving "a natural person, or the legal representative of such natural person, who (A) receives personalized investment advice about securities from a broker, dealer or investment adviser; and (B) uses such advice primarily for personal, family, or household purposes." 15 U.S.C. 80b–11(g)(2).

[lxx] Other regulated actors also provide investment advice, including the trust departments of banks and their trust officers, separate trust companies and their trust officers, and, on occasion, insurance agents with respect to sales of cash value life insurance products and various forms of annuities. This paper does not seek to address the regulation of these providers.

[lxxi] *Webster's Revised Unabridged Dictionary* (1913) defines "adviser" as "One who advises." The term "advisor" is not found in this dictionary. However, the common practice in the United State is to use the spelling "advisor." However, the text of the Investment Advisers Act of 1940 and regulations adopted thereunder use the spelling "adviser." Both spellings are now generally deemed acceptable by many dictionaries.

[lxxii] See, e.g., James J. Angel, *On the Regulation of Advisory Services: Where do we go from here* (Oct. 31, 2011), stating, "Advisers have a higher standard of care in that their recommendations must be in the best interest of the client, whereas broker recommendations are held to a slightly weaker suitability standard."

[lxxiii] Advisers Act Section 202(a)(11) defines "investment adviser" to mean "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." Advisers Act Section 202(a)(11)(C) excludes from the investment adviser definition any broker or dealer (i) whose performance of its investment advisory services is "solely incidental" to the conduct of its business as a broker or dealer; and (ii) who receives no "special compensation" for its advisory services. Accordingly, broker-dealers providing investment advice in accordance with this exclusion are not subject to the fiduciary duty imposed by the Advisers Act, but remain subject to the fiduciary duties imposed by state common law.

[lxxiv] The SEC staff noted the ways that brokers receive compensation in its 2011 Special Study: "Generally, the compensation in a broker dealer relationship is transaction-based and is earned through commissions, mark-ups, mark-downs, sales loads or similar fees on specific transactions, where advice is provided that is solely incidental to the transaction. A brokerage relationship may involve incidental advice with transaction-based compensation, or no advice and, therefore no charge, for advice." SEC Staff 2011 Study, *supra* n. 2, at pp. 10-11. Interestingly, the SEC Staff did not note the fact that brokers also receive compensation which is in the form of asset-based compensation, similar to the "assets under management" fee structure of most investment advisers, such as 12b-1 fees and payment for shelf space. 12b-1 fees have been criticized by this author as possible "special compensation" and "investment advisory fees in drag." *See* Ron Rhoades, "7 reasons why wirehouses shouldn't milk the old business model," RIABiz,

Jan. 28, 2010 (available at http://www.riabiz.com/a/114009/7-reasons-why-wirehouses-shouldn39t-milk-the-old-business-model).

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. Three times in that decision the Court emphasized that the term "investment adviser" was "broadly defined" by Congress. Additionally, in discussing the exclusion for brokers (insofar as their advice is solely incidental to brokerage transactions for which they receive no special compensation), the U.S. Court of Appeals stated:

> "The relevant language in the committee reports suggests that Congress deliberately drafted the exemption in subsection (C) to apply as written. Those reports stated that 'investment adviser' is so defined as specifically to exclude ... brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only **brokerage commissions**) …." [**Emphasis added**.]

As a result of this language, all arrangements in which broker-dealer firms and their registered representatives receive compensation other than commission-based compensation should be reviewed to see if the definition of "investment adviser" found in 15 U.S.C. §80b-2.(a)(11) applies: "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities …."

For example, does the receipt of 12b-1 fees by broker-dealer firms and their registered representatives, which by the SEC's own admission are asset-based fees and relationship compensation, run afoul of the IAA when received by those outside investment advisory relationships with their customers. The written submissions to the SEC by many brokerage industry representatives acknowledge that 12b-1 fees are utilized in large part to compensate registered representatives for the fostering of an ongoing relationship between the registered representative and the investor, including the provision of advice over time with respect to a customer's personal circumstances, and including financial planning, estate planning, and investment advice (not specific to any transaction). Moreover, the SEC has in the past acknowledged that, to meet the "compensation" test under the Advisers Act: "It is not necessary that an adviser's compensation be paid directly by the person receiving investment advisory services, but only that the investment adviser receive compensation from some source for his services." SEC Release IA-770 (1981).

While industry representatives have argued that the 12b-1 fee "compensation" received by the broker-dealer firm is not paid by the customer directly, there is no qualification in the definition of investment adviser which says that compensation must be directly paid by an investor. Moreover, there is a common law principle which attorneys were taught when they were in law school: "You cannot do indirectly what you cannot do directly." In other words, "if it walks like a duck…." While admittedly Class C shares in particular, and fee-based compensation in general, might at times better align the interests of investors with those of financial intermediaries, such an alignment is not the basis of any exclusion from the application of the IAA. Given the significance of this issue, all ongoing payments to advice-providers deserve close scrutiny – including ongoing payments for shelf space, variable annuity product provider annual fees to broker-dealers, and – as stated above – 12b-1 fees.

12b-1 fees also may violate the Sherman Act and its anti-trust prohibitions, inasmuch as they negate the ability of a customer to effectively negotiate, in many instances, the compensation for advisory services. This issue, involving unlawful restraint of trade, is beyond the scope of this paper.

[lxxv] As stated in the SEC Staff's 2011 Report:

> The Advisers Act excludes from the investment adviser definition any broker or dealer: (i) whose performance of its investment advisory services is "solely incidental" to the conduct of its business as a broker or dealer; and (ii) who receives no "special compensation" for its advisory services. To rely on the exclusion, a broker-dealer must satisfy both of these elements.
>
> Generally, the 'solely incidental' element amounts to a recognition that broker-dealers commonly give a certain amount of advice to their customers in the course of their regular business as broker-dealers and that "it would be inappropriate to bring them within the scope of the [Advisers Act] merely because of this aspect of their business." On the other hand, "special compensation" "amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendering of advice should be considered an investment adviser and not be excluded from the purview of the [Advisers] Act merely because he is also engaged in effecting market transactions in securities." Finally, the Commission staff has taken the position that a registered representative of a broker-dealer is entitled to rely on the broker-dealer exclusion if he or she is providing investment advisory services to a customer within the scope of his or her employment with the broker-dealer.

SEC Staff 2011 Report, *supra* n.2, at pp. 15-16.

[lxxvi] The products and services offered by broker-dealers fall into two broad categories: brokerage services and dealer services. Generally, a broker is one who acts as an agent for someone else, while a dealer is one who acts as principal for its own account. A firm can act as both a broker and a dealer. The licensed employees of a broker-dealer are referred to as "registered representatives" and, until recent years, were often commonly referred to as "stockbrokers."

[lxxvii] The SEC's March 1, 2013 release acknowledges that brokers and their registered representatives may possess a fiduciary duty under state common law: "A broker-dealer may have a fiduciary duty under certain circumstances. This duty may arise under state common law, which varies by state. Generally, courts have found that broker-dealers that exercise discretion or control over customer assets, or *have a relationship of trust and confidence with their customers*, are found to owe customers a fiduciary duty similar to that of investment advisers." [*Emphasis added.*]

See also 2011 SEC Staff Study, *supra* n.2, at pp.10-11. "While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances. Moreover, broker-dealers are subject to statutory, Commission and SRO requirements that are designed to promote business conduct that protects customers from abusive practices, including practices that may be unethical but may not necessarily be fraudulent." It should be noted that the views expressed in the Study were those of the staff and do not necessarily reflect the views of the Commission or the individual Commissioners.

See also A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 2009), available at http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf, stating: "While the statutes and regulations do not uniformly impose fiduciary obligations on a [broker-dealer (BD)], a BD may have a fiduciary duty under certain circumstances, at times under state common law, which varies by state. Generally, BDs that exercise discretion or control over customer assets, or *have a relationship of trust and confidence with their customers,* are found to owe customers a fiduciary duty similar to that of investment advisers … State common law imposes fiduciary duties upon persons who make decisions regarding the assets of others. *This law generally holds that a futures professional owes a fiduciary duty to a customer if it is offering personal financial advice.*" *Id.* at pp.9-10. [*Emphasis added.*]

[lxxviii] Registered investment advisers are separately licensed under the Investment Advisers Act of 1940. Their licensed employees are referred to as "investment adviser representatives." However, many financial services firms offer both broker-dealer and investment advisory services, which leads to the connotation of the firm (and its licensed employees who also possess both Series 6/7 and 65 licensure) as "dual registrants." As of mid-October 2010, approximately 88% of investment adviser representatives were also registered representatives of a FINRA-registered broker-dealer.

[lxxix] The suitability standard imposes both additional substantive (fairness) and procedural (disclosure) obligations upon broker-dealers, in addition to the requirements of good faith applicable to the performance of contracts between all those in arms-length relationships. The SEC and the U.S. Consumer Futures Trading Commission (CFTC) recent summarized the broker-dealers suitability obligation as follows:

> Under the federal securities laws and SRO rules, broker-dealers are required to deal fairly with their customers. This includes having a reasonable basis for recommendations given the customer's financial situation (suitability), engaging in fair and balanced communications with the public, providing timely and adequate confirmation of transactions, providing account statement disclosures, disclosing conflicts of interest, and receiving fair compensation both in agency and principal transactions. In addition, the SEC's suitability approach requires BDs to determine whether a particular investment recommendation is suitable for a customer, based on customer-specific factors and factors relating to the securities and investment strategy. A BD must investigate and have adequate information regarding the security it is recommending and ensure that its recommendations are suitable based on the customer's financial situation and needs. The suitability approach in the securities industry is premised on the notion that securities have varying degrees of risk and serve different investment objectives, and that a BD is in the best position to determine the suitability of a securities transaction for a customer. Disclosure of risks alone is not sufficient to satisfy a broker-dealer's suitability obligation.

A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 2009), available at http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf, at p.9.

[lxxx] *See* SEC Release No. 34-69013; IA-3558; File No. 4-606, *Duties of Brokers, Dealers, and Investment Advisers* (March 1, 2013) ("Today, broker-dealers and investment advisers routinely provide to retail customers many of the same services, and engage in many similar activities related to providing personalized investment advice about securities to retail customers. While both investment advisers and broker-dealers are subject to regulation and

oversight designed to protect retail and other customers, the two regulatory schemes do so through different approaches notwithstanding the similarity of certain services and activities … Studies suggest that many retail customers who use the services of broker-dealers and investment advisers are not aware of the differences in regulatory approaches for these entities and the differing duties that flow from them.") *Id.* at pp. 3-4 (citations omitted).

[lxxxi] Cheryl Goss Weiss, A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty, 23 Iowa J. Corp. L. 65, 68 (1997).

[lxxxii] See Blaine F. Aikin, Kristina A. Fausti, *Fiduciary: A Historically Significant Standard*, 30 Rev. Banking & Financial Law 155, 157 (2010-11).

[lxxxiii] "[C]ourts have linked the fiduciary duty of loyalty to the biblical principle that no person can serve two masters." *Id.*, at pp.157-8. *See also Beasley v. Swinton*, 46 S.C. 426; 24 S.E. 313; 1896 S.C. LEXIS 67 (S.C. 1896) ("Christ said: 'No man can serve two masters, for either he will hate the one and love the other, or else he will hold to the one and despise the other. Ye cannot serve God and Mammon [money].'") *Id.* at ____, quoting Matthew 6:24.

[lxxxiv] "Chinese historical texts also recognize fiduciary principles of trust and loyalty. One of the three basic questions of self-examination attributed to Confucius (551 BC–479 BC) asks: 'In acting on behalf of others, have I always been loyal to their interests?'" Aitkin and Fauti, *supra* n.__,. at p.158.

[lxxxv] "Aristotle (384 BC–322 BC) consistently recognized that in economics and business, people must be bound by high obligations of loyalty, honesty and fairness and that society suffers when such obligations are not required." *Id.*

[lxxxvi] "Cicero (103 BC–46 BC) noted the relationship of trust between an agent and principal (known to Romans as mandatory and mandator, respectively), and emphasized that an agent who shows carelessness in his execution of trust behaves very dishonorably and 'is undermining the entire basis of our social system.'" *Id.* at 158-9.

[lxxxvii] *See, e.g., Carter v. Harris*, 25 Va. 199; 1826 Va. LEXIS 26; 4 Rand. 199 (Va. 826) ("It is well settled as a general principle, that trustees, agents, auctioneers, and all persons acting in a confidential character, are disqualified from purchasing. The characters of buyer and seller are incompatible, and cannot safely be exercised by the same person. Emptor emit quam minimo potest; venditor vendit quam maximo potest. The disqualification rests, as was strongly observed in the case of the *York Buildings Company v. M'Kenzie*, 8 Bro. Parl. Cas. 63, on no other than that principle which dictates that a person cannot be both judge and party. No man can serve two masters. He that it interested with the interests of others, cannot be allowed to make the business an object of interest to himself; for, the frailty of our nature is such, that the power will too readily beget the inclination to serve our own interests at the expense of those who have trusted us."). *Id*. at 204.

[lxxxviii] *Wormley v. Wormley*, 21 U.S. 421; 5 L. Ed. 651; 1823 U.S. LEXIS 290; 8 Wheat. 421 (1823). *See also Michoud v. Girod*, 45 U.S. 503; 11 L. Ed. 1076; 1846 U.S. LEXIS 412; 4 HOW 503 (1846) ("[I}f persons having a confidential character were permitted to avail themselves of any knowledge acquired in that capacity, they might be induced to conceal their information, and not to exercise it for the benefit of the persons relying upon their integrity. The characters are inconsistent. Emptor emit quam minimo potest, venditor vendit quam maximo potest."]

[lxxxix] *SEC v. Capital Gains Research* Bureau, 375 U.S. 180; 84 S. Ct. 275; 11 L. Ed. 2d 237; 1963 U.S. LEXIS 2446 (1963) ("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 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.'' *United States v. Mississippi Valley Co*., 364 U.S. 520, 550, n. 14.") *Id.* at p. 249 (fn.50).

[xc] Generally, relationships between two parties fall into one of two categories. The first category is that in which arms-length negotiations between the parties take place. Sometimes the consumer is aided by specific laws which impose some additional duties on the other party. For example, upon broker-dealers there is imposed the requirement that investment products sold to an investor be "suitable," at least as to the risks associated with that investment. Additionally, various disclosures may be required of broker-dealers under federal securities laws. Yet,

even with enhanced safeguards, the arms-length relationship of the parties involved in the sale of an investment product can still be described as:

PRODUCT MANUFACTURERS ⇒ MANUFACTURERS' (SALES) REPRESENTATIVES ⇒ CUSTOMER

By contrast, the fiduciary relationship arises in situations where the law has clearly recognized that fiduciary duties attach, such as principal and agent relationships, or where there exists the actual placing of trust and confidence by one party in another and a great disparity of position and influence between the parties. In these situations, mere disclosure of material facts is thought to be inadequate as a means of consumer protection, and hence the fiduciary standards of conduct are imposed. The relationship of the parties in a fiduciary relationship is reversed, as follows:

CLIENT ⇒ FIDUCIARY ADVISOR (CLIENT'S REPRESENTATIVE) ⇒ INVESTMENT PRODUCT PROVIDERS

[xci] *See e.g.,* Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795 (1983) ("Another social trend which increases the importance of fiduciary law is the change in perception of power, and the emergence of new forms of power … Specialization of labor has become one of the main features of our modem society. Specialization is important because it maximizes the benefits from labor … pooling: the transfer of resources by many persons to a small number of experts. Pooling benefits the participants because it may produce economies of scale … Financial institutions present one example of the benefits of pooling … Relations that stem from specialization and pooling are often classified as fiduciary because they pose the problem of abuse of power that is common to fiduciary relations….") *Id.* at 803-4.

[xcii] *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979) ("A fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation." citing Restatement, Second, Trusts § 2).

[xciii] The Employee Benefits Securities Administration of the U.S. Department of Labor is expected to re-promulgate, in the second half of 2013, its "Definition of Fiduciary" proposed rule, which would greatly expand the situations in which those providing investment advice to plan sponsors and/or plan participants would be regarded as fiduciaries and subject to ERISA's strict "sole interests" fiduciary standard and its prohibited transaction rules. EBSA's re-proposal is also likely to extend ERISA's fiduciary obligations to IRA accounts. *See* Melanie Waddell, "3 Issues That Will Dominate DOL Fiduciary Debate," *AdvisorOne* (Feb. 28, 2013), available at http://www.advisorone.com/2013/02/28/3-issues-that-will-dominate-dol-fiduciary-debate.

[xciv] *Jothann v. Irving Trust Company*, 151 Misc. 107; 270 N.Y.S. 721, *citing Wendt v. Fischer*, 215 A.D. 196; 213 N.Y.S. 351 (1926).

[xcv] *Jackson* v. *Gorham,* 98 Cal. App. 112, 276 P. 391, 393.

[xcvi] *Leedom* v. *Palmer,* 274 Pa. 22, 117 A. 410, 411.

[xcvii] *Southern Trust Co. v. Lucas* (C.C.A.) 245 F. 286, 288 (___).

[xcviii] *Hancock v. Anderson*, 160 Va. 225; 168 S.E. 458; 1933 Va. LEXIS 201 (Va. 1933)

[xcix] "I can't advise you in this matter as I have told you I am representing the second mortgage man and therefore I can't give you any advice. You will have to go somewhere else and get your advice in the matter because I am interested in it." *Id.* at 236.

[c] *Id.* at 239.

[ci] *Id.* at 240, 242-3.

[cii] Arthur C. Laby, *Fiduciary Obligation of Broker-Dealers and Investment Advisers*, 55 Vill.L.R. 701, 714 (2010), noting that since the Investment Advisers Act of 1940 and the federal common law promulgated thereunder does not apply to broker-dealers, federal courts must look to state law to determine brokers' fiduciary status.

[ciii] Trust law, largely followed by the Employee Retirement Income Security Act's (ERISA's) application of its "sole interests" fiduciary standard, seeks to solve the problem of agency problems by placing limits upon the fiduciary's conduct, and prohibiting certain forms of action. "The problem with problem with disempowerment is that in protecting the principal from mis- or malfeasance by the agent, the law also disabled the agent from undertaking acts useful for the principal." Robert Sitkoff, *The Economic Structure of Fiduciary Law*, 91 Boston U.L.Rev. 1039, 1042 (2011).

[civ] "Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." § 1.01 "Agency Defined," RESTATEMENT (THIRD) OF AGENCY (2006). "An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship." § 8.01 "General Fiduciary Principle," RESTATEMENT (THIRD) OF AGENCY (2006).

[cv] The incorporation of aspects of contract law into fiduciary duties has led to a broad academic discussion regarding whether fiduciary duties are default rules. Over two decades have passed since Cooter and Freedman (1991) and Easterbrook and Fischel (1993) espoused the contractualists' model of fiduciary law. *See, e.g.*, Sitkoff, supra n.___, at , 1041.

Yet, the contractualists' theory of fiduciary law appears misplaced, at least in the context of advisory relationships. "[C]ontract law concerns itself with transactions while fiduciary law concerns itself with relationships." Rafael Chodos, *Fiduciary Law: Why Now! Amending the Law School Curriculum*, 91 Boston U.L.R. 837, 845 (and further noting that "Betraying a relationship is more hurtful than merely abandoning a transaction." *Id*. *See also* Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 Buff. L. Rev. 99, 104-29 (2008) (rejecting contractual approach as descriptive theory of fiduciary duties, and at 129-30 (arguing that signature obligation of fiduciary is to adopt ends of his or her principal).

The author posits that there may be greater flexibility in contracting around fiduciary duties where the entrustor is an employer of a non-expert employee (i.e., in an employer-employee relationship) and has greater control and, presumably, knowledge than the employee. Even then, the "tendency of courts to construe fiduciary limitations narrowly and to be suspicious of provisions purporting to eliminate all fiduciary duties is understandable given the long tradition of treating business partners and managers as fiduciaries." Chodos, at p.894 (further noting that: "This approach also is consistent with the general drafting principle that limitations on fiduciary duties are strictly construed. *See, e.g., Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 171–72 (Del. 2002); RESTATEMENT (THIRD) OF AGENCY § 8.06 (2006).") *Id.*

Hence, greater emphasis on the contractual nature of fiduciary obligations may exist when contracting parties enter into a partnership agreement or a limited liability company operating agreement, given that most state statutes permit these parties, upon entry into the relationship, to negotiate (to a degree) the legal duties owed to one another. Yet, in relationships of an advisory-client nature, where there exists a vast disparity in knowledge between the advisor and the client, and where clients do not normally seek legal advice prior to entry into such relationships, the ability of the advisor to negate fiduciary duties by contract is properly more circumscribed.

Other scholars appear reject the contractualist theory of fiduciary duties more broadly. *See, e.g.*, Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209 (1995) ("[C]ircumstances exist where fiduciary duties are not waivable for reasons such as doubts about the quality of the entrustors' consent (especially when given by public entrustors such as shareholders), and the need to preserve institutions in society that are based on trust. Further, non-waivable duties can be viewed as arising from the parties' agreement ex ante to limit their ability to contract around the fiduciaries' duties. Under these circumstances fiduciary rules should generally be mandatory and non-waivable … I conclude that private and public fiduciaries should be subject to a separate body of rules and reject the contractarian view..") *Id. See also* Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts,* 82 MARQ. L. REV. 303, 305 (1999) ("This Article explores the nature of fiduciary relationships, shows that they arise and function in ways alien to contractualist thought, and that they have value and serve purposes unknown to the contractualists.")

[cvi] As Professor Laby notes, "Historically, providing advice has given rise to a fiduciary duty owed to the recipient of the advice. Both the *Restatement (First)* and *Restatement (Second) of Torts* state, "[a] fiduciary relation exists between two persons when one of them is under a duty to act for *or to give advice* for the benefit of another upon matters within the scope of the relation" [citing RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979) (citation omitted) (emphasis added); RESTATEMENT (FIRST) OF TORTS § 874 cmt. a (1939) (citation omitted) (emphasis added)].

[cvii] John R. Dos Passos, A Treatise on the Law of Stock-Brokers and Stock Exchanges, The Banks Law Publishing Co., 2ND Edition (1905), Vol. 1, p.2 (available at http://ia700303.us.archive.org/28/items/lawofstockbroker01dosp/lawofstockbroker01dosp.pdf).

[cviii] *Id.* at pp.3-4.

[cix] *Id. See also Banta v. Chicago*, 172 Ill. 204; 50 N.E. 233; 1898 Ill. LEXIS 2855 (Ill. 1898) ("the business of brokers continued to expand, and they subsequently undertook to effect the negotiation of bonds and other evidences of indebtedness, and certificates of shares in the capital stock of incorporated companies. The advent of brokers into this branch of business is referred to by Chief Justice Beck in the early case of *Gibbons v. Rule*, 12 Moore, 539, (13 E.C.L. 444,) which was decided in 1827, as follows: 'The statute 8 and 9 William III, chap. 20, by which the first government loan was raised, speaks of a new description of brokers, -- persons employed in buying and selling tallies, the government securities of those days. These have since been called stock brokers.' The statute referred to was enacted by the Parliament of England in the year 1697.") *Id.* at 237.

[cx] *See* An Act to Restrain the Number and Ill Practice of Brokers and Stock Jobbers, 1697, 8 & 9 Will. 3, c. 32 (Eng.) [hereinafter Statutes], available at http://www.british-history.ac.uk/report.aspx?compid=46880.

[cxi] John R. Dos Passos, at p.4.

[cxii] *See* James A. Klimek, A Brief History of Securities Law, available at http://www.klimek-law.com/Brief%20History.shtml ("In 1707 Parliament was in a deregulatory phase and allowed the statute to lapse.").

[cxiii] The Act permitted brokers to receive not more than ten shillings per cents for a brokerage fee, and imposed a stiff penalty for receiving additional compensation not permitted by the Act, stating: "if any such Broker or Brokers so to be admitted as aforesaid shall directly or indirectly deal for him or themselves in the Exchange or Remittance of Moneys or shall buy any Talleys Orders Bills or Share or Interest in any Joint Stock to be assigned or transferred to his owne Use or buy any Goods Wares or Merchandizes to sell againe for his owne Benefitt or Advantage or shall make any Gain or Profitt in buying or selling any Goods over and above the Brokage allowed by this Act hee or they so offending shall forfeit the Su[m]m of Two hundred pounds and being convicted of [any] such Offence shall be for ever incapable to trade act or deal as a Broker for any Person or Persons whatsoever." *Id.* at section IX. The Act ws only in existence for approximately ten years. *See* James A. Klimek, *A Brief History of Securities Law*, available at http://www.klimek-law.com/Brief%20History.shtml ("In 1707 Parliament was in a deregulatory phase and allowed the statute to lapse.").

[cxiv] John R. Dos Passos, at p. 173.

[cxv] *Id.*, at p.176, citing *Banta v. Chicago*, 172 Ill. 201.

[cxvi] John R. Dos Passos, at pp. 180-1.

[cxvii] As was well-known in the early case law: "The principle is undeniable that an agent to sell cannot sell to himself, for the obvious reason that the relations of agent and purchaser are inconsistent, and such a transaction will be set aside without proof of fraud." *Porter v. Wormser* , 94 N. Y. 431, 447 (1884). The Investment Advisers Act of 1940 provided a specific exception to this legal principle for investment advisers who engaged in principle trades, but requiring as a safeguard in-advance disclosures and the consent of the client.

[cxviii] Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65, 66 (1997) (providing a summary of the historical development of brokers and dealers before the '33 and '34 securities acts).

[cxix] Matthew P. Allen, supra n. ___, at p.21. *See also* Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535, 586-87 (2005).

See also Angela Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, & Farrukh Suvankulow, *Perspectives on Investment Advisers and Broker Dealers*, RAND INST. FOR CIV. JUST., 49, t.4.9 (2008) [hereinafter RAND Study], at 7.

[cxx] *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e (2006) ("Any agent has power over the principal's interests to a greater or lesser degree. This determines the scope in which fiduciary duty operates.").

[cxxi] Laby, at 751.

[cxxii] **The Securities Markets Study (1935)**

An influential early study of the securities market was conducted following the 1929 stock market crash. Written in large part prior to the adoption of the Securities Exchange Act of 1934,[cxxii] the entire study was published by Twentieth Century Fund in 1935. Entitled "The Securities Market," the study provided a long review of the functions of the securities markets and the activities of their various actors and participants (including brokers and "investment counsel").

The authors of the study described the "brokerage-firm-customer relationship" as follows:

> A brokerage firm stands in a four-fold relationship toward tis customer.
>
> 1. It acts as his broker in the purchase and sale of securities and in the borrowing and lending of stocks.
> 2. It acts as a pledgee, in which capacity it either advances its own capital to finance his margin transactions, or, much more commonly, advances capital borrowed from banks.
> 3. It is the custodian of his securities and cash.
> 4. *It exercises, to some extent, the function of an investment counsel to him.*
>
> These relationships imply great responsibilities and obligations on the part of a brokerage firm. Under these circumstances the customer is entitled to expect the fullest possible protection … *To the greatest extent possible, a condition should be created where the conflict of interest between broker and customer is reduced to the minimum.* [*Emphasis added.*]

The Securities Market study went further in suggesting protections for conflicts of interest for *investment counsel* – those individuals who were paid directly by their clients – stating:

> We believe that anyone who entrusts his investment problems to an investment counsel is entitled to protection ... He should be assured that his financial advisor is possessed of at least certain minimum qualifications and, in addition, that *he is free from all entanglements that might divide his loyalties …*
>
> No individual should be granted, or permitted to retain, a license to practice as investment counsel for pay who is in the business of underwriting, distributing, buying or selling securities either as a broker or principal; or who is in the employ of, or is in any way affiliated with, or is a stockholder or partner in, any organizations engaged in any manner whatever in such activities … No licensed investment counsel should be permitted to employ, or to retain in his employment, any one in any way connected with any activity or implied [in the foregoing sentence]; or to associate himself as a partner, joint stockholder, or otherwise with any such disqualified person.[cxxii] [*Emphasis added.*]

In essence, the Securities Market study recommended that brokers be held to the "best interests" fiduciary standard of conduct, with conflicts of interest minimized. Also, the study recommended the separation of brokers and dealers (who deal in their own securities, or who sell offerings of securities firms in initial or subsequent public offerings).

The Securities Market study also, in essence, recommended that investment counsel be held to the "sole interests" fiduciary standard in which avoidance of all conflicts of interest was required. Additionally, no "dual registration" (as exists today) as both a broker (or dealer) and investment adviser ("investment counsel" in 1935) would be permitted, given the insidious conflicts of interest under such affliations.

[cxiii] *See, e.g. In re Ruskay* (U.S. Ct. App. 2nd Cir.), 5 F.2d 143; 1925 U.S. App. LEXIS 2618 (1925) ("Equity regards a fund so paid and received as impressed with a trust in favor of the one who paid it over and who is beneficially entitled.") *Id.* at p. 144.

[cxiv] Norman S. Poser and James A. Fano, Broker-Dealer Law and Regulation (Wolters Kluwer, Fourth Edition) (2011 Supp.), at p.16-36.

[cxv] *Birch v. Arnold*, 88 Mass. 125; 192 N.E. 591; 1934 Mass. LEXIS 1249 (Mass. 1934).

[cxvi] *Id*.

[cxvii] *Birch v. Arnold* , *citing Reed v. A. E. Little Co*., 256 Mass. 442, 152 N.E. 918, and *Wendt v. Fischer*, 243 N.Y. 439, 443, 444, 154 N.E. 303.

[cxviii] *Patsos vs. First Albany Corp*., 433 Mass. 323; 741 N.E.2d 841; 2001 Mass. LEXIS 19 (Mass. 2001), at pp. 322-3.

[cxix] *Id.* at pp.332-3.

[cxx] *Id*. at pp. 334-5.

[cxxi] *Id*. at 334.

[cxxii] *Id*. at p.335. In *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523; 1987 U.S. App. LEXIS 16820; Fed. Sec. L. Rep. (CCH) P93,693; 9 Fed. R. Serv. 3d (Callaghan) 1318; Comm. Fut. L. Rep. (CCH) P24,179 (C.A. 5th Cir. 1987), the Court stated: "It is clear that the nature of the fiduciary duty owed will vary, depending on the relationship between the broker and the investor. Such determination is necessarily particularly fact-based. And although courts draw no bright-line distinction between the fiduciary duty owed customers regarding discretionary as opposed to nondiscretionary accounts, the nature of the account is a factor to be considered." *Id.* at 530. *See also Broofield vs. Kosow*, 349 Mass. 749; 212 N.E.2d 556; 1965 Mass. LEXIS 804 (1965) ("the plaintiff alone, by reposing trust and confidence in the defendant, cannot thereby transform a business relationship into one which is fiduciary in nature. The catalyst in such a change is the defendant's knowledge of the plaintiff's reliance upon him. In redressing an abuse of trust and confidence equity will review such factors as the relation of the parties prior to the incidents complained of, the plaintiff's business capacity or lack of it contrasted with that of the defendant, and the readiness of the plaintiff to follow the defendant's guidance in complicated transactions wherein the defendant has specialized knowledge. Equity will, in sum, weigh whether unjust enrichment results from the relationship.") *Id.* at 755.

[cxxiii] *Johnson v. Winslow*, Supreme Court of New York, New York County, 155 Misc. 170; 279 N.Y.S. 147 (1935).

[cxxiv] *Norris v. Beyer*, 124 N.J. Eq. 284; 1 A.2d 460 (1938). [**Emphasis added.**]

[cxxv] *Laraway v. First National Bank Of La Verne*, 39 Cal. App. 2d 718; 104 P.2d 95 (1940).

[cxxvi] Hazen, Thomas Lee, Stock Broker Fiduciary Duties and the Impact of the Dodd-Frank Act. North Carolina Banking Institute, Vol. 15, 2011; UNC Legal Studies Research Paper No. 1767564. Available at SSRN: http://ssrn.com/abstract=1767564.

[cxxxvii] Matthew P. Allen, A Lesson from History, Roosevelt to Obama - The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty, Entrepreneurial Bus. Law. J. (2010), at p. 20, *citing* Steven A. Ramirez, The Professional Obligations ofSecurities Brokers Under Federal Law: An Antidote for Bubbles?, 70 U. Cin. L. Rev. 527 (2002), at p. 534 (*quoting* H.R. Rep. No. 73-85, at 1-2 (1933)).

[cxxxviii] *Seventh Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1941*, at p. 158, citing *Earll v. Picken* (1940) 113 F. 2d 150.

[cxxxix] *Seventh Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1941*, at p. 158.

[cxl] *1942 SEC Annual Report*, p. 15, referring to *In the Matter of Willlam J. Stelmack Corporation*, Securities Exchange Act Releases 2992 and 3254.

[cxli] 1963 SEC Study. *See also Arleen W. Hughes*, Exch. Act Rel. No. 4048, 27 S.E.C. 629 (Feb. 18, 1948) (Commission Opinion), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949) (broker-dealer is fiduciary where she created relationship of trust and confidence with her customers);

[cxlii] *Pirnie, Simons & Co., Inc. v. Whitney*, 144 Misc. 812; 259 N.Y.S. 193; 1932 N.Y. Misc. LEXIS 1216 (Sup.Ct.NY, 1932).

[cxliii] Chester T. Lane, Address Before The Seattle Bond Club (Mar. 14, 1938), available at http://www.sec.gov/news/speech/1938/031438lane.pdf.

[cxliv] George C. Matthews, A Discussion of the Maloney Act Program, before the Investment Bankers Association of America, October 23, 1938, available at http://sec.gov/news/speech/1938/102338mathews.pdf.

[cxlv] Senator Francis T. Maloney, Regulation of the Over-the-Counter Security Markets, Address at the California Security Dealers Association, Investment Bankers Association, National Association of Securities Dealers 2 (Aug. 22, 1939) (transcript available in the SEC Library at 11 SEC Speeches, 1934-61).

[cxlvi] *The Bulletin*, published by the National Association of Securities Dealers, Volume I, Number 2 (June 22, 1940).

[cxlvii]*N.A.S.D. News*, published by the National Association of Securities Dealers, Volume II, Number 1 (Oct. 1, 1941).

[cxlviii] *The Bulletin*, published by the National Association of Securities Dealers, Volume I, Number 2 (June 22, 1940). [*Emphasis added*.]

[cxlix] History of the NASD, by Wallace H. Fulton, First President [Executive Director] of the NASD, 1939 – 1964, available at http://www.nmta.us/site/DocsPosted/CFPB/HistoryoftheNASD.pdf.

[cl] Matthew P. Allen, *A Lesson from History, Roosevelt to Obama — The Evolution Of Broker-Dealer Regulation: From Self-Regulation, Arbitration, And Suitability To Federal Regulation, Litigation, and Fiduciary Duty*, 5 Entreprenurial Bus.L.J. 1, 9 (2010).

[cli] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963). *See also Transamerica Mortgage Advisors, Inc*., 444 U.S. 11, 17 (1979) ("[T]he Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations."). As stated by SEC staff, "The adviser's fiduciary duty is enforceable under Advisers Act Sections 206(1) and (2), which prohibit an adviser from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client" and from engaging in "any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client." SEC Staff 2011 Study, *supra* n.__, at pp. 21-2.

[clii] *Brandt, Kelly & Simmons, LLC*, Admin. Proc. File No. 3-11672 (SEC Sept. 21, 2004), *citing SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 180 (1963).

[cliii] "A main theme in the cases that developed the sole interest rule was the fear that without the prohibition on trustee self-interest, a conflicted trustee would be able to use his or her control over the administration of the trust to conceal wrongdoing, hence to prevent detection and consequent remedy. Lord Hardwicke, sitting in 1747, before the sole interest rule had hardened in English trust law, was worried about a self-dealing trustee being able to conceal misappropriation. In 1816 in *Davoue v. Fanning*, the foundational American case recognizing and enforcing the then-recently-settled English rule, Chancellor Kent echoed this concern: "There may be fraud, as Lord Hardwicke observed, and the [beneficiary] not able to prove it." In order "to guard against this uncertainty," Kent endorsed the rule allowing the beneficiary to rescind a conflicted transaction "without showing actual injury." In his Commentaries on American Law, Kent returned to the point that the sole interest rule "is founded on the danger of imposition and the presumption of the existence of fraud, inaccessible to the eye of the court." John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest*, 114 Yale L. J. 929, 944 (2005).