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August 6, 2018

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

RE: File Number S7-09-18
Comment Letter #1:
Proposed Interpretation of Fiduciary Duties Arising Under the Advisers Act

Dear Chair Clayton, Commissioners and Staff of the U.S. Securities and Exchange Commission:

As a researcher regarding the application of fiduciary law to the delivery of financial planning and investment advice, I submit these comments. *This letter is submitted on my own behalf, and not on behalf of any organization, firm, or institution to which I belong or may be affiliated.*

The content of this comment letter can be broken into the following major sections:

- A. Responses to the 3 Main Questions Posed by the SEC: (1) Sufficiency of the SEC's Guidance; (2) Omissions; and (3) Whether Codification Should Occur.**
- B. The Misinterpretation of *SEC vs. Capital Gains*: Disclosure is Not Sufficient to Satisfy A Fiduciary's Obligations When a Conflict of Interest is Present**
- C. The Ineffectiveness of Disclosures: Compelling Academic Research Supports the Fiduciary Standard's Application of the Fiduciary Duty of Loyalty**
- D. The Problem of Shedding the Fiduciary Hat: Dual Registrants**
- E. Correctly Applying the Fiduciary Standard of Conduct Requires an Understanding of the Important Public Policy Rationale that Supports the Application of Fiduciary Principles**
- F. The Interplay Of State Common Law and the Investment Advisers Act Of 1940 Imposing Fiduciary Duties on the Delivery Of Financial and Investment Advice**
- G. Edits to the Commission's Interpretation of the Fiduciary Duties Arising Under the Investment Advisers Act of 1940**

I provide these comments from my perspective as an attorney-at-law (estate planning, taxation) for 32 years, a registered investment adviser representative for 17 years, a participant in financial advisory association committees and boards and as a speaker at conferences and symposia and a researcher and commentator on fiduciary law as applied to financial services for over 14 years, and as a professor of finance and financial planning providing instruction in investments and financial planning for the past 6 years.¹ I hope that this comment letter, which seeks to integrate the law and legal theory surrounding the fiduciary principle with practical application discerned from my many observations as to what actually occurs in the marketplace for financial and investment advice, will assist the Commission as it further considers its proposed interpretation.

A. Responses to the 3 Main Questions Posed by the SEC: (1) Sufficiency of the SEC’s Guidance; (2) Omissions; and (3) Whether Codification Should Occur.

Release #IA-4998 asks of commentators the following general questions, and I provide my general replies thereto.

(1) Does the Commission’s proposed interpretation offer sufficient guidance with respect to the fiduciary duty under section 206 of the Advisers Act?

In response to this first question, the SEC’s interpretation of the fiduciary standard of conduct, especially as it relates to how conflicts of interest are properly managed, appears to be based upon an incorrect interpretation and application of the *SEC vs. Capital Gains*² decision on the key duties of a fiduciary financial and investment adviser when a conflict of interest is present. I set forth and explain the correct interpretation in a later section of this comment letter.³

I am also concerned that the SEC’s interpretation of the federal fiduciary standard of conduct, and in particular the processes that must be observed when a conflict of interest is present, fails to incorporate the guidance investment advisers require, which guidance can be discerned from state common law (which informs the federal fiduciary standard arising under the Advisers Act). In my edits to the Commission’s

¹ I currently serve Director of the Personal Financial Planning program and assistant professor – finance, in the Gordon Ford College of Business at Western Kentucky University. I am also a state-registered investment adviser (Scholar Financial), serving a select group of clients with holistic financial and investment advice. I have previously served as Chief Compliance Officer and Chair of the Investment Committee of an SEC-registered investment advisory firm. I am also a member of The Florida Bar and currently serve select clients in estate planning and transfer tax planning matters. I served as Reporter for the Financial Planning Association’s Fiduciary Task Force (2006-7) and Standards of Conduct Task Force (2007), and I have held positions in various committees and boards within several financial planning organizations. I am also a member and former Chair of the Steering Committee of The Committee for the Fiduciary Standard (www.thefiduciarystandard.org). I have written many articles regarding the fiduciary standard with the view of informing investment advisers of their duties, including blog posts at www.scholarfp.blogspot.com. Again, these comments are submitted on my own behalf and not on behalf of any organization, firm, or institution to which I may belong or with whom I may be affiliated.

² *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180 (1963) [herein referred to as “SEC vs. Capital Gains.”]

³ See Section B, *infra*.

proposed interpretation in a later section of this comment letter⁴ I provide language with additional suggested guidance.

In enacting the Advisers Act, Congress recognized that advisers are fiduciaries to their clients, but Congress did not create that duty. The fiduciary duties of investment advisers already existed, under state common law, and continue today. Indeed, the Commission has acknowledged that the Advisers Act *incorporates* common law principles.⁵

Should the Commission's interpretations of the federal fiduciary standard diverge and be inconsistent with the consensus of state common law, such resulting inconsistencies could result in investment advisers becoming subject to liability if they may seek to rely only upon the Commission's interpretation of their fiduciary obligations. It must be noted that the vast majority of claims⁶ brought against investment advisers are based not on the Advisers Act and the regulations promulgated thereunder, as the Investment

⁴ See Section G, *infra*.

⁵ In a settled enforcement action, Brandt, Kelly & Simmons, LLC, the Commission sued a registered adviser and its managing partner. The adviser negotiated with TD Waterhouse Investor Services (TDW) to move the adviser's client accounts from another broker-dealer to TDW. The adviser's managing partner told TDW that the other brokerage firm would charge the advisory clients a fee to terminate their accounts. To reimburse that fee, TDW offered to pay the adviser \$ 7500 and the adviser agreed that it would use the money to reimburse clients. The adviser, however, did not tell clients about the reimbursement funds and used the money to cover operating expenses. When the SEC settled the case, it wrote that the adviser willfully violated sections 206(1) and (2) of the Advisers Act, "which incorporate common law principles of fiduciary duties." Thus, the Commission's view was that the fiduciary duty created by the Advisers Act encompassed state common law fiduciary obligations. Brandt, Kelly & Simmons, LLC, Admin. Proc. File No. 3-11672, 2004 WL 2108661 (SEC Sept. 21, 2004).

⁶ When an investment advisor breaches its fiduciary duty to its client, in addition to possible enforcement actions that might be brought by the Commission and/or by state securities regulators, the client may also possess a claim against their investment advisor based upon state common law fiduciary duties. The Senate Report accompanying the Private Securities Litigation Reform Act of 1995 ("PSLRA") described the importance of private rights of action as follows:

The SEC enforcement program and the availability of private rights of action together provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws. As noted by SEC Chairman Levitt, "private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program." [citation omitted]

See S. REP. NO. 104-98, at 8 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 687; *see also Basic Inc. v. Levinson*, 485 U.S. 224, 230-32 (1988) (private cause of action is an "essential tool for enforcement of the 1934 Act's requirements").

Note, also, that preserves state authority in limited situations to bring antifraud enforcement actions. This savings clause retains state jurisdiction as follows: "Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." 15 U.S.C. § 77(r)(c)(1).

The forum for such private claims depends on whether there is a forum selection clause in the investment advisor agreement between the investment advisor and client, and whether that arbitration clause has been negated by state law or regulation. As a result, court proceedings involving investment advisers may occur, arbitration before a panel such as the American Arbitration Association ("AAA"). Dual registrants' arbitration occurs before FINRA's arbitration panels.

Advisers Act of 1940 provides very limited private causes of action.⁷ Rather, breach of fiduciary duty claims against investment advisers are typically based upon state common law.⁸ Accordingly, maintaining consistency⁹ with state common law should be a major factor in how the federal fiduciary standard arising under the Advisers Act is applied. The interpretation of the fiduciary duties arising under the Advisers Act does not preempt,¹⁰ and should not seek to eclipse, state common law for breach of fiduciary duty by an investment adviser, given the limited remedies afforded to clients under the Advisers Act itself. Rather, the effect should be complementary.¹¹

As the Commission’s application of the Advisers Act does not preempt most other federal laws nor state statutory and common law, the Commission’s interpretation of the investment adviser’s fiduciary duty only establishes a floor, and not a ceiling. Different or stricter fiduciary duties and more robust obligations of investment advisers might arise from other federal statutes (such as ERISA), state statutory laws and regulations promulgated thereunder, and state common law. While different sources of fiduciary law arise, the Commission should seek to conform to state common law (which informs the federal fiduciary standard), in order that the “floor” and the “ceiling” not become too distant. In other words, it is important that the Commission’s interpretation of the Advisers Act’s fiduciary standard of conduct be informed by, and be consistent with, the majority view of courts applying state common law standards.

⁷ In *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11 (1979), the U.S. Supreme Court held that private plaintiffs are only able to sue their advisers under Section 215 of the Advisers Act. Section 215 provides that contracts made in violation of the Advisers Act, or the performance of which would violate the Advisers Act, are void. See Investment Advisers Act of 1940 § 215(b), 15 U.S.C. § 80b-15 (2018).

⁸ I acknowledge that SEC Release IA-4889 (2018) does provide, in the text of footnote 44: “Separate and apart from potential liability under the antifraud provisions of the Advisers Act enforceable by the Commission for breaches of fiduciary duty in the absence of full and fair disclosure, investment advisers may also wish to consider their potential liability to clients under state common law, which may vary from state to state.” I also acknowledge fn. 7 of IA-4889, stating: “This Release is intended to highlight the principles relevant to an adviser’s fiduciary duty. It is not, however, intended to be the exclusive resource for understanding these principles.” As stated, my concern is that the federal fiduciary duty, as related by the SEC, is inconsistent in several respects with state common law, as I discuss in more detail in the subsequent sections of this comment letter.

⁹ The Lockstep Doctrine, in which state courts follow the decisions of an inferior federal court as to an issue of federal law, illustrates (in reverse) the need for consistency. The doctrine is premised on the idea that one court will treat as binding another court’s interpretation of the law – not because it has to, but because of the benefits that such an approach generates. The federal law sees improvement. There exists better consistency in the application of the law. A higher quality in the adjudication of the law results.

¹⁰ Several provisions in NSMIA expressly avoid preempting or limiting a state’s ability to investigate and enforce its own anti-fraud laws. See, for example, Section 203A(b)(2) and Section 222(d) of the Advisers Act. See *Zuri-Invest AG v. Natwest Fin., Inc.*, 177 F. Supp. 2d 189, 195 (S.D.N.Y. 2001) (National Securities Markets Improvement Act of 1996 (“NSMIA”) does not preempt state common law claims for fraud and conspiracy) (quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)). As the court stated, “legislative history indicates that it was the ‘[Commerce] Committee’s intention not to alter, limit, expand, or otherwise affect in any way any State statutory or common law with respect to fraud or deceit . . . in connection with securities or securities transactions.’” *Id.*, citing Conference Report, H.R. Conf. Rep. 104-864, 104th Congr. 2d Sess. At 34 (1996) (*Emphasis added*). Indeed, few statutes would possess such an “extraordinary pre-emptive power.” *Id.*, quoting *Metro. Life Ins. Co. v. Taylor*, 481 U.S. 58, 65 (1987).

¹¹ Nearly all of the leading legal theorists of the 20th Century generally agree that “the growth of the regulatory state should complement, not displace, common law.” Note, Common Law and Federalism in the Age of the Regulatory State, 92 Iowa L.Rev. 545, 556 (2007).

The rationale for such conformity was stated recently by Chair Clayton: “[D]iffering standards confuse investors and may impose compliance costs on investment professionals.”¹²

In my suggested edits to the Commission’s interpretation, I set forth an interpretation of the federal fiduciary standard as properly informed by state common law. I suggest changes to the Commission’s interpretation in order to better adhere to common law fiduciary principle, to correct the Commission’s misapplication of language found in *SEC vs. Capital Gains*, and to provide more detailed and better guidance to investment advisers and their clients.

(2) Are there any significant issues related to an adviser’s fiduciary duty that the proposed interpretation has not addressed?

The Commission omits sufficient detail, as can be discerned from state common law and other sources, that effectively conveys the depth of the fiduciary’s obligations. In a latter section of this comment letter I provide edits and additions to the Commission’s interpretation, in order to bring the Commission’s interpretation into accord with state common law and as a means of providing more explicit guidance to both investment advisers and their clients.

A significant issue not addressed in the Commission’s proposed interpretation involves the requirement of reasonable compensation. While, due to time constraints imposed by the short comment period, I do not expressly address this requirement in this comment letter, if the Commission extends the time for submission of comments I will re-visit this issue during a future comment letter.

(3) Would it be beneficial for investors, advisers or broker-dealers for the Commission to codify any portion of our proposed interpretation of the fiduciary duty under section 206 of the Advisers Act?

I suggest that great caution must be taken in the codification of any principles-based standard. While the efforts of the Commission to educate and inform investment advisers, through its proposed interpretation, are helpful (although not entirely correct, as I discuss in detail herein), codification of the standard through further rule-making would be inappropriate.

Fiduciary duties are not static; rather, they must evolve¹³ over time to meet the ever-changing business practices of advisors and fraudulent conduct successfully circumscribed.

The need for evolution of the fiduciary standard of conduct has been known for well over a century. “Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly

¹² Chair Jay Clayton, Speech, “The Evolving Market for Retail Investment Services and Forward-Looking Regulation — Adding Clarity and Investor Protection while Ensuring Access and Choice” (May 2, 2018).

¹³ As evidenced by the writings of Dean Roscoe Pound, in *THE SPIRIT OF THE COMMON LAW* (Transaction Publishers 1999) (1921), state common law is well-suited to a central role in the development and application of legal theories because of its unique ability to combine precedent and certainty with the power to change to meet new societal needs. *Id.* at 182. Likewise, in the 1930’s, as the role of statutes and administrative agencies grew larger, Dean James McCauley Landis pointed out the need for greater interdependence between administrative agency’s interpretations of the law and the common law. James M. Landis, *Statutes and the Sources of Law*, in *HARVARD LEGAL ESSAYS*, 213, 233 (1934).

circumvented at once by new schemes beyond the definition. Messieurs, the fraud-feasors, would like nothing half so well as for courts to say they would go thus far, and no further in its pursuit.”¹⁴

Because fraud is by its very nature boundless, the one fiduciary standard of conduct applicable to investment advisers should not be subjected to attempts to define or restrict it legislatively, or by rule-making, by means of any particular definition. As observed in an early speech from the Commission’s legal counsel to its Corporate Finance division:

Like fraud, abuse of trust is not a fact but a conclusion to be drawn from facts. *The terms ‘gross abuse of trust’ or ‘gross misconduct’ should not be limited by any hard and fast definition.* Both constitute fraud in its general sense ... the interpretation of gross misconduct and gross abuse of trust as used in Section 36 will depend not only upon relevant common law principles but also upon the declaration of policy as set forth in the Act¹⁵ [*Emphasis added.*]

Breach of fiduciary duty is constructive fraud, to which the same principle applies.

Moreover, the Commission’s interpretations, if codified, may become outdated over time as innovations occur in the investment advisory industry. Should codification occur of the federal fiduciary standard, over time the Commission could be prohibited from taking action against practices that would violate common law fiduciary standards applicable to investment advisers.

Should codification occur, then the Commission, without continually reviewing and revising its own regulations, could also be subjected to claims that defeat enforcement actions on the grounds of indeterminacy or vagueness. The vagueness doctrine, as articulated by the U.S. Supreme Court, requires that a penal statute define offenses with sufficient clarity so that an ordinary person can understand what conduct is prohibited, and so that the statute does not lead to arbitrary or discriminatory enforcement.¹⁶

The Commission should also seek to preserve the flexibility of state common law, as such state common law continues to inform the Advisers Act and the federal fiduciary standard. As the delivery of investment advice evolves over time, courts implementing the common law fiduciary duty can respond to such changes, and to particular facts and circumstances, and thereby continue to develop the fiduciary obligations of investment advisers. Under state common law, the courts may draw fiduciary principles

¹⁴ *Stonemets v. Head*, 248 Mo. 243, 154 SW 108 (1913) (Judge Lamb, writing for the Missouri Supreme Court). *See also* Justice Douglas’s majority opinion in *Pepper v. Litton*, 308 U.S. 295, 311 (1939), wherein he stated: “He who is in such a fiduciary position cannot serve himself first and his *cestuis* second ... He cannot use his power for his personal advantage and to the detriment of [the *cestuis*], no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation ... Otherwise, the fiduciary duties ... would go for naught: exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart.”

¹⁵ Speech, “Diversiform Dishonesty” by Edward H. Cashion, Counsel to the Corporation Finance Division, U.S. Securities and Exchange Commission, on November 17, 1945 to the National Association of Securities Commissioners, where in reference to Section 36 of the Investment Company Act of 1940.

¹⁶ *United States v. Williams*, 553 U.S. 285, 304 (2008); *Kolender v. Lawson*, 461 U.S. 352, 357 (1983).

from tort law, agency law,¹⁷ or trust law, each of which contains its own set of requirements with respect to fiduciary obligation.

Furthermore, by not seeking to “codify” the principles-based¹⁸ fiduciary standard as a set of more specific rules, the Commission preserves its own ability to adapt to insights from financial economics research affecting investment advisory practices, to insights from behavioral economics, and to innovations occurring within the investment advisory industry itself. The beauty of a principles-based standard lies in its ability to guide actors subject to it, regardless of the new business models or practices or greater use of technology that might emerge in the future as the financial services industry continues to evolve over time.

B. The Misinterpretation of *SEC vs. Capital Gains*: Disclosure is Not Sufficient to Satisfy A Fiduciary’s Obligations, When a Conflict of Interest is Present

Commentators often opine that the U.S. Supreme Court approved, in its 1963 *SEC vs. Capital Gains* decision, of “disclosure” as the sole means of satisfying a fiduciary’s duty of loyalty, when a conflict of interest is present. But, such commentators choose to ignore these words in the decision – which cannot be ignored:

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**¹⁹
[**Emphasis added.**] [**Emphasis added.**]

These words, contained in the *SEC vs. Capital Gains* decision, are often ignored by commentators, most of whom are employed either directly or indirectly by broker-dealer firms²⁰ and hence, it may be assumed,

¹⁷ I would opine that agency law should not, however, be seen as the primary source for the application of the fiduciary standards of conduct for investment advisers. Unlike the investment adviser-client relationship, in a principal-agent relationship the principal usually possesses control over the agent. In the investment adviser-client relationship it is the fiduciary (investment adviser) who usually possesses (or should possess, as an expert, in order to adhere to her or his fiduciary obligations) a great deal of knowledge regarding the workings of the capital markets. It could be stated that sources of developed fiduciary law that are more analogous to the investment adviser-client relationship could be looked at for guidance, such as the law concerning attorneys and their clients, or (with some limitation, given differences in both the standard of due care and the “sole interest” duty of loyalty) ERISA.

¹⁸ The Commission 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>.

¹⁹ *SEC vs. Capital Gains*, at text accompanying note 48.

²⁰ Many broker-dealer firms (and dual registrant firms) seek to avoid restrictions upon their business practices, and the fiduciary standard of conduct – properly applied in accordance with common law principles - is perhaps the

are engaged in what can only be considered “wishful thinking.” Yet, their desired interpretation of the decision – that all that is required when a conflict of interest is present is disclosure of the conflict, followed by “mere” (not “informed”) consent – has no foundation in the law. The words of the U.S. Supreme Court – “in this case” and “we need not go that far ... since here the Commission seeks only disclosure of a conflict of interests” – show the Court’s judicial restraint only. The U.S. Supreme Court’s holding was to apply a federal fiduciary standard to the conduct at issue; the Court was not called upon to delineate the many requirements imposed upon investment advisers as a result of such federal fiduciary standard.

It must be understood that in the *SEC vs. Capital Gains* enforcement action, where the Commission sought injunctive relief, the Commission only sought a breach of the fiduciary duty for the adviser’s failure to disclose. This limited nature of the enforcement action by the Commission is understandable. Failure to disclose a conflict of interest, when present, is clearly a violation of the fiduciary duty of loyalty. Proof of failure to disclose is easy to provide. In contrast, other requirements that exist (as are set forth in more detail in my edits to the proposed interpretation, set forth later herein, and specially as to the requirements of informed consent and continued substantive fairness), often require expert testimony, greatly complicating and making more expensive enforcement actions.

The 1933 Securities Act and the Securities and Exchange Act of 1934 both adopt a “full disclosure” regime as a protection for individual investors. But, as made clear by the U.S. Supreme Court, the Investment Advisers Act of 1940 goes further. It recognizes the long-standing understanding that the fiduciary standard exists because disclosure is inadequate as a means of consumer protection in situations in which there is a great disparity in power or knowledge.

Previous actions involving the application of the Advisers Act’s fiduciary standard of conduct support the proper interpretation that disclosure, in and of itself, does not negate a fiduciary’s duties to his or her client. The Commission long disagreed with the notion that all that is required to satisfy one’s fiduciary obligations, when a conflict of interest is present, is “disclosure” and “consent”:

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 Investment Advisers Act of 1940 (“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.** The adviser must have a reasonable belief that the entry of the client into the transaction is in the client’s interest. The facts concerning the adviser’s interest, including its level, may bear upon the reasonableness of any belief that he may have that a transaction is in a client’s interest or his capacity to make such a judgment.²¹ [**Emphasis added.**]

most significant restriction upon the conduct of the firm and its personnel. At its core, the fiduciary standard of conduct restrains conduct – and deters greed.

²¹ *Rocky Mountain Financial Planning, Inc.* (pub. avail. Feb. 28, 1983) (Emphasis added.)

It has long been the Commission's position that the "an investment adviser must not effect transactions in which he has a personal interest in a manner that could result in preferring his own interest to that of his advisory clients."²²

Furthermore, 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 all 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.²³ The Investment Advisers Act of 1940 goes further; it imposes fiduciary obligations upon investment advisers. Indeed, if disclosure alone were all that was required of an investment adviser when a conflict of interest was present, there would be no need for the fiduciary standard – and there would have been no pressing need for the enactment of the Advisers Act itself.

Fundamentally, the fiduciary standard of conduct changes the character of the relationship; instead of representing the product manufacturer, the fiduciary becomes the purchaser's representative, acting on behalf of the client. The law permits the client to trust the fiduciary, as the law recognizes that the fiduciary standard of conduct is imposed in situations where public policy dictates and where disclosures are likely to be ineffective.

²² SEC Rel. No. IA-1092, October 8, 1987, 52 F.R. 38400, *citing Kidder, Peabody & Co., Inc.*, 43 S.E.C. 911, 916 (1968).

²³ Some commentators seize upon this language of the *SEC vs. Capital Gains* decision when they attempt to argue that disclosure of the conflict of interest is all that is required:

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....

C. The Ineffectiveness of Disclosures: Compelling Academic Research Supports the Fiduciary Standard’s Application of the Fiduciary Duty of Loyalty

The SEC’s emphasis on disclosure, drawn from the focus of the 1933 and 1934 Securities Acts on enhanced disclosures, results from the myth that investors carefully peruse²⁴ the details of disclosure documents that regulation delivers. However, under the scrutinizing lens of stark reality, this picture gives way to an image of a vast majority of individual investors who are unable, due to behavioral biases²⁵ as well as a lack of knowledge of our complicated financial markets, to comprehend disclosures,²⁶ yet alone undertake sound investment decision-making.²⁷ As stated by former SEC Commissioner Troy A. Parades:

The federal securities laws generally assume that investors and other capital market participants are perfectly rational, from which it follows that more disclosure is always better than less. However, investors are not perfectly rational. Herbert Simon was among the first to point out that people are boundedly rational, and numerous studies have since supported Simon’s claim. Simon recognized that people have limited cognitive abilities to

²⁴ For years it has been known that that investors do not read disclosure documents. *See, generally*, Homer Kripke, *The SEC and Corporate Disclosure: Regulation In Search Of A Purpose* (1979); Homer Kripke, *The Myth of the Informed Layman*, 28 *Bus. Law.* 631 (1973). *See also* Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 *Stan. L. Rev.* 7, 19 (1994) (“[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures”); Kenneth B. Firtel, *Note*, “Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933,” 72 *S. Cal. L. Rev.* 851, 870 (1999) (“[T]he average investor does not read the prospectus”).

²⁵ For an overview of various individual investor bias such as bounded irrationality, rational ignorance, overoptimism, overconfidence, the false consensus effect, insensitivity to the source of information, the fact that oral communications trump written communications, and other heuristics and bias, *see* Robert Prentice, “Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future,” 51 *Duke L. J.* 1397 (2002).

²⁶ Even a case note describing *SEC vs. Capital Gains* decision at the time of its issuance observed the inherent weakness of disclosures in dealing with the complex financial markets. The Supreme Court, 1963 Term—Dealing by Advisers in Recommended Securities, 78 *Harv. L. Rev.* 292, 294 (1964) (“If the investing public is truly naïve, disclosure does not provide a realistic method of protection.”)

²⁷ *See, e.g.*, Lusardi A. *Financial Literacy: An Essential Tool for Informed Consumer Choice?*. Dartmouth College, Harvard Business School, and National Bureau of Economic Research; 2008. [“Most individuals cannot perform simple economic calculations and lack knowledge of basic financial concepts, such as the working of interest compounding, the difference between nominal and real values, and the basics of risk diversification. Knowledge of more complex concepts, such as the difference between bonds and stocks, the working of mutual funds, and basic asset pricing is even scarcer.”]

See also, e.g., FINRA and U.S. Department of the Treasury. *Financial Capability in the United States National Survey—Executive Summary*. Washington, DC: United States Department of the Treasury and the FINRA Investor Education Foundation; 2009. [“In today’s complex financial marketplace, it can take a great deal of motivation, ability, and opportunity to sort through both relevant and irrelevant data necessary to make optimal decisions. This asks a great deal of consumers, many of whom face the pressures of time poverty as well as limited financial resources. Others simply cannot or do not want to perform all the tasks needed to optimize their financial situation (i.e., set decision criteria, diligently search for information, weigh attributes, and evaluate alternatives). Furthermore, these financial decisions are highly person or household specific: one family’s decision may not work for another. And even if consumers go through a rigorous decision-making process, there can be problems with implementation.”]

process information. As a result, people tend to economize on cognitive effort when making decisions by adopting heuristics that simplify complicated tasks. In Simon's terms, when faced with complicated tasks, people tend to "satisfice" rather than "optimize," and might fail to search and process certain information.²⁸

Nor should clients possess the obligation to achieve a sufficient state of financial literacy in order to be able to undertake sufficient judgments about securities, themselves. Financial literacy efforts, except those directed at basic financial concepts such as budgeting, savings, and the proper use of credit, are insufficient to overcome the huge knowledge gap between financial and investment advisers and their clients. This knowledge gap occurs in other professions that are also bound by a fiduciary standard of conduct. As observed by the Financial Planning Association of Australia Limited, "The average person will no more become an instant financial planner simply because of direct access to products and information than they will a doctor, lawyer or accountant."²⁹

The inability of clients to understand disclosures should not be underestimated. In a 2005 study:

Madrian, Choi and Laibson recruited two groups of students – 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 wrote. '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.'³⁰

²⁸ Troy A. Parades, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 Wash. Univ. L. Rev. 417, 419-9 (2003).

²⁹ "Submission to the Financial System Inquiry by the Financial Planning Association of Australia Limited," December 1996.

³⁰ 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>.

The researchers updated their experiment in 2010. Choi, James, David Laibson, and Brigitte Madrian. *Why does the law of one price fail? An experiment on index mutual funds*. 23 *Review of Financial Studies* 1405 (2010) ["We asked 730 experimental subjects to each allocate a hypothetical \$10,000 among four real S&P 500 index funds. All subjects received the funds' prospectuses. To make choices incentive-compatible, subjects' expected payments depended on the actual returns of their portfolios over a specified time period after the experimental session. We offered especially large incentives in one version of our experiment; for each of the 391 subjects in this implementation, choosing the most expensive portfolio instead of the least expensive portfolio reduced his or her wealth by \$94 ... no non-portfolio services were provided. Thus, the optimal portfolio allocates everything to the lowest-cost index fund ... Our largest subject group (which received the largest incentives) consists of Harvard staff members—all white collar non-faculty employees – who on average have many years of experience managing their

Other researchers have more recently explored these behavioral biases:

Nudging investors big and small toward better decisions. *Decision*, 2(4), 319-326 (“Investors significantly reduce their future returns by selecting mutual funds with higher fees, allured by higher past returns that do not predict future performance. This suboptimal behavior, which can roughly halve an investor’s retirement savings, is driven by 2 psychological factors. One factor is difficulty comprehending rate information, which is critical given that mutual fund fees and returns are typically communicated in percentages. A second factor is devaluing small differences in returns or fees (i.e., a peanuts effect).”³¹)

Another similar study came to similar conclusions:

More problematic, naïve diversification may explain a number of investment decisions that otherwise appear irrational or uninformed. For example, our study contained two index funds that were described as identical except for fees—they tracked the same index, contained the same holdings, and reported the same past performance. Overall, 74.6% of WBL participants and 65.2% of MTurk participants who invested in the low-fee index fund also invested in the high-fee index fund. Similarly, 68% of MTurk investors allocated at least some money to a higher-fee actively managed fund that was really just a closet index fund, in that its holdings and performance were identical to those reported by the index funds. This was also true of 74.1% of WBL subjects. On a somewhat different point, 79.6% of WBL and 74.1% of MTurk investors allocated at least some money to a money market fund. They did so despite the instruction to invest for a thirty-year time frame for which liquidity concerns should be minimal. Notably, the reported returns of the money market funds were significantly lower than the other fixed income alternatives ...

[W]e deliberately designed our study, in contrast to other experimental studies (and the real world of investing), to make fee information simple, accessible, and comparable. Our simplification was designed to enable us to differentiate between a cognitive failure—the inability to understand fee information—and a motivational failure—indifference to fees even when the fee information is clear and available. Our results suggest that subjects who

personal finances. Furthermore, 88% have a college degree, and 60% have graduate school education as well. Our next largest group of participants consists of MBA students from Wharton. The remaining subjects are college students recruited on the Harvard campus. Our MBA subjects report an average combined SAT score of 1453, which is at the 98th percentile nationally, and our college subjects report an average score of 1499, which is at the 99th percentile. When we measure financial literacy directly, we find that all three subject groups are more knowledgeable than the typical American investor ... Despite eliminating non-portfolio services, we find that almost none of the subjects minimized fees. On average, staff, MBA students, and college students respectively paid 201, 112, and 122 basis points more in fees than they needed to when they received only the funds’ prospectuses to aid their decision ... Even subjects who claimed to prioritize fees in their portfolio decision showed minimal sensitivity to the fee information in the prospectus. Subjects apparently do not understand that S&P 500 index funds are commodities. In our experiment, fees paid are increasing in financial illiteracy. *In the real world, this problem is likely to be exacerbated by the financial advisors whose compensation is increasing in the fees of the mutual funds they sell to their clients.* When consumers in a commodity market observe prices and quality with noise, a high degree of competition will not drive markups to zero (Gabaix, Laibson, and Li, 2005; Carlin, 2009). Our results suggest that such noise helps account for the large amount of price dispersion in the mutual fund market ... *In sum, although better disclosure and financial education may be helpful, the evidence in this paper and Beshears et al. (2008) indicate that their effect on portfolios is likely to be modest”]* *Id.* (Emphasis added.)⁰⁰

³¹ Newall, P. W. S., & Love, B. C. Nudging investors big and small toward better decisions (2015), in abstract.

are not motivated to seek and use fee information will fail to do so even when cognitive barriers are minimal ...

Our results with respect to both fees and diversification raise broader questions about the extent to which retail investors understand the investment process. Efficient retirement investing demands that investors understand not only basic principles of costs and diversification, but also the effect of compounding, the value of asset allocation, and the consequences of these choices for investing over a thirty-year (or longer) time horizon ... Given our subjects' expressed levels of discomfort with the investment process, we predict that, rather than attempting to understand these concepts, investors search for short-cuts, heuristics, and opportunities to delegate ... Delegating responsibility for investment decisions makes investors vulnerable to the choices of professionals—choices that may be opaque, shielded from market discipline, or tainted by conflicts of interest.³²

Individual investors also possess substantial confusion about mutual fund fees and costs, such as loads and 12b-1 fees.³³ And many, many customers of brokers believe that the advice they receive from their broker is free.³⁴ Simpler disclosures do not appear to make mutual fund investors more sophisticated.³⁵

³² Jill E. Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PA. L. REV. 605, 636-37, 643, 645 (2014).

³³ *See, e.g.*, Letter dated March 10, 2015 to Mary Jo White, Chair, SEC, from Consumer Federation of America, Americans for Financial Reform, Fund Democracy, Consumer Action, Public Citizen, and AFL-CIO (“One way that brokers obscure the costs that investors incur for their services is by charging for those services through 12b-1 fees rather than through up-front commissions. While there is nothing inherently wrong with charging for services in incremental payments, this practice suffers from several important short-comings. Because 12b-1 fees are not considered commissions, they are not subject to FINRA commission limits. Because the fees are buried within the administrative fee charged by mutual funds and annuities, investors often fail to understand how much they are paying or what they are paying for through these fees.”) *Id.* at p.4.

³⁴ The *Rand Report* (Jan. 2008 draft) reported that 75 out of 299 respondents to a survey (as to those who answered the question posed), or nearly 25%, reported that they paid “zero” fees to their broker or investment adviser. Interestingly enough, 70% of those investors surveyed indicated that they were very satisfied with their financial services advisor. This begs the question – if the 25% who thought they were paying nothing found out the truth, would they still be very satisfied? And if the other 75% who believed they were paying some fees (but who likely were unaware of the total actual fees and costs they paid) found out the true fees and costs paid, would they be satisfied with their financial advisor?

Likewise, while a 2011 Cerulli Associates survey of 7,800 households found that 47 percent would prefer to pay commissions rather than asset-based fees (preferred by 27 percent), lump-sum retainer fees (18 percent) or hourly fees (8 percent), a large percentage of those investors (33 percent) did not know how they currently pay for investment advice, with another 31 percent believing that the advice they currently receive is free (“Commissions Win The Day Over Fees,” 2011).

³⁵ John Beshears, James J. Choi, David Laibson, Brigitte C. Madrian, *How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices? EXPLORATIONS IN THE ECONOMICS OF AGING*, University of Chicago Press (2011). “[T]he Summary Prospectus reduces the amount of time spent on the investment decision without adversely affecting portfolio quality. On the negative side, the Summary Prospectus does not change, let alone improve, portfolio choices. Hence, simpler disclosure does not appear to be a useful channel for making mutual fund investors more sophisticated and for creating competitive pricing pressure on mutual fund companies. Our experiments also shed light on the scope of investor confusion regarding loads. Even when our subjects have a one-month investment horizon—where minimizing loads is the only sensible strategy—they do not avoid loads. In our

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

The primary difficulty with disclosure as a regulatory response is that there is limited evidence that disclosure is effective in overcoming investor biases. ... It is unclear ... that intermediaries offer meaningful investor protection. Rather, there is continued evidence that broker-dealers, mutual fund operators, and the like are ineffective gatekeepers. Understanding the agency costs and other issues associated with investing through an intermediary may be more complex than investing directly in equities³⁶

Many other academic studies in recent years indicate the ineffectiveness of disclosures given the substantial behavioral biases individuals possess, as well as the perverse effects of disclosures upon providers of services.³⁷ For example:

Cain, Loewenstein, and Moore (2011) suggest that receiving unbiased advice in addition to (disclosed) biased advice can help ameliorate inadequate discounting of conflicted advice ... The empirical evidence on disclosure suggests that in isolation it may be ineffective and could actually exacerbate problems arising from conflicts of interest. Without other intervention, disclosure has been found to make advisors more comfortable in inflating their recommendations (Cain, Loewenstein, and Moore, 2005), increasing pressure on advisees to comply with advice

experiment, subjects chose funds with an average load of 3.00 percent in the conditions with an investment horizon of one month. This choice is like betting that the chosen portfolio has an (implausible) excess log return relative to the load-minimizing portfolio of 24 percentage points per year. We conclude that our subjects either do not understand how loads work or do not take them into account. We also conclude that the Summary Prospectus does nothing to alleviate these kinds of errors.”] *Id.*

³⁶ Jill E. Fisch, “Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst,” 10 *Lewis & Clark L. Rev.* 57, 74-83 (2006).

³⁷ See, e.g., George Loewenstein, Cass R. Sunstein, and Russell Golman, Disclosure: Psychology Changes Everything, 6 *Annu. Rev. Econ.* 391 (2014) [“Psychological factors severely complicate the standard arguments for the efficacy of disclosure requirements. Because attention is both limited and motivated, disclosures may be ignored, especially if they are complex and provide unwelcome news, and new disclosures, even of valid information, may turn out to distract attention from older and possibly more important ones. As a result of limited attention and the other psychological factors discussed in Section 3, disclosure requirements appear to have been less effective in changing recipient behavior than their proponents seem to assume ... Unfortunately, disclosure of misaligned incentives can have perverse effects on the producer side of the equation. Specifically, advisors who would have otherwise been intrinsically motivated to provide unbiased advice can feel morally licensed to provide biased advice once a conflict of interest has been disclosed. And because of insinuation anxiety, advice recipients may feel greater pressure, with this disclosure, to follow the now less trusted advice.”] *Id.* at 413-4.

A study conducted by the Australian Securities & Investment Commission in 2006 found that advisors were six times more likely to offer “bad advice” (advice that was subjectively determined not to have considered key factual issues, did not fit the client’s needs, or was likely to leave the client worse off) when the advisor had a conflict of interest over compensation (e.g., commissions) and three times more likely when suggesting an associated product (e.g., an in-house fund). The study also found that consumers were rarely able to detect bad advice.

See also Carmel, Eyal and Carmel, Dana and Leiser, David and Spivak, Avia, Facing a Biased Adviser While Choosing a Retirement Plan: The Impact of Financial Literacy and Fair Disclosure. (July 9, 2015). [“The aim of the present study was to explore the effect of the advice given by the agent, along with that of two further factors: a fair disclosure statement regarding the agent’s conflict of interest, and the customer’s degree of financial literacy. Two experiments conducted among undergraduate students in Israel showed that customers mostly follow the agent’s recommendation, even against their best interest, and despite the presence of a fair disclosure statement.”]

(Loewenstein, Cain, Sah, 2011; Sah, Loewenstein and Cain, 2013), and confusing recipients when the information disclosed is not representative of objectivity (Dopuch, King, Schwartz, 2003). Additionally, people with low levels of financial literacy or who are anxious (Gino, Brooks, and Schweitzer, 2012) may not pay sufficient attention to the information that is disclosed.³⁸

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

Analysis of the tension between investor understanding and complexity remains scant. During the debate over the original enactment of the federal securities laws, Congress did not focus on the ability of investors to understand disclosure of complex transactions. Although scholars assumed that ordinary investors would not have that ability, they anticipated that sophisticated market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors.³⁹

A growing body of academic research into the behavioral biases of investors reveals substantial obstacles individual investors must overcome in order to make informed decisions,⁴⁰ and reveal the inability of individual investors to contract for their own protections.⁴¹

³⁸ Jeremy Burke, Angela A. Hung, Jack Clift, Steven Garber, and Joanne K. Yoong, *Impacts of Conflicts of Interest in the Financial Services Industry* (RAND working paper, Feb. 2015), at pp. 39-40.

³⁹ Steven L. Schwarcz, *Rethinking The Disclosure Paradigm In A World Of Complexity*, *Univ. Ill. L. Rev.* Vol. 2004, p.1, 7 (2004), *citing* “Disclosure To Investors: A Reappraisal Of Federal Administrative Policies Under The ‘33 and ‘34 Acts (The Wheat Report),” 52 (1969); *accord* William O. Douglas, “Protecting the Investor,” 23 *Yale Rev.* 521, 524 (1934).

⁴⁰ 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>.

⁴¹ *See* Robert Prentice, *Whither Securities Regulation Some Behavioral Observations Regarding Proposals for its Future*, 51 *Duke Law J.* 1397 (March 2002). Professor Prentices summarizes: “Respected commentators have floated several proposals for startling reforms of America’s seventy-year-old securities regulation scheme. Many involve substantial deregulation with a view toward allowing issuers and investors to contract privately for desired levels of disclosure and fraud protection. The behavioral literature explored in this Article cautions that in a deregulated securities world it is exceedingly optimistic to expect issuers voluntarily to disclose optimal levels of

Moreover, the perverse effects of disclosure have been noted. Rather than improving the quality of investment advice provided, disclosures of conflict of interest often result in worse advice being provided, as this study pointed out:

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.⁴²

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

⁴² Cain, Daylian M., Loewenstein, George, and Moore, Don A., "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest"(2003).

See also Argandoña, Antonio, Conflicts of Interest: The Ethical Viewpoint. IESE Business School Working Paper No. 552, stating:

As a rule, we tend to assume that competent, independent, well trained and prudent professionals will be capable of making the right decision, even in conflict of interest situations, and therefore that the real problem is how to prevent conscious and voluntary decisions to allow one's own interests (or those of third parties) to prevail over the legitimate interests of the principal – usually by counterbalancing the incentives to act wrongly, as we assume that the agents are rational and make their decisions by comparing the costs and benefits of the various alternatives.

Beyond that problem, however, there are clear, unconscious and unintended biases in the way agents gather, process and analyze information and reach decisions that make it particularly difficult for them to remain objective in these cases, because the biases are particularly difficult to avoid. It has been found that,

- The agents tend to see themselves as competent, moral individuals who deserve recognition.
- They see themselves as being more honest, trustworthy, just and objective than others.
- Unconsciously, they shut out any information that could undermine the image they have of themselves – and they are unaware of doing so.
- Also unconsciously, they are influenced by the roles they assume, so that their preference for a particular outcome ratifies their sense of justice in the way they interpret situations.
- Often, their notion of justice is biased in their own favor. For example, in experiments in which two opposed parties' concept of fairness is questioned, both tend to consider precisely what favors them personally, even if disproportionately, to be the most fair.
- The agents are selective when it comes to assessing evidence; they are more likely to accept evidence that supports their desired conclusion, and tend to value it uncritically. If evidence contradicts their desired conclusion, they tend to ignore it or examine it much more critically.
- When they know that they are going to be judged by their decisions, they tend to try to adapt their behavior to what they think the audience expects or wants from them.
- The agents tend to attribute to others the biases that they refuse to see in themselves; for example, a researcher will tend to question the motives and integrity of another researcher who reaches conclusions that differ from her own.

Note as well that “instead of leading investors away from their behavioral biases, financial professionals may prey upon investors’ behavioral quirks ... Having placed their trust in their brokers, investors may give them substantial leeway, opening the door to opportunistic behavior by brokers, who may steer investors toward poor or inappropriate investments.”⁴³ Moreover, “not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but ... competitive pressures almost guarantee that they will do so.”⁴⁴ Indeed, many brokers and other financial advisors have received training, time and again, stressing the need to first and foremost establish a relation of trust and confidence with the client; after trust is established, it is taught that the client usually defers to the judgment of the advisor as to recommendations made, usually without further inquiry by the client, thereby permitting the financial advisor to take advantage of the client.

There is no doubt that financial services professionals desire to gain the trust of their customers and clients. But the acquisition of the trust of a customer or client should carry with it the full application of the fiduciary standard of conduct. Engagement in trust-based sales activities, without concurrent imposition of fiduciary standards, can result to wholesale harm to individual investors, as alluded to by Professor Langevoort, who undertook these observations regarding “trust-based selling”:

[W]hen faced with complex, difficult and affect-laden choices (and hence a strong anticipation of regret should those choices be wrong), many investors seek to shift responsibility for the investments to others. This is an opportunity – the core of the full-service brokerage business – to use trust-based selling techniques, offering advice that customers sometimes too readily accept. Once trust is induced, the ability to sell vastly more complicated, multi-attribute investment products goes up. Complex products that have become widespread in the retail sector, like equity index annuities, can only be sold by intensive, time-consuming sales effort. As a result the sales fees (and embedded incentives) are very large, creating the temptation to oversell. In the mutual fund area, the broker channel – once again, driven by generous incentives - sells funds aggressively. Recent empirical research suggests that buyers purchase funds in this channel at much higher cost but performance on average is no better, and often worse, than readily available no-load funds.⁴⁵

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- Generally speaking, the agents tend to give far more importance to other people’s predispositions and circumstances than to their own.

For all these reasons, agents, groups and organizations believe that they are capable of identifying and resisting the temptations arising from their own interests (or from their wish to promote the interests of others), when the evidence indicates that those capabilities are limited and tend to be unconsciously biased.

Id. at pp. 6-7.

⁴³ Stephen J. Choi and A.C. Pritchard, “Behavioral Economics and the SEC” (2003), at p.18.

⁴⁴ Robert Prentice, “Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis,” 2003 U.Ill.L.Rev. 337, 343-4 (2003), *citing* Jon D. Hanson & Douglas A. Kysar, “Taking Behavioralism Seriously: The Problem of Market Manipulation,” 74 N.Y.U.L.REV. 630 (1999) and *citing* Jon D. Hanson & Douglas A. Kysar, “Taking Behavioralism Seriously: Some Evidence of Market Manipulation,” 112 Harv.L.Rev. 1420 (1999).

⁴⁵ Donald C. Langevoort, “The SEC, Retail Investors, and the Institutionalization of the Securities Markets” (Jan. 2009), prior version available at available at SSRN: <http://ssrn.com/abstract=1262322>.

D. The Problem of Shedding the Fiduciary Hat: Dual Registrants

While the issue of the duties of dual registrants was not addressed at length in the Commission's proposed interpretation, the issues relating to dual registration are many. I submit that the Commission should revisit the issue of dual registrant, by requiring investment advisers to not be able to take off the "fiduciary hat" (i.e., no "hat-switching") with respect to the same client. Nor should an investment adviser be relieved of her or his fiduciary obligations as to some of the accounts of a client (i.e., no wearing of "two hats" – one for each account).

Time and again our courts have enumerated the fiduciary maxim: "No man can serve two masters."⁴⁶ 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.*"⁴⁷

The ineffectiveness of disclosures, discussed in the prior section, extends to situations in which a dual registrant seeks to change her or his status from that of a fiduciary to a non-fiduciary. It is highly doubtful that, even with disclosure and consent, the client understands and appreciates the ramifications of such a change in status.⁴⁸

Furthermore, the Commission recognized, long ago, that trust-based selling – such as the preparation of comprehensive financial plans as a means to gain the trust of the client – should result in the imposition of fiduciary status for the entirety of the relationship. Indeed, 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 Commission:

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)(1) 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

⁴⁶ 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 is 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.

⁴⁷ *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.*"]

⁴⁸ See, e.g., Frankel, Tamar, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209. ("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 made 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.")

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.⁴⁹

The Commission long ago recognized that dual interests should not exist. For example, the Commission opined that the receipt of soft dollars by a dual registrant would be inappropriate if the client was not credited:

Because the advisory clients' commission dollars generate soft dollar credits, soft dollar benefits are the assets of the clients.⁵⁰

The difficulties of reconciling fiduciary duties when dual interests are to be served has not gone unnoticed by other commentators and jurists over the many years in which fiduciary principles have been applied. For example, long ago Chief Justice Harlan Stone noted:

I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.'⁵¹

Justice Shientag of the New York Supreme Court also noted the rationale against permitting a person to serve dual interests:

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.⁵²

⁴⁹ *In the Matter of Haight & Company, Inc.* (Feb. 19, 1972).

⁵⁰ *In the Matter of Haight & Company, Inc.* (Feb. 19, 1972). This prior rule likes in stark contrast with current requirements of the Commission.

⁵¹ Harlan Stone (future Chief Justice of the U.S. Supreme Court), *The Public Influence of the Bar* (1934) 48 Harv. L.Rev. 1, 8-9.

⁵² *Bayer v. Beran*, 49 N.Y.S.2d 2, *citing see* Republic New York Securities Corp., Advisers Act Rel. No. 1789, 1999 SEC LEXIS 278 (February 10, 1999).

And, in a decision over 180 years old, the dangers of dual interests were clearly stated, as was the remedy (the avoidance of dual interests by a continuance of fiduciary status across the relationship):

The temptation of self interest is too powerful and insinuating to be trusted. Man cannot serve two masters; he will forsake the one and cleave to the other. Between two conflicting interests, 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.”⁵³

Fiduciary is a status relation that results, in the arena of financial planning and investments, from an undertaking⁵⁴ to provide advice to a client. And fiduciary status, under the common law, extends across the entirety of the relationship.⁵⁵

Investment advisers are (or, at least, should be) professionals.⁵⁶ They possess professional obligations to their clients. A fundamental characteristic of a profession is that its members agree to certain

⁵³ *Thorpe v. McCullum*, 1 Gilman (6 Ill.) 614, 626 (1844).

⁵⁴ See, e.g., James Edelman, *The Role of Status in the Law of Obligations: Common Callings, Implied Terms and Lessons for Fiduciary Duties* (2013), stating: “In Australia, in the leading Australian formulation of the fiduciary duty, Mason J explained that the ‘critical’ feature of fiduciary relationships was that the fiduciary ‘undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense.’ ... The same is true in Canada ... the Supreme Court of Canada said of fiduciary duties in equity that ‘[i]t is fundamental to all ad hoc fiduciary duties that there be an undertaking by the fiduciary, which may be either express or implied, that the fiduciary will act in the best interests of the other party....’” *Id.* at text surrounding fn. 21-24 (*Citations omitted.*)

⁵⁵ A fiduciary is in a relationship with the entrustor. See, e.g., Edward P. Richards and Katharine C. Rathburn, *LAW AND THE PHYSICIAN* (1993), “The physician-patient relationship is a member of a special class of relationships called *fiduciary relationships*.” (*Emphasis in original.*)

Once in the relationship, fiduciary status extends across all aspects of that relationship. See David Glusman, Gabriel Ciociola, *ACCOUNTANTS’ ROLES AND RESPONSIBILITIES IN ESTATES AND TRUSTS* (2009), stating in pertinent part, and in the context of trustees, that the “relationship is one where the beneficiary is able to rely on the fiduciary with confidence and trust. Further still, the fiduciary is required to act with unquestioned good faith, always maintaining the best interests of the beneficiary even over his or her personal interests. A fiduciary’s duty extends to all aspects of financial and related operations.”

The Certified Financial Planner Board of Standards, Inc. recently adopted a new “Code of Ethics and Standards of Conduct,” effective October 1, 2019, that essentially provides that the fiduciary standard of conduct applies to all aspects of the financial planning and investment relationship with the client. “The new Code and Standards includes a range of important changes, including expanding the application of the fiduciary standard that requires CFP® professionals to act in the best interest of the client at all times when providing financial advice.” CFP Board web site, “New Code of Ethics and Standards of Conduct” page (retrieved Aug. 4, 2018).

⁵⁶ 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,

restrictions upon their conduct. When the fiduciary mantle has been assumed with respect to a client, the investment adviser’s fiduciary status should properly extend to the entirety of the relationship with that client.

E. Correctly Applying the Fiduciary Standard of Conduct Requires an Understanding of the Important Public Policy Rationale that Supports the Application of Fiduciary Principles

The key to understanding fiduciary principles, and why and how they are applied, rests in discerning the various public policy objectives the fiduciary standard of conduct is designed to meet.

(1) Fiduciary Status Addresses “Overreaching” When Person-To-Person Advice Is Provided

The Investment Advisers Act of 1940 “recognizes that, with respect to a certain class of investment advisers, a type of personalized relationship may exist with their clients ... The essential purpose of [the Advisers Act] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful.”⁵⁷ “The Act was designed to apply to those persons engaged in the investment-advisory profession -- those who provide personalized advice attuned to a client's concerns, whether by written or verbal communication⁵⁸ ... The dangers of fraud, deception, or overreaching that motivated the enactment of the statute are present in personalized communications”⁵⁹

(2) 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

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.” Commission 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.*] However, some of the hallmarks of a profession do not exist for investment advisers. For example, some authorities regard substantial higher education, such as a four-year college degree in which a specialized course of study is pursued relating to the activities to be pursued, as a necessary precondition for recognition of a profession.

The need for professional status, and the concurrent restraints on conduct that flow therefrom, was even recognized 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, *THE THEORY OF MORAL SENTIMENTS* at p.229 (E.G. West ed. 1969).

⁵⁷ *Lowe v. SEC*, 472 U.S. 181, 200, 201 (1985).

⁵⁸ *Id.* at 208.

⁵⁹ *Id.* at 210.

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.”⁶⁰

(3) 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 the entrusted power only for the benefit of the client. Indeed, if a client could easily protect himself or herself from an abuse of the fiduciary advisor’s power, authority, or delegation of trust, then there would be no need for imposition of fiduciary duties. Hence, fiduciary status is imposed as a means of aiding consumers in navigating the complex financial world, 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 fines, may shift monitoring costs back to all of the fiduciaries which are regulated.

(4) 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 (as was the situation with Madoff).

(5) Consumers’ Difficulty In Identifying And Understanding Conflicts Of Interest; Conflicts of Interest Cause Individuals to Avoid Financial Advisers

⁶⁰ 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.

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) 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.

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.⁶¹

Consumers are harmed, as they are deterred from seeking out financial advice. “[N]on-affluent consumers often perceive financial advisers (and the institutions for which they work) to be attempting to sell financial products at the expense of providing financial advice, resulting in consumers avoiding financial advisers because of a lack of trust.”⁶²

⁶¹ 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>.

⁶² Dan Iannicola, Jr. and Jonas Parker, Ph.D. of The Financial Literacy Group, *Barriers to Financial Advice for Non-Affluent Consumers* (2010), at p.33. The authors also quote a 2010 interview with Pam Krueger: “There is a common perception that financial advice comes at the cost of buying something, that you will be pushed into something. And it’s a very real perception, it’s very accurate, especially at the lower end. For example, teachers who have pensions and are earning forty thousand a year, they are very skeptical. They know that there’s no one out there who’s going to profit by giving advice to this market. They think to themselves, - We don’t have enough money for financial advisers to make money [from serving us], so we’re gonna get a sales pitch. We’re gonna get the cheap

Given the poor financial-decision making by Americans today, with the majority failing to save enough for the future needs and to invest properly, it is crucially important that Americans achieve a higher degree of trust in financial advisors. The only manner this will be achieved is through proper application of the fiduciary standard of conduct on all providers of investment *advice*.

(6) 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 (formerly of 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.

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

and pre-packaged version, and it’s gonna be poor quality, not genuine advice. The advisor will be looking at his watch. It’s perceived as a sales pitch, to the benefit of the seller.” *Id.* at p.35.

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.”⁶³

This is why it is important to fiduciary advisors to be able to distinguish themselves from non-fiduciaries. Economic incentives⁶⁴ should exist for persons to become investment advisers and be subject to the higher standard of conduct.

(7) Monitoring And Reputational Threats Are Largely Ineffective

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

(8) 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-

⁶³ 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).

⁶⁴ 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 Cardozo 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.

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.⁶⁵ 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.

(9) 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 perception⁶⁶ 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.⁶⁷

(10) Public Policy Encourages Saving and Proper Investing

As stated in a 2002 white paper authored by Professor Macy:

⁶⁵ Tamar Frankel, *Trusting And Non-Trusting: Comparing Benefits, Cost And Risk*, Working Paper 99-12, Boston University School of Law.

⁶⁶ "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.

⁶⁷ "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>.

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.⁶⁸

Americans need expert, trusted financial and investment advice. But, without trust in financial advisers, due to the lack of a proper fiduciary standard applied to the delivery of financial advice, at all times, consumers are reluctant to seek out financial and investment advice. 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."⁶⁹

(11) The Proper Imposition of Fiduciary Duties Fosters U.S. Economic Growth

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 today. It 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

⁶⁸ 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.

⁶⁹ Tamar Frankel, "Regulation and Investors' Trust In The Securities Markets," 68 Brook. L. Rev. 439, 448 (2002).

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.”⁷⁰ More recently the financial services sector’s bite into corporate profits has been estimated at one-third or higher.⁷¹

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,⁷² 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.⁷³

⁷⁰ 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.

⁷¹ “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/>.

⁷² 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/>.

⁷³ “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. 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,

It is well documented that public trust is positively correlated with economic growth.⁷⁴

Moreover, public trust is also correlated with participation by individual investors in the stock market.⁷⁵ 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.⁷⁶

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. Colombo:

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.⁷⁷

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”⁷⁸

“Foreign Ownership of U.S. Financial Assets: Implications of a Withdrawal” (Congressional Research Service, April 8, 2013), p.1.

⁷⁴ 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.

⁷⁶ Georganakos, 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>.

⁷⁷ Ronald J. Colombo, *Trust and the Reform of Securities Regulation*, 35 *Del. J. Corp. L.* 829 (2010).

⁷⁸ *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.

As the returns of the capital markets are diverted away from individual Americans - the owners of capital - to Wall Street,⁷⁹ the accumulation of capital falls. This results in less accumulated capital for investment purposes - an effect that compounds over time with severe negative consequences for the long-term health of the U.S. economy. The cost of capital to corporations increases. And innovation, without capital, equates to missed opportunities for U.S. economic growth.⁸⁰

The fiduciary standard is the antidote for this problem of excessive rent-taking by non-fiduciary financial advisors. In *Bayer v. Beran*, 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.”⁸¹

Furthermore, as financial services industry scandals have been exposed in the media in recent years, many individual investors have fled the capital markets, and perhaps (as to some) for all time. Not knowing who to trust, these investors now choose to not participate at all in capital formation at all, instead choosing to place their hard-earned savings into “safe” depository accounts.

⁷⁹ The growth of the financial services industry has grown to an extraordinary proportion of the overall U.S. economy. As stated in a recent article by Gautam Mukunda appearing in the Harvard Business Review: “In 1970 the finance and insurance industries accounted for 4.2% of U.S. GDP, up from 2.8% in 1950. By 2012 they represented 6.6%. The story with profits is similar: In 1970 the profits of the finance and insurance industries were equal to 24% of the profits of all other sectors combined. In 2013 that number had grown to 37%, despite the after effects of the financial crisis. These figures actually understate finance’s true dominance, because many nonfinancial firms have important financial units. The assets of such units began to increase sharply in the early 1980s. By 2000 they were as large as or larger than nonfinancial corporations’ tangible assets” Gautam Mukunda, [“The Price of Wall Street’s Power.”](#) Harvard Business Review (June 2014).

⁸⁰ Indeed, many studies have demonstrated that Wall Street's excesses impair U.S. economic growth and the formation of new businesses and jobs. For example: “[F]inancialization depresses entrepreneurship. Paul Kedrosky and Dane Stangler of the Kauffman Foundation find that as financialization increases, startups per capita decrease, in part because the growth in the financial sector has distorted the allocation of talent. They estimate that if the sector were to shrink as a share of GDP back to the levels of the 1980s, *new business formation would increase by two to three percentage points*. We have substantial circumstantial evidence to show that these trends have had negative consequences at the macro level: *‘the influence of finance sector size on economic growth turns negative when financial services become too large a share of an economy and that high levels of financial activity crowd out investment and R&D in the non-finance sector.’*” (*Emphasis added.*) William A. Galston and Elaine C. Kamarck, The Brookings Institute.

The result of this excessive rent extraction by Wall Street is impairment of the growth of the U.S. economy. As Steve Denning recently noted in *Forbes*: “The excessive financialization of the U.S. economy reduces GDP growth by 2% every year, according to a 2015 study by International Monetary Fund. That’s amassive drag on the economy – some \$320 billion per year. Wall Street has thus become, not just a moral problem with rampant illegality and outlandish compensation of executives and traders: Wall Street is a macro-economic problem of the first order ... Throughout history, periods of excessive financialization have coincided with periods of national economic setbacks, such as Spain in the 14th century, The Netherlands in the late 18th century and Britain in the late 19th and early 20th centuries. The focus by elites on “making money out of money” rather than making real goods and services has led to wealth for the few, and overall national economic decline. ‘In a financialized economy, the financial tail is wagging the economic dog.’” Steve Denning, [“Wall Street Costs The Economy 2% Of GDP Each Year.”](#) Forbes (May 31, 2015).

⁸¹ 49 N.Y.S.2d 2.

This demise of individual investor participation in the stock market should not be unexpected. “[S]pecific trust in advice given by financial institutions represents a prominent factor for stock investing, compared to other tangible features of the banking environment.”⁸²

This result – individual investors fleeing from stock market investing - should have not been unexpected. Nor should it be unexpected that lack of trust in Wall Street will translate to lower economic growth in future years:

It is well documented that public trust is positively correlated with economic growth ... and with participation in the stock market ... we develop a two-period theoretical model in which investors entrust their wealth to a continuum of heterogeneous agents and rely on the agents to honor their fiduciary duty ... Trust that arises from the law evolves because investors can rely on the government to make sure that agents honor their fiduciary duty to clients ... we consider the effect that professional fees have on the trust that forms in markets ... We show that when the value to social capital is relatively low and/or the growth potential in the economy is low, it is never optimal to institute a Coasian plan (absence of government regulation). We also show that *ceteris paribus* there should be more government intervention in a low-trust equilibrium than in a high-trust equilibrium.⁸³

As recently observed:

If [conflicts of interest] are widespread, the adverse effects of these conflicts can plague entire markets. If investors believe the agency costs of equity are too high, they will avoid buying shares in favour of bonds, thus limiting the access of business to capital. Similarly, lacking trust in asset managers or collective investment schemes, investors will forego the advantages of this form of investment: the expertise of the agent and the economies of scale offered by asset pooling. Instead, investors will make and implement their investment decisions alone and risk the potentially adverse consequences. From a macroeconomic viewpoint, those consequences can be dire in terms of misallocation of resources: capital markets may dry up and savings may vanish or be inefficiently invested. Conflicts of interest thus are a source of concern not only for individual principals, but also for society at large, and indeed the state. Public regulation is necessary insofar as individuals may not be able to fend for themselves and cannot enforce their rights alone.⁸⁴

⁸² Georarakos, Dimistris, and Pasini, Giacomo, Trust, Sociability and Stock Market Participation (2009), available at <http://www.aueb.gr/conferences/Crete2010/Senior/Georarakos.pdf>. [See also César Calderón, Alberto Chong, and Arturo Galindo, Structure and Development of Financial Institutions and Links with Trust: Cross-Country Evidence (2001) (“We use a new World Bank data set that provides the most comprehensive coverage of financial development and structure to this date. We find that trust is correlated with financial depth and efficiency as well as with stock market development.”) Available at <http://www.iadb.org/res/publications/pubfiles/pubWP-444.pdf>.

⁸³ Carlin *et. al.*, *supra*.

⁸⁴ Bahar, Rashid and Thévenoz, Luc, Conflicts of Interest: Disclosure, Incentives, and the Market. Conflicts Of Interest: Corporate Governance & Financial Markets, Luc Thévenoz and Rashid Bahar, eds., Kluwer Law International and Schulthess, 2007, at pp.____. Available at SSRN: <http://ssrn.com/abstract=964778>.

F. The Interplay Of State Common Law and the Federal Investment Advisers Act Of 1940 as to Their Imposition of Fiduciary Duties on the Delivery Of Financial and Investment Advice⁸⁵

(1) The (Federal) Investment Advisers Act of 1940 Creates a Federal Fiduciary Duty.

The existence of a “federal fiduciary standard”⁸⁶ under the Investment Advisers Act of 1940 and under ERISA does not mean that deference is not provided to the scope of fiduciary duties as they exist under state common law. The analysis of fiduciary obligations arising under the Advisers Act and under ERISA should be informed by state common law.⁸⁷

Since the application of state common law may vary, the federal fiduciary standard imposed by the Advisers Act is not necessarily identical to the fiduciary standards found in the common law of all of the states. “Federal courts applying a ‘federal fiduciary principle’ ... could be expected to depart from state fiduciary standards at least *to the extent necessary to ensure uniformity* within the federal system.”⁸⁸ [*Emphasis added.*] Furthermore, as stated by Professor Arthur Laby, the federal fiduciary standard “does not incorporate the entire body of state law with respect to fiduciary obligation. One leading case, *Steadman v. SEC*, stated explicitly that the federal fiduciary standard of Capital Gains Research Bureau encompasses less than the full panoply of common law fiduciary duties.”⁸⁹

Hence, the Commission must recognize that the Investment Advisers Act does not establish a ceiling as to the duties of investment advisers. Section 206 of the Advisers Act imposes “minimum standards on the

⁸⁵ Some investment advisers might incorrectly assume that compliance with the Commission’s interpretation is all that is required in meeting their fiduciary obligations. The Commission should, at the outset of its own interpretation, clearly and affirmatively recognize that its interpretation only addresses the fiduciary obligations of registered investment advisers under the Investment Advisers Act of 1940. The Commission sets only the floor, and not the ceiling, for the fiduciary standard of conduct. The Commission should add, in the body of its interpretation, a discussion of the interplay of federal and state statutory and common law, for the guidance of investment advisers. The Commission might also work with the U.S. Department of Labor to provide guidance on ERISA’s stricter fiduciary standard and prohibited transaction rules. The Commission might also work with the North American Securities Administrators Association to identify any distinctions in how the Commission’s application of the Advisers Act differs from state statutory law and state common law.

⁸⁶ In *Santa Fe Industries v. Green*, 430 U.S. 462 (1977), the US. Supreme Court stated that the Advisers Act’s reference to fraud and the principle of equity implies that Congress intended to establish “federal fiduciary standards.” *Id.* at 472 n.11 (1977).

⁸⁷ “*See U.S. v. Brennan*, 938 F.Supp. 1111 (E.D.N.Y., 1996), [Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law....”], *citing Varsity 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.

⁸⁸ *Santa Fe Industries, Inc v. Green*, 430 U.S. 462, 479, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). (Whether implied preemption of state law occurs in order to achieve such uniformity is a subject deserving of its own outline.)

⁸⁹ Arthur Laby, *The Fiduciary Obligations of Broker-Dealers*, 55 Villanova L. Rev. 701, 717 (2010).

behavior of investment ... advisers”⁹⁰ Moreover, neither federal nor state securities laws generally preempt common law claims based upon breach of fiduciary duty.⁹¹

Hence, I submit that the Commission should seek to ensure that the federal fiduciary principle is consistent with the state common law fiduciary principle, especially in those circumstances where there is little deviation among the states in its recitation or application. Where there is deviation among state courts (which is rare in the application of the fiduciary standard upon those providing personalized investment advice),⁹² the Commission should appropriately consider any distinctions and then act, when called upon to decide, to achieve uniformity where possible. If the Commission acts to lessen the fiduciary obligations of investment advisers under the Advisers Act, as I fear has been set forth in this proposed Release (for the reasons I state herein), the floor set by the Commission as to the duties of investment advisers arising under the Advisers Act will deviate, more and more greatly, over time; the floor will become too distant from the ceiling – causing confusion for both investment advisers and their clients.⁹³

While some commentators have observed that U.S. Supreme Court created the federal fiduciary duty arising under the Investment Advisers Act of 1940 through its 1963 decision in *SEC vs. Capital Gains*,⁹⁴ the reality is that the Commission early on recognized that the Advisers Act imposed fiduciary obligations upon investment advisers.

It should be noted that early proceedings brought by the Commission against investment advisers were few in number, for the Advisers Act, as originally passed, required little more than registration by investment advisers with the Commission. This was because it was not until 1960 that Congress amended the Advisers Act to provide the Commission with authority to inspect the books and records of investment

⁹⁰ *Burks v. Lasker*, 441 U.S. 471 (concurring opinion of Stewart, J., fn. 10).

⁹¹ “[I]nvestment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship.” SEC Release IA-40 (Jan. 5, 1945).

⁹² There are not a great many cases discussing the application of the fiduciary standard of conduct to investment advisers under state common law. Nor, in the cases surveyed, do I find much disagreement as to how the fiduciary standard is applied upon investment advisers under state common law. There is some variance, however, as to whether state common law is applied to other actors in financial services, such as brokers, bankers, and insurance agents.

⁹³ Aspects of the federal fiduciary standard may be ascertained when those aspects have been determined by prior federal law. *See, e.g., Laird vs. Integrated Res., Inc.*, 897 F.2d 826, 837 (5th Cir. 1990) (“Course may refer to these (federal) cases instead of state analogies in deciding whether this status prohibits particular conduct.”). However, state common law continues to inform the interpretation of the Advisers Act, especially when aspects of the federal fiduciary standard of conduct have not yet previously been considered by the courts. The existence of the “federal fiduciary standard” under the Investment Advisers Act of 1940 does not mean that deference is not provided to the scope of fiduciary duties as they exist under state common law. *See, e.g., U.S. v. Brenman*, 938 F.Supp. 1111 (E.D.N.Y., 1996) (“Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law. *See, e.g., Varsity v. Howe*, ___ U.S. ___, ___, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996); *F.D.I.C. v. Wright*, 87 B.R. 1011 (D.S.D. 1988) (bankruptcy).”) *Id.* at 1119.

⁹⁴ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

advisers, to prescribe book-keeping practices, to require the retention of records, and to impose various reporting requirements.⁹⁵

Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (“Advisers Act”) make it unlawful for an investment adviser to “employ any device, scheme, or artifice to defraud any client or prospective client”⁹⁶ or to “engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”⁹⁷ In the landmark decision *SEC vs. Capital Gains Research Bureau*, the U.S. Supreme Court confirmed a widely held previous understanding when it held that these provisions imposed broad fiduciary duties upon investment advisers.⁹⁸ Subsequently, in *Santa Fe Industries v. Green*,⁹⁹ Justice Byron White clarified via a footnote that “Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.”

The Advisers Act places few substantive burdens on investment advisers compared to the more detailed proscriptions found in the Investment Company Act and the Securities and Exchange Act of 1934. Instead, it relies upon broad proscriptions to curtail fraudulent conduct by investment advisers. The SEC has acknowledged that the Advisers Act is a “principles-based” regulatory regime, rather than one based upon rules.¹⁰⁰

(2) The Imposition of Fiduciary Duties under State Common Law and its Relationship to the Advisers Act.

Franklin D. Roosevelt’s vision for a world of professional, fiduciary investment advisers, which led to the enactment of the Investment Advisers Act of 1940, was not plucked from the air. Nor was the Advisers

⁹⁵ Nadler, *Federal Fiduciary Duties and Private Equity: The Search for Workable Standards*, 1 *Columbia Bus.L.R.* 254, 257 (2018).

⁹⁶ 15 U.S.C. § 80b-6(1). Section 206 of the Advisers Act establishes “a statutory fiduciary duty for [investment advisers] to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients.” *SEC v. DiBella*, Slip Copy, 2007 WL 2904211 (D.Conn. 2007) (citing *SEC v. Moran*, 922 F.Supp. 867, 895-96 (S.D.N.Y. 1996)); see also *Capital Gains Research Bureau, Inc.*, 375 U.S. at 194.

⁹⁷ 15 U.S.C. § 80b-6(2).

⁹⁸ 375 U.S. 180, 194 (1963). In this landmark decision, the Investment Advisers Act of 1940 (“Advisers Act”), which does not utilize the term “fiduciary” at any time in its statutory text, was construed to apply broad fiduciary duties upon investment advisers. An “investment adviser” as defined under the Advisers Act is a fiduciary. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 191-92, 194, 201; *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). Section 206 of the Advisers Act establishes “a statutory fiduciary duty for [investment advisers] to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients.” *SEC v. DiBella*, Slip Copy, 2007 WL 2904211 (D.Conn. 2007) (citing *SEC v. Moran*, 922 F.Supp. 867, 895-96 (S.D.N.Y. 1996)).

⁹⁹ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977).

¹⁰⁰ 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>.

Act new in its approach to the duties imposed on investment advisers. As stated by the U.S. Supreme Court in its seminal 1963 decision, there was “growing recognition by common-law courts that the doctrines of actual 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.”¹⁰¹

The Advisers Act incorporates the common law principles of fiduciary duties.¹⁰² State common law,¹⁰³ also known as “judge-made law,” has its roots in judicial decisions handed down nearly a millennium ago, in the days of King Arthur the Great of England. In fact, perhaps the most compelling elicitation of the fiduciary principle can be discerned from English common law.¹⁰⁴ The English common law involving the fiduciary standard was adopted as part of the state common law now found in the United States.¹⁰⁵

¹⁰¹ *SEC v. Capital Gains Research Bureau*, 375 U.S., at 194, 84 S.Ct., at 284. “[The] 1909 New York case of *Ridgely v. Keene*, 134 App. Div. 647, 119 N. Y. Supp. 451, illustrates the continuing development in the application of fiduciary duties under state common law. An investment adviser, who published an investment advisory service, agreed for compensation paid by a promoter of the security to influence his clients to buy shares in that certain security. The investment adviser did not disclose the agreement to his client. The court declared the act in question ‘a palpable fraud.’” *SEC v. Capital Gains Research Bureau*, 375 U.S. ____.

In another early decision, the Arizona Supreme Court early on held that a confidential relationship exists between a client and his or her financial adviser when there is an imbalance of knowledge so that the client relies heavily on the adviser for advice. *Stewart v. Phoenix Nat'l Bank*, 49 Ariz. 34, 64 P.2d 101, 106 (1937) (holding that a confidential relationship existed when the bank had acted as the plaintiff's financial adviser for many years and he relied upon the bank's advice).

¹⁰² *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).

¹⁰³ The common law forms a major part of the law of those countries of the world with a history as British colonies. In the United States, the common law includes extensive non-statutory law reflecting precedent derived from centuries of court decisions, both in the United States and England. Among other prescriptive aspects, the common law imposes duties upon parties to various contracts and relationships, independent of the existence of any statute or regulation.

¹⁰⁴ In dictum in the 1998 English (U.K.) case of *Bristol and West Building Society v. Matthew*, Lord Millet undertook what has been described as a “masterful survey” of the fiduciary principle: “A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principle is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of the fiduciary obligations. They are the defining characteristics of a fiduciary.”

¹⁰⁵ See, e.g., John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest*, 114 Yale L. J. 929, 944 (2005) [“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

To the extent not in conflict therewith, the analysis of fiduciary principles continues to be informed by state common law.¹⁰⁶ And state common law continued to impose duties upon investment advisers independent of the Advisers Act.¹⁰⁷

Under state common law, great care is taken to not lessen the fiduciary standard, reflective of the fact that some entrustors (such as employers) usually possess greater knowledge¹⁰⁸ and power, that other entrustors (such as co-venturers) may often possess equal bargaining power, and that other entrustors are truly reliant and dependent upon the advice of their fiduciary.

Another type of fiduciary relationship, in which stricter fiduciary duties are imposed, is that of attorney and client. Rarely in this instance can the client waive the attorney's fiduciary duty of loyalty. At times there is an absolute prohibition on any attempted waiver of the attorney's duty; for example, an attorney normally cannot prepare a will for which he or she is a beneficiary. In other situations, in recognition of the vast disparity of knowledge and sophistication between the attorney and his or her client, waivers of the fiduciary duty of loyalty can only occur following consultation with independent legal counsel, or at least advice to so consult. For example, an attorney cannot normally enter into a joint business with a client without, at the minimum, advising the client to seek independent legal advice prior to the formation of the relationship.

Similar to the relationship of attorney and client is that of investment adviser and client. Few would dispute that there is vast information asymmetry present between investment advisers and their individual clients, at least 99% of the time. And few would dispute that attempts to educate investors on the complexities of the capital markets are largely ineffective; it simply takes a very high level of expertise to be able to successfully navigate today's complex world of investments.

Nor do disclosures do much good. A huge body of academic research confirms what investment advisers already know – consumers don't often read disclosures, and even when they do they don't understand

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.”]

¹⁰⁶ 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.

¹⁰⁷ See, e.g., *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).

¹⁰⁸ 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.” 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 *Entrepreneurial Bus.L.J.* 1, 9 (2010).

them. This academic research is covered in another section of this comment letter.¹⁰⁹ Disclosures don't work. Period. (If they did work, the fiduciary standard would never have arisen under the law.)

(3) Distinguishing Arms-Length vs. Fiduciary-Entrustor Relationships.

To understand when fiduciary status may be imposed by the law, it is first necessary to distinguish between “arms-length” and “fiduciary-entrustor” relationships.

Most commercial transactions involve arms-length relationships. “Absent express agreement of the parties¹¹⁰ or extraordinary circumstances, however, parties dealing at arms-length in a commercial transaction lack the requisite level of trust or confidence between them necessary to give rise to a fiduciary obligation.”¹¹¹ Ordinary “buyer-seller relationships” do not give rise to the imposition of fiduciary duties upon the seller.¹¹² In arms-length, commercial relationships, the level of trust or confidence reposed by the customer in the other party is not exceptional.

In contrast to arms-length relationships, the law imposes upon one party to some relationships the status of a fiduciary. This form of relationship is called the “fiduciary relationship” or “fiducial relationship.” One upon whom fiduciary duties are imposed is known as the “fiduciary” and is said to possess “fiduciary

¹⁰⁹ See Section C.

¹¹⁰ *Pension Committee v. Banc of America Securities*, 592 F.Supp.2d 608, 624 (S.D.N.Y., 2009) (“a fiduciary relationship may arise where the parties to a contract specifically agree to such a relationship”).

¹¹¹ *Pension Committee v. Banc of America Securities*, 592 F.Supp.2d 608, 624 (S.D.N.Y., 2009) (“no fiduciary duties arise where parties deal at arm's length in conventional business transaction”); *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423, 460 (S.D.N.Y., 2006), citing *Nat'l Westminster Bank, U.S.A. v. Ross*, 130 B.R. 656, 679 (S.D.N.Y.1991) (“Where parties deal at arms length in a commercial transaction, no relation of confidence or trust sufficient to find the existence of a fiduciary relationship will arise absent extraordinary circumstances.” (citing, *inter alia*, *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 738-39 (2d Cir.1984); *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, N.A.*, 731 F.2d 112, 122 (2d Cir. 1984))), *aff'd*, *Yaeger v. Nat'l Westminster*, 962 F.2d 1 (2d Cir.1992) (table); *Beneficial Commercial Corp. v. Murray Glick Datsun, Inc.*, 601 F.Supp. 770, 772 (S.D.N.Y. 1985) (“[C]ourts have rejected the proposition that a fiduciary relationship can arise between parties to a business transaction.” (citing *Grumman Allied Indus., Inc.*, 748 F.2d at 738-39; *Wilson-Rich v. Don Aux Assocs., Inc.*, 524 F.Supp. 1226, 1234 (S.D.N.Y.1981); *duPont v. Perot*, 59 F.R.D. 404, 409 (S.D.N.Y.1973)); *WIT Holding Corp. v. Klein*, 282 A.D.2d 527, 724 N.Y.S.2d 66, 68 (App.Div.2001) (“Under these circumstances, where the parties were involved in an arms-length business transaction involving the transfer of stocks, and where all were sophisticated business people, the plaintiff's cause of action to recover damages for breach of fiduciary duty should have been dismissed.”).

¹¹² *In re Prudential Ins. Co. of America Sales Prac.*, 975 F.Supp. 584 (D.N.J., 1996), where, in a case involving sales by life insurance agents of variable appreciable life insurance products as “investment plans,” the court stated: “An essential feature and consequence of a fiduciary relationship is that the fiduciary becomes bound to act in the interests of her beneficiary and not of herself. Obviously, this dynamic does not inhere in the ordinary buyer-seller relationship. Thus, ‘the efforts of commercial sellers — even those with superior bargaining power — to profit from the trust of consumers is not enough to create a fiduciary duty. If it were, the law of fiduciary duty would largely displace both the tort of fraud and much of the Commercial Code.’ *Committee on Children's Television, Inc., v. General Foods Corp.*, 35 Cal.3d 197, 221, 197 Cal.Rptr. 783, 789, 673 P.2d 660, 675 (1983) (en banc).” *In re Prudential Ins. Co. of America Sales Prac.* At 616.

status.” The fiduciary standard of conduct is consistently described by the courts as the “highest standard of duty imposed by law.”¹¹³

The term "fiduciary" comes to us from Roman law, and means "a person holding the character of a trustee, or a character analogous of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires."¹¹⁴ Indeed, the Latin root of the word fiduciary – *fiduciarius* – means one in whom trust – *fiducia* – reposes. Legal usage in many jurisdictions also developed an overlay – an implication of a particular relationship of confidence between the fiduciary and those who had placed their trust in that person.

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

More recently, Justice Philip Talmadge of the State of Washington Supreme Court summarized the core aspects of current fiduciary relationships:

A fiduciary relationship is a relationship of trust, which necessarily involves vulnerability for the party reposing trust in another. One's guard is down. One is trusting another to take actions on one's behalf. Under such circumstances, to violate a trust is to violate grossly the expectations of the person reposing the trust. Because of this, the law creates a special status for fiduciaries, imposing duties of loyalty, care, and full disclosure upon them. One can call this the fiduciary principle.¹¹⁵

(4) “Generally Accepted” Fiduciary Relationships Under the Law

The recognition of the existence of a fiduciary relationship under the common law is said to consist of two main branches. The first branch of fiduciary status consists of a list of accepted and prescribed relationships — principal and agent, attorney and client, executor or trustee and beneficiary, director or

¹¹³ See, generally BLACK'S LAW DICTIONARY 523 (7th ed. 1999) (“A duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another.”); also see *F.D.I.C. v. Stahl*, 854 F.Supp. 1565, 1571 (S.D. Fla., 1994) (“Fiduciary duty, the highest standard of duty implied by law, is the duty to act for someone else's benefit, while subordinating one's personal interest to that of the other person); and see *Perez v. Pappas*, 98 Wash.2d 835, 659 P.2d 475, 479 (1983) (“Under Washington law, it is well established that ‘the attorney-client relationship is a fiduciary one as a matter of law and thus the attorney owes the highest duty to the client.’”), cited by *Bertelsen v. Harris*, 537 F.3d 1047 (9th Cir., 2008); also see *Donovan v. Bierwirth*, 680 F. 2d 262, 272, n.8 (2nd Cir., 1982) (fiduciary duties are the “highest known to law”).

¹¹⁴ BLACK'S LAW DICTIONARY, 5th Edition (1979)].

¹¹⁵ *Von Noy v. State Farm Mutual Automobile Insurance Company*, 2001 WA 80 (WA, 2001) (J. Talmadge, concurring opinion).

officer in the corporation, partners, joint venturers, guardian and ward, and parent and child. The common law has defined, over the years, these relationships to be fiduciary in nature, and they are generally accepted as such.

(5) Fiduciary Relationships Under the Law Arising From Relationships of Trust and Confidence, Generally

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

The development of this second branch of fiduciary relationships accelerated during the 20th Century and continues today, in response to the increased complexity of our modern world. Increased amounts of specialization are required in modern society, and this in turn leads to greater reliance on others in order to obtain greater affluence. As stated by Professor Tamar Frankel, “Courts, legislatures, and administrative agencies increasingly draw on fiduciary law to answer problems caused by these social changes.”¹¹⁶

Courts have held that a fiduciary relationship, resulting from a relationship based upon trust and confidence, need not be created by contract. Fiduciary obligations may arise out of any relationship where both parties understand that a special trust or confidence has been reposed. “A fiduciary relation does not depend on some technical relation created by or defined in law. It may exist under a variety of circumstances and does exist in cases where there has been a special confidence reposed in one who, in equity and good conscience, is bound to act in good faith and with due regard to the interests of the one reposing the confidence.”¹¹⁷ Stated differently, once a relation between two parties is established, “its classification as fiduciary and its legal consequences are primarily determined by the law rather than the parties. Thus, unlike a party to a contract, a person may find himself in a fiduciary relation without ever having intended to assume fiduciary obligations. The courts will look to whether the arrangement formed by the parties meets the criteria for classification as fiduciary, not whether the parties intended the legal consequences of such a relation.”¹¹⁸

Moreover, while it is often believed that fiduciary duties were only applied in early law to situations in which control over property (such as in a “trustee-beneficiary” relationship) was shifted, this is clearly not the case. Fiduciary status was also imposed, very early on in the law, upon those providing advice.¹¹⁹

¹¹⁶ Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795, 796 (1983).

¹¹⁷ *In re Clarke's Market, L.L.C.*, 322 B.R. 487, 495 (Bankr. N.H., 2005).

¹¹⁸ Tamar Frankel, “Fiduciary Law,” 71 Calif. L. Rev. 795, 817 (1983).

¹¹⁹ “The rule in *Keech v. Sandford* is not confined to trustees. ‘Whenever a person clothed with a fiduciary or quasi fiduciary character or position gains some personal advantage by availing himself of such character or position, a constructive trust is raised by courts of equity, such person becomes a constructive trustee, and the advantage gained

(6) Factors In Determining Whether Fiduciary Status is Imposed; When A “Relationship of Trust and Confidence” Arises.

“Mere subjective trust does not transform arms-length dealing into a fiduciary relationship.”¹²⁰ Something more must be present. But the existence of one fact, or its non-existence, is not determinative. Rather, a variety of circumstances may indicate that a fiduciary relationship exists, as opposed to an arms-length relationship.

The test of whether a fiduciary relationship exists under the common law often requires a fact-intensive inquiry.¹²¹ The indicia of a fiduciary relationship, or evidential factors, include:

- (1) Influence or the ability to exert influence;
- (2) placement of trust;
- (3) vulnerability¹²² or dependency;
- (4) substantial disparity in knowledge,¹²³

must be held by him for the benefit of his cestui que trust.’ [citing Walter G. Hart, The Development of the Rule in *Keech v. Sandford*, Law Q. Rev., 21 (1905): 258, 259].” F. Johnston, Jr., “Natural Law and the Fiduciary Duties of Business Managers,” 8 J. MARKETS & MORALITY 8 (2005): 27, 30, noting that the Court in *Michould v. Girod* cited examples of the general rule from Roman law as well as from English law. See also John McGhee, “The Role of Fiduciary Obligations in Commercial Disputes,” stating: “[T]he early use of the word ‘trust’ was not confined to private settlements. A person had a confidence reposed or entrusted in him not only where he had been asked to hold property belonging to another but also where he was given some power to exercise on behalf of another or where another person relied upon him for advice. All these situations were known as ‘trusts’. In due course, however, as detailed rules for private settlements grew up in the eighteenth and nineteenth centuries, ‘trust’ acquired a technical meaning. Other relationships in which equity intervened on the basis of confidence were referred to as ‘quasi-trusts’, trusts ‘for limited purposes’ or as being ‘similar to’ trusts. The word ‘fiduciary’ eventually became used to describe these relationships.” *Id.*, (1998) 114 L.Q.R. 214, 399 (UK).

¹²⁰ *Exxon Corp. v. Breezevale Ltd.*, 82 S.W.3d 429 (Tex. App., 2002).

¹²¹ See *ARA Automotive Group v. Central Garage, Inc.*, 124 F.3d 720,723 (C.A.5 (Tex.), 1997) (“The existence of a fiduciary relationship, outside of formal relationships that automatically give rise to fiduciary duties, is usually a fact intensive inquiry”).

¹²² However, merely because some degree of vulnerability exists does not necessarily give rise to a fiduciary relationship. See *New England Surfaces v. E.I. Du Pont De Nemours*, 517 F.Supp.2d 466, 488-9 (D. Me., 2007) (“In *Webber Oil Co. v. Murray*, Webber agreed to provide gasoline to the public through pumps owned by Webber at a convenience store owned by Murray ... Murray staffed the pumps, collected the sales and paid the proceeds to Webber. Id Through the course of their relationship, Webber loaned money to Murray, and Murray and his wife signed promissory notes to Webber ... the Law Court declined to find a fiduciary relationship in this situation. ‘The evidence here showed no such relationship, but rather only a conventional business deal. Certainly one party was economically stronger than the other, but that is often the case in a business deal, and not the basis for a finding of a relationship of confidence.’” Quoting *Webber Oil Co. v. Murray*, 551 A.2d 1371(Me.1988).)

¹²³ Yet, superior knowledge or expertise, standing alone, has been held to be insufficient to impose fiduciary status on the one with the higher level of knowledge or expertise. See *Henneberry v. Sumitomo Corp. of America*, 532 F.Supp.2d 523, 550 (S.D.N.Y., 2007) (“a fiduciary obligation will not be imposed on one party ‘merely because it possesses relative expertise as compared to the other’ ... ‘Allegations of reliance on another party with superior expertise, standing by themselves, will not suffice’”) (citations omitted).

- (5) placement of confidence,¹²⁴
- (6) the actual exercise of control over a party;
- (7) the ability of the fiduciary, by virtue of his or her position or authority, to derive profits at the expense of his or her client;
- (8) the use of a title which denotes a relationship of trust and confidence.

Note, again, that any oral or written contract regarding the non-existence of a fiduciary relationship is not dispositive of the issue.

(7) The Limited (Quasi)-Fiduciary Duties of Brokers, Arising from Agency.

A broker and its registered representatives possess, under general principles of agency law, limited fiduciary duties to their customers. A broker is sometimes said to be a quasi-fiduciary to a client, but these fiduciary duties are limited to the scope of the agency. For example, the broker-dealer firm accepts responsibility as an “agent” of the customer for the proper execution of the brokerage transaction. In connection with the scope of that agency, the broker-dealer and its registered representatives owe “limited fiduciary duties” or “quasi-fiduciary duties” to the customer. However, no broad fiduciary duties exist with respect to most registered representatives and their broker-dealer firms, under the law of agency, at least with respect to non-discretionary accounts.

In contrast, when a broker accepts actual or *de jure* discretion over a client’s account, under this branch of fiduciary relationships fiduciary status for the broker will result due to the application of agency law. Various judicial decisions note that common law fiduciary duties arise from the principal-agent relationship, and that these duties will usually be interpreted quite broadly. In essence, since the scope of the agency includes the exercise of discretionary authority to undertake sales and purchases in the account, the agent (registered representative) owes a fiduciary duty to the principal (the customer) in the actions undertaken which exercise that discretion. Some state courts apply the very broad triad of fiduciary duties – loyalty, due care, and utmost good faith – when the broker-dealer possesses discretion over a customer’s account.¹²⁵ Additionally, even though an account may be “non-discretionary” on paper,

¹²⁴ A fiduciary relationship “is a relationship founded upon trust or confidence reposed by one person in the integrity and fidelity of another ... in which influence has been acquired and abused, in which confidence has been reposed and betrayed” *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423, 458 (S.D.N.Y., 2006). “A fiduciary relationship may exist where one party reposes confidence in another and reasonably relies on the other's superior expertise or knowledge.” *WIT Holding Corp. v. Klein*, 282 A.D.2d 527, 724 N.Y.S.2d 66, 68 (App.Div.2001). However, the mere exchange of confidential information does not give rise to a fiduciary relationship. See *U.S. v. Cassese*, 273 F.Supp.2d 481, 487 (S.D.N.Y., 2003) (“The present case is also similar to *Walton v. Morgan Stanley & Co. Inc.*, 623 F.2d 796 (2d Cir.1980). In *Walton*, the Second Circuit held that when two corporations' management were ‘at all times responsible for different interests, and ... had no relationship to each other before or other than in the acquisition discussions,’ they ‘must be presumed to have dealt, absent evidence of an extraordinary relationship, at arm's length.’ *Id.* at 798. The fact that information exchanged between the two parties is confidential does nothing to change their relationship from arms-length into a fiduciary relationship. *Id.* at 799.”)

¹²⁵ See *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 461 F Supp 951, 953 [ED Mich. 1978] [“[u]nlike the broker who handles a non-discretionary account, the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense.”]. Of course, the Commission takes the view that possessing discretion over a brokerage

some state courts find that the registered representative may exercise *de facto* control over non-discretionary accounts. In essence, such a finding transforms the scope of the agency from a limited one to a broad one, and fiduciary duties then apply to that broadened scope of the agency.¹²⁶

(8) State Investment Adviser Statutes and Fiduciary Standards.

In most cases, securities statutes and regulations adopted by various states (so-called Blue Sky laws) prohibit conduct similar to that prohibited by Section 206 of the Advisers Act. Applying the same rationale utilized by the U.S. Supreme Court in *SEC vs. Capital Gains Research Bureau*, these state provisions could be interpreted to impose a fiduciary duty upon investment advisers.

In addition, NASAA Model Rule USA 2002 502(b), “Prohibited Conduct in Providing Investment Advice,” states in part: “A person who is an investment adviser, an investment adviser representative or a federal covered investment adviser is a fiduciary and has a duty to act primarily for the benefit of its clients.” Additionally, NASAA Model Rule 102(a)(4)-1, “Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers,” repeats the foregoing statement.

account subjects the broker to registration under the Advisers Act, which in turn imposes upon the broker the full set of federal fiduciary duties.

¹²⁶ *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc. & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd* 647 F. 2d. 165 (6th Cir. 1981) (recognizing that broker who has *de facto* control over nondiscretionary account generally owes customer duties of a fiduciary nature; looking to customer’s sophistication, and the degree of trust and confidence in the relationship, among other things, to determine duties owed); *Paine Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d. 508 (Colo. 1986) (evidence “that a customer has placed trust and confidence in the broker” by giving practical control of account can be “indicative of the existence of a fiduciary relationship”); *MidAmerica Federal Savings & Loan v. Shearson/American Express*, 886 F.2d. 1249 (10th Cir. 1989) (fiduciary relationship existed where broker was in position of strength because it held its agent out as an expert); *SEC v. Ridenour*, 913 F.2d. 515 (8th Cir. 1990) (bond dealer owed fiduciary duty to customers with whom he had established a relationship of trust and confidence); C. Weiss, “A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty,” 23 Iowa J. Corp. Law 65 (1997). *Cf. De Kwiakowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302-03, 1308-09 (2d Cir. 2002) (noting that brokers normally have no ongoing duty to monitor non-discretionary accounts but that “special circumstances,” such as a broker’s *de facto* control over an unsophisticated client’s account, a client’s impaired faculties, or a closer-than-arms-length relationship between broker and client, might create extra-contractual duties).

If a broker has provided broad advice relative to investment strategies and decisions, and if the customer has frequently relied on that advice, there is a strong indication that the account is discretionary. There are many factors, however, that apply. In each instance it is a “facts and circumstances” analysis. For example, a key factor is the investment sophistication of the customer, since an inexperienced or naive customer is more likely to leave the control of an account in the broker's hands. *Kaufman*, 464 F.Supp. at 536; *Leib*, 461 F.Supp. at 954; *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 433 (N.D.Cal.1968). Conversely, a customer who has sufficient understanding and intelligence to be able to evaluate a broker's recommendations and exercise independent judgment as to those recommendations can be viewed as controlling the account. *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673 (9th Cir.1982); *Marshak v. Blyth Eastman Dillon & Co., Inc.*, 413 F.Supp. 377 (N.D.Okla.1975). Thus, for example, the court in *Leib* considered the customer's age, education, intelligence, and investment experience as among the relevant considerations in determining that the customer was sufficiently involved in and informed about his account to be deemed in control of the account. 461 F.Supp. at 954. Additionally, the *Lieb* court noted that if the broker is socially or personally involved with the customer, this suggests relinquishment of control by the customer because of the relationship of trust and confidence. The *Patsos* court enumerated similar factors.

(9) ERISA’s Imposition of (Stricter) Fiduciary Standards.

Section 3(21)(A)(ii) of ERISA sets out a simple two-part test for determining fiduciary status. First, does a person render investment advice with respect to any moneys or other property of a plan, or has any authority or responsibility to do so. Second, does the person receives a fee or other compensation, direct or indirect, for doing so. If both parts of this test are met, then under the plain language of the statute the “person” (who may be an individual or a business entity) is a “fiduciary” and ERISA’s fiduciary duties attach.

Status as a fiduciary under ERISA is to be determined by the person’s functions, with respect to the employee benefit plan. As stated by the U.S. Supreme Court, “In defining the term “fiduciary” in § 3(21)(A) of ERISA, Congress struck a balance that it believed would protect plan participants without impinging on the ability of employers to make business decisions. In recognition that ERISA allows trustee-beneficiary arrangements that the common law of trusts generally forbids, Congress “define[d] ‘fiduciary’ not in terms of formal trusteeship, but in functional terms of control and authority over the plan.””¹²⁷

The importance of who is, and who is not, a fiduciary under ERISA’s regulations should not be understated. Despite the general aversion of the courts to find that federal law preempts state common law claims based upon actual or constructive fraud, some specific federal statutes, such as ERISA, preempt state common law in specific situations. For example, ERISA preempts state common law when investment advice is provided on an account governed by ERISA.¹²⁸

Unfortunately, shortly after the enactment of ERISA the U.S. Department of Labor (DOL) enacted a regulation which substantially constrained the plain language of the statute.¹²⁹ While the DOL sought to amend this regulation during this past decade to greatly expand the application of ERISA’s fiduciary standard to nearly all who provide recommendations on securities and insurance products to ERISA-

¹²⁷ *Vanity Corp. v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996).

¹²⁸ Section 514 of ERISA provides, with certain exceptions specifically enumerated, that the provisions of Titles I and IV of ERISA supersede any and all laws of the States as they relate to any employee benefit plan covered under ERISA.

¹²⁹ The regulation significantly narrowed the plain language of section 3(21)(A)(ii), creating a 5-part test that must be satisfied in order for a person to be treated as a fiduciary by reason of rendering investment advice. For advice to constitute “investment advice,” an adviser who does not have discretionary authority or control with respect to the purchase or sale of securities or other property for the plan must: (1) Render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property; (2) On a regular basis; (3) Pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, that; (4) The advice will serve as a primary basis for investment decisions with respect to plan assets, and that; (5) The advice will be individualized based on the particular needs of the plan.

covered plans (both plan sponsors, and plan participants), as well as upon those who advise individual investors in IRA accounts,¹³⁰ these new regulations were recently vacated through judicial action.¹³¹

“ERISA does not expressly enumerate the particular duties of a fiduciary, but rather ‘relies on the common law of trusts to define the general scope of a fiduciary’s responsibilities.’”¹³² “[T]he Supreme Court first recognized that ERISA protects employee benefit plans by setting forth certain fiduciary duties applicable to their management. Although these duties find their basis in the common law of trusts, the Court cautioned that ERISA’s standards and procedural protections ‘partly reflect a congressional determination that the common law of trusts did not offer completely satisfactory protection.’ In some instances ‘trust law will offer only a starting point, after which courts must go on to ask whether, or to what extent, the language of the statute, its structure, or its purposes require departing from common-law trust requirements.’ In so doing, courts should take account of competing congressional purposes, ‘such as Congress’[s] desire to offer employees enhanced protection for their benefits, on the one hand, and, on the other, its desire not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering welfare benefit plans in the first place.’”¹³³

G. Edits to the Commission’s Interpretation of the Fiduciary Duties Arising Under the Investment Advisers Act of 1940

In undertaking this commentary, in the text below, I reproduce Sections I and II of Release No. IA-4889.

For ease of tracking the suggested changes, and my rationale for same:

- I reformat the original text’s footnotes to place them after each paragraph, in the body of the text. This permits the reader to distinguish between the original footnotes contained in the proposed interpretation and those I have added.

¹³⁰ As summarized by Krisa Benskin, Baker Botts L.L.P., in an article entitled *Fiduciary Rule Vacated: Transition Relief Extended*: “On April 6, 2016, the Department of Labor (“DOL”) issued a final regulation that redefined who is a fiduciary under Section 3(21)(a) of the Employee Retirement Income Security Act of 1974 (“ERISA”) when providing investment advice to a retirement plan or IRA holder (the “Final Rule”). The Final Rule required anyone being paid to give investment advice to retirement savers to follow fiduciary standards of conduct, which are familiar to ERISA practitioners and plan fiduciaries but may be new to IRA investors. This included advice on transactions previously unregulated by DOL, like rollovers from retirement plans to IRAs.

The Final Rule also provided an exemption designed to address the conflicts of interest inherent in the payments that financial advisors receive in connection with many retail transactions, such as commissions, trailing commissions, and 12b-1 fees. Under this exemption (the “best interest contract exemption” or “BIC Exemption”), a financial adviser could continue to provide advice even though the compensation for that advice might present a conflict of interest. In order to qualify under the BIC Exemption, a financial adviser must, among other requirements, acknowledge their fiduciary status with respect to the investment advice they are giving and adhere to certain “impartial conduct standards”. Generally, these standards require advisors to make recommendations in the best interests of participants, receive only reasonable compensation, and not provide misleading information.”

¹³¹ *Chamber of Commerce et al. v. U.S. Department of Labor* (5th Cir. 2018).

¹³² *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407, 412 (5th Cir., 2003), *citing* Edward E. Bintz, *Fiduciary Responsibility Under ERISA: Is There Ever a Fiduciary Duty to Disclose?*, 54 U. PITT. L. REV. 979, 985 (1993).

¹³³ *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407 (5th Cir., 2003), *citing* *Varity Corp. v. Howe*, 516 U.S. 489, 494, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996).

- I then undertake additions and ~~deletions~~ to the SEC’s proposed text and footnotes.
- I provide recitations to authority, and additional discussion, in my own footnotes, set forth at the bottom of each page.
- I move a few sections around, to aid in clarity.

**INTERPRETATION OF THE FIDUCIARY STANDARD OF CONDUCT
ARISING UNDER THE INVESTMENT ADVISERS ACT OF 1940¹**

¹ 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified, and when we refer to rules under the Advisers Act, or any paragraph of these rules, we are referring to title 17, part 275 of the Code of Federal Regulations [17 CFR 275], in which these rules are published.

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I. INTRODUCTION

An investment adviser is a fiduciary, and as such is held to the highest standard of conduct and must act in the best interest of its client.² Its fiduciary obligation, which includes an affirmative duty of utmost good faith and full and fair disclosure of all material facts, is established under various federal laws and state common law and is important to the Commission's investor protection efforts.³ The Commission also regulates broker-dealers, including the obligations that broker-dealers owe to their customers. Investment advisers and broker-dealers provide advice and services to retail investors and are important to our capital markets and our economy more broadly. Broker-dealers and investment advisers may have different types of relationships with their customers and clients and have different models for providing advice, which provide investors with choice about the levels and types nature and extent¹³⁴ of advice they receive and how they pay for the services or products that they receive.

² *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (“SEC v. Capital Gains”). See also *infra* notes 26 - 32 and accompanying text; Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256 (July 2, 2004); Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) (“Compliance Programs Release”); Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Investment Advisers Act Release No. 1862 (Apr. 5, 2000). We acknowledge that investment advisers also have antifraud liability with respect to prospective clients under section 206 of the Advisers Act.

³ See *SEC v. Capital Gains*, *supra* note 2.

~~Today, the Commission is proposing a rule that would require all broker-dealers and natural persons who are associated persons of broker-dealers to act in the best interest of retail customers⁴ when making a recommendation of any securities transaction or investment strategy involving securities to retail customers (“Regulation Best Interest”).⁵ We are also proposing to require registered investment advisers and registered broker-dealers to deliver to retail investors a relationship summary, which would provide these investors with information about the relationships and services the firm offers, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and whether the firm and its financial professionals currently have reportable legal or disciplinary events.⁶ In light of the comprehensive nature of our proposed set of rulemakings,¹³⁵ [W]e believe it would be appropriate and~~

¹³⁴ I do not concur that broker-dealers and investment advisers always possess “different types of relationships with their customers and clients and have different models for providing advice.” For reasons explained herein, brokers can – are often are – held to broad fiduciary duties of due care, loyalty, and utmost good faith. Moreover, the Commission’s attempt to distinguish between continual, versus episodic, delivery of advice is not in accord with what actually occurs for many, if not most, customers of “full-service” broker-dealer firms. Accordingly, I have suggested these deletions from the SEC’s introduction.

¹³⁵ I disagree wholeheartedly with the Commission’s proposed “Regulation Best Interest,” for several reasons, two of which include:

First, the use of the term “best interest” – when such term has been utilized for centuries by both the courts and in laymen’s terms – to describe obligations that do not arise to the level of a fiduciary obligations – would in effect seek to redefine the very concept of a fiduciary and, in so doing, diminish it. I state my rationale in a separate comment letter submitted to the Commission.

beneficial to address in one release⁷ and reaffirm – and in some cases clarify – certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act.⁸

⁴ An investment adviser has a fiduciary duty to all of its clients, whether or not the client is a retail investor.

⁵ ~~Regulation Best Interest, Exchange Act Release No. 34-83062 (April 18, 2018) (“Regulation Best Interest Proposal”).~~

⁶ ~~Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Investment Advisers Act Release No. IA 4888 (April 18, 2018) (“Form CRS Proposal”).~~

⁷ This Release is intended to highlight the principles relevant to an adviser’s fiduciary duty. It is not, however, intended to be the exclusive resource for understanding these principles.

⁸ The Commission recognizes that many advisers provide impersonal investment advice. *See, e.g.*, Advisers Act rule 203A-3 (defining “impersonal investment advice” in the context of defining “investment adviser representative” as “investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts”). This Release does not address the extent to which the Advisers Act applies to different types of impersonal investment advice.

~~An investment adviser’s fiduciary duty is similar to, but not the same as, the proposed obligations of broker-dealers under Regulation Best Interest.⁹ While we are not proposing a uniform standard of conduct for broker-dealers and investment advisers in light of their different relationship types and models for providing advice, we continue to consider whether we can improve protection of investors through potential enhancements to the legal obligations of investment advisers. Below, in addition to our interpretation of advisers’ existing fiduciary obligations, we request comment on three potential enhancements to their legal obligations by considering areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context.¹³⁶~~

⁹ ~~Regulation Best Interest Proposal, *supra* note 5. In addition to the obligations proposed in Regulation Best Interest, broker-dealers have a variety of existing specific obligations, including, among others, suitability, best execution, and fair and reasonable compensation. *See, e.g., Hanly v. SEC*, 415 F.2d 589, 596-97 (2d Cir. 1969) (“A securities dealer occupies a special relationship to a~~

Second, since the term “best interests” is synonymous with the fiduciary standard, and since Section 913(g)(1) of the Dodd-Frank Act provides that if the fiduciary duty is extended to broker-dealers, then “the standard of conduct for such broker or dealer with respect to such customer *shall be the same as* the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act of 1940”¹³⁵ [*Emphasis added.*]

For these and for other reasons detailed in my separate comment letter regarding proposed “Regulation Best Interests,” I would delete this paragraph from the Commission’s final interpretation.

¹³⁶ I disagree that an investment adviser’s fiduciary duty is “similar to ... the proposed obligations of broker-dealers under Regulation Best Interest. One can be in an salesperson-customer (arms-length) relationship, or a fiduciary-entrustor relationship, but it is impossible to be both. My separate comment letter regarding proposed Regulation Best Interest sets forth my objections. Accordingly, I would delete this paragraph from the Commission’s final interpretation.

buyer of securities in that by his position he implicitly represents that he has an adequate and reasonable basis for the opinions he renders.”); and FINRA rules.

II. INVESTMENT ADVISERS’ FIDUCIARY STANDARD OF CONDUCT DUTY

The Advisers Act establishes a federal fiduciary standard for investment advisers.¹⁰ This fiduciary standard is based on equitable common law principles and is fundamental to advisers’ relationships with their clients under the Advisers Act.¹¹ The fiduciary duty to which advisers are subject is not specifically defined in the Advisers Act or in Commission rules, but 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.”¹² An adviser’s fiduciary duty is imposed under the Advisers Act in recognition of the nature of the relationship between an investment adviser and a client and the desire “so far as is presently practicable to eliminate the abuses” that led to the enactment of the Advisers Act.¹³ It is made enforceable by the antifraud provisions of the Advisers Act.¹⁴ Investment advisers also possess broad fiduciary duties arising under state common law, which is enforceable primarily through civil action brought against the investment adviser by the adviser’s client.

¹⁰ *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) (“*Transamerica Mortgage v. Lewis*”) (“§ 206 establishes federal fiduciary standards to govern the conduct of investment advisers.”) (quotation marks omitted); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 471, n.11 (1977) (in discussing *SEC v. Capital Gains*, stating that the Supreme Court’s reference to fraud in the “equitable” sense of the term was “premised on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers”); *SEC v. Capital Gains*, *supra* note 2; Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) (“Investment Advisers Act Release 3060”) (“Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients’ interests to its own,” citing *Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) (“Investment Advisers Act Release 2106”)).

¹¹ See *SEC v. Capital Gains*, *supra* note 2 (discussing the history of the Advisers Act, and how equitable principles influenced the common law of fraud and changed the suits brought against a fiduciary, “which Congress recognized the investment adviser to be”).

¹² See *SEC v. Capital Gains*, *supra* note 2.

¹³ See *SEC v. Capital Gains*, *supra* note 2 (“The Advisers Act 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.” and also noting that the “declaration of policy” in the original bill, which became the Advisers Act, declared that “the national public interest and the interest of investors are adversely affected 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 [sic] 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” (citing S. 3580, 76th Cong., 3d Sess., § 202 and 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, at 28). See also *In the Matter of Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948) (“Arleen Hughes”) (discussing the relationship of trust and confidence between the client and a dual registrant and stating that the registrant was a fiduciary and subject to liability under the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act).

¹⁴ *SEC v. Capital Gains*, *supra* note 2; *Transamerica Mortgage v. Lewis*, *supra* note 10 (“[T]he Act’s legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.”).

[Formatting Note: The Original Paragraph Contained in the SEC’s Release Has Been Segregated Into Separate Paragraphs, Below, In Order To Provide Elaboration Upon The Concepts Conveyed.]

An investment adviser’s fiduciary duty under the Advisers Act comprises a duty of due care and a duty of loyalty,¹³⁷ although other duties may be surmised. Several commenters responding to Chairman Clayton’s June 2017 request for public input¹⁵ on the standards of conduct for investment advisers and broker-dealers acknowledged these duties.¹⁶

¹⁵ Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers, Chairman Jay Clayton (June 1, 2017), available at

¹³⁷ 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). In the context of corporate directors’ fiduciary duties, dictum in *Cede & Co. v. Technicolor, Inc.*, the Delaware Supreme Court announced for the first time that corporate directors owe a “triad” of fiduciary duties, including not only the traditional duties of loyalty and care, but a third duty of “good faith.” 634 A.2d 345, 361 (Del. 1993) (emphasis omitted). See, e.g., Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 Del. J. Corp. L. 1, 11 (2006) (“In short, the duty of good faith has long been both explicit and implicit in corporation statutes and implicit in case law. Recently, it has become explicit in case law as well.”); Hillary A. Sale, *Delaware’s Good Faith*, 89 Cornell L. Rev. 456, 494 (2004) (advocating the need for “a separate good faith duty” to address “those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts”).

But not all scholars believe that a separate duty of utmost good faith exists. See, e.g., Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 Wake Forest L. Rev. 1131 (2006); Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. Davis L. Rev. 457 (2009); Andrew C.W. Lund, *Opting Out of Good Faith*, 37 Fla. St. U. L. Rev. ____ (2010)

However, often the duty of “utmost good faith” is merged into the other two duties. For example, in the context of fiduciary duties arising for certain actors in corporations, 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.

<https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31>
 (“Chairman Clayton’s Request for Public Input”).

¹⁶ See, e.g., Comment letter of the Investment Adviser Association (Aug. 31, 2017) (“IAA Letter”) (“The well-established fiduciary duty under the Advisers Act, which incorporates both a duty of loyalty and a duty of care, has been applied consistently over the years by courts and the SEC.”); Comment letter of the Consumer Federation of America (Sept. 14, 2017) (“an adviser’s fiduciary obligation ‘divides neatly into the duty of loyalty and the duty of care.’ The duty of loyalty is designed to protect against ‘malfeasance,’ or wrongdoing, on the part of the adviser, while the duty of care is designed to protect against ‘nonfeasance,’ such as neglect.”).

This fiduciary duty requires an adviser “to adopt the principal’s goals, objectives, or ends.”¹⁷

¹⁷ Arthur B. Laby, *The Fiduciary Obligations as the Adoption of Ends*, 56 *Buffalo Law Review* 99 (2008). See also Restatement (Third) of Agency, §2.02 Scope of Actual Authority (2006) (describing a fiduciary’s authority in terms of the fiduciary’s reasonable understanding of the principal’s manifestations and objectives).

This means the adviser must, at all times, serve the best interest of its clients and not subordinate its clients’ interest to its own.¹⁸

¹⁸ Investment Advisers Act Release 3060, *supra* footnote 10 (adopting amendments to Form ADV and stating that “under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients’ interests to its own,” *citing* Investment Advisers Act Release 2106 *supra* note 10); *SEC v. Tambone*, 550 F.3d 106, 146 (1st Cir. 2008) (“Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors.”); *SEC v. Moran*, 944 F. Supp. 286 (S.D.N.Y. 1996) (“Investment advisers are entrusted with the responsibility and duty to act in the best interest of their clients.”). See also *In re Prudential Ins. Co. of America Sales Prac.*, 975 F.Supp. 584, 616 (D.N.J., 1996) (“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.”)

The federal fiduciary duty is imposed through the antifraud provisions of the Advisers Act.¹⁹ The duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship through contract when the client receives full and fair disclosure and provides informed consent,²⁰ and further provided the transaction is substantively fair to the client. Although the ability to tailor the terms means that the application of the fiduciary duty will vary with the terms of the relationship, the relationship in all cases remains that of a fiduciary to a client. In other words, the investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty.²¹

¹⁹ See *supra* note 14.

²⁰ See *infra* note 40 and accompanying text for a discussion of informed consent.

²¹ As an adviser’s federal fiduciary obligations are enforceable through section 206 of the Act, we would view a waiver of enforcement of section 206 as implicating section 215(a) of the Act, which provides that “any condition, stipulation or provision binding any person to waive compliance with any provision of this title. . . shall be void.” Some commenters on Chairman Clayton’s

Request for Public Input and other Commission requests for comment also stated that an adviser's fiduciary duty could not be disclosed away. *See, e.g.*, IAA Letter *supra* note 16 (“While disclosure of conflicts is crucial, it cannot take the place of the overarching duty of loyalty. In other words, an adviser is still first and foremost bound by its duty to act in its client’s best interest and disclosure does not relieve an adviser of this duty.”); Comment letter of AARP (Sept. 6, 2017) (“Disclosure and consent alone do not meet the fiduciary test.”); Financial Planning Coalition Letter (July 5, 2013) responding to SEC Request for Data and Other Information, Duties of Brokers, Dealers, and Investment Advisers, Exchange Act Release No. 69013 (Mar. 1, 2013) (“Financial Planning Coalition 2013 Letter”) (“[D]isclosure alone is not sufficient to discharge an investment adviser’s fiduciary duty; rather, the key issue is whether the transaction is in the best interest of the client.”) (internal citations omitted). *See also* Restatement (Third) of Agency, § 8.06 Principal’s Consent (2006) (“The law applicable to relationships of agency as defined in § 1.01 imposes mandatory limits on the circumstances under which an agent may be empowered to take disloyal action. These limits serve protective and cautionary purposes. Thus, an agreement that contains general or broad language purporting to release an agent in advance from the agent’s general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent’s fiduciary duty may not reflect an adequately informed judgment on the part of the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent’s position in ways not foreseeable by the principal at the time the principal agreed to the release. In contrast, when a principal consents to specific transactions or to specified types of conduct by the agent, the principal has a focused opportunity to assess risks that are more readily identifiable.”); Tamar Frankel, Arthur Laby & Ann Schwing, *The Regulation of Money Managers*, (updated 2017) (“The Regulation of Money Managers”) (“Disclosure may, but will not always, cure the fraud, since a fiduciary owes a duty to deal fairly with clients.”).

Commission.

We discuss our views²² on an investment adviser’s fiduciary duty in more detail below.²³

²² In various circumstances, other regulators, including the U.S. Department of Labor, state common law, and other legal regimes, including state securities law, impose obligations on investment advisers. In some cases, these standards may differ from the standard imposed and enforced by the

²³ The interpretations discussed in this Release also apply to automated advisers, which are often colloquially referred to as “robo-advisers.” Robo-advisers, like all SEC-registered investment advisers, are subject to all of the requirements of the Advisers Act, including the requirement that they provide advice consistent with the fiduciary duty they owe to their clients. The staff of the Commission has issued guidance regarding how robo-advisers can meet their obligations under the Advisers Act, given the unique challenges and opportunities presented by their business models. *See* Division of Investment Management, SEC, Staff Guidance on Robo Advisers, (February 2017), available at <https://www.sec.gov/investment/im-guidance-2017-02.pdf>.

A. Duty of Due Care

As fiduciaries, investment advisers owe their clients a duty of due care.²⁴

²⁴ See Investment Advisers Act Release No. 2106, *supra* note 10 (stating that under the Advisers Act, “an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting,” which is the subject of the release, and citing SEC v. Capital Gains *supra* note 2, to support this point). See also Restatement (Third) of Agency, § 8.08 (discussing the duty of care that an agent owes its principal as a matter of common law); The Regulation of Money Managers, *supra* note 21 (“Advice can be divided into three stages. The first determines the needs of the particular client. The second determines the portfolio strategy that would lead to meeting the client’s needs. The third relates to the choice of securities that the portfolio would contain. The duty of care relates to each of the stages and depends on the depth or extent of the advisers’ obligation towards their clients.”).

The Commission has discussed the duty of care and its components in a number of contexts.²⁵ The duty of care includes, among other things: (i) the duty to act and to provide advice that is in the best interest¹³⁸ of the client, (ii) the duty to seek best execution of a client’s transactions where the adviser has the responsibility to select broker-dealers to execute client trades, and (iii) the duty to provide advice and monitoring over the course of the relationship.

²⁵ See, e.g., Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406 (Mar. 16, 1994) (“Investment Advisers Act Release 1406”) (stating that advisers have a duty of care and discussing advisers’ suitability obligations); Securities; Brokerage and Research Services, Exchange Act Release No. 23170 (Apr. 23, 1986) (“Exchange Act Release 23170”) (“an adviser, as a fiduciary, owes its clients a duty of obtaining the best execution on securities transactions.”). We highlight certain contexts in which the Commission has addressed the duty of care but we note that there are others; for example, voting proxies when an adviser undertakes to do so. Investment Advisers Act Release 2106, *supra* note 10.

i. Duty to Provide Advice With the Requisite Degree of Required Expertise, Due Diligence, and Skill. that is in the Client’s Best Interest

We have addressed an adviser’s duty of care in the context of the provision of personalized investment advice. In this context, the duty of care includes a duty to make a reasonable inquiry into a client’s financial situation, level of financial sophistication, investment experience, and investment objectives (which we refer to collectively as the client’s “investment profile”) and a duty to provide personalized advice that is suitable for and in the best interest of the client based on the client’s investment profile.²⁶

²⁶ In 1994, the Commission proposed a rule that would make express the fiduciary obligation of investment advisers to make only suitable recommendations to a client. Investment Advisers Act

¹³⁸ Scholars generally presume that the duty to act in the “best interests” of the client invokes, primarily, the fiduciary duty of loyalty. However, at times the term “best interests” is also utilized to describe the duty of due care. See, e.g., Julian Velasco, A Defense of the Corporate Law Duty of Care, 40 J. of Corporation Law 646, 649 (2015) [“the duty of care is necessary to let fiduciaries know that they have a legal duty to pursue the beneficiaries' interests with skill and diligence (i.e., carefully)”].

Release 1406, *supra* note 25. Although never adopted, the rule was designed, among other things, to reflect the Commission's interpretation of an adviser's existing suitability obligation under the Advisers Act. We believe that this obligation, when combined with an adviser's fiduciary duty to act in the best interest of its client, requires an adviser to provide investment advice that is suitable¹³⁹ for and applying the requisite level of expertise, due diligence and skill. ~~in the best interest of its client.~~¹⁴⁰

An adviser must, before providing any personalized investment advice and as appropriate thereafter, make a reasonable inquiry into the client's investment profile. The nature and extent of the inquiry turn on what is reasonable under the circumstances, including the nature and extent of the agreed-upon advisory services, the nature and complexity of the anticipated investment advice, and the investment profile of the client. For example, to formulate a comprehensive financial plan for a client, an adviser might obtain a range of personal and financial information about the client, including current income, investments, assets and debts, marital status, insurance policies, and financial goals.²⁷

²⁷ Investment Advisers Act Release 1406, *supra* note 25. After making a reasonable inquiry into the client's investment profile, it generally would be reasonable for an adviser to rely on information provided by the client (or the client's agent) regarding the client's financial circumstances, and an adviser should not be held to have given advice not in its client's best interest if it is later shown that the client had misled the adviser.

An adviser must update a client's investment profile in order to adjust its advice to reflect any changed circumstances.²⁸ The frequency with which the adviser must update the information in order to consider changes to any advice the adviser provides would turn on many factors, including whether the adviser is

¹³⁹ The suitability standard applicable to broker-dealers has been applied to investment advisers. However, 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. As the Commission has previously stated, 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 under the duty of due care extend much further than the duties imposed under the suitability standard.

¹⁴⁰ Ross Jordan, Note, Thinking Before Rulemaking: Why the SEC Should Think Twice Before Imposing a Uniform Fiduciary Standard On Broker-Dealers and Investment Advisers, *50 U. Louisville L. Rev.* 491 (2012). ["The confusion surrounding the meaning of "acting in the client's best interest," or the best interest standard, is due to the SEC's inconsistent interpretation of an adviser's duty of care under the Advisers Act. As noted by Professor Barbara Black, following the holding in *Capital Gains*, the best interest standard was viewed as one part of an adviser's duty of loyalty to disclose conflicts of interest, as opposed to being part of an adviser's duty of care. However, after a while, the SEC began referring to the best interest standard in the context of the quality of an adviser's investment advice, instead of an adviser's disclosure obligations. Essentially, the Commission began describing the best interest standard as part of an adviser's duty of care-to manage the client's portfolio in the best interest of the client-rather than part of an adviser's duty of loyalty to disclose conflicts of interest.] [*Citations omitted.*]

aware of events that have occurred that could render inaccurate or incomplete the investment profile on which it currently bases its advice. For example, a change in the relevant tax law or knowledge that the client has retired or experienced a change in marital status might trigger an obligation to make a new inquiry.

²⁸ We note that this would not be done for a one-time financial plan or other investment advice that is not provided on an ongoing basis. *See also infra* note 37.

An investment adviser must also have a reasonable belief that the personalized advice is suitable for ~~and in the best interest of~~ the client based on the client's investment profile. A reasonable belief would involve considering, for example, whether investments are recommended only to those clients who can and are willing to tolerate the risks of those investments and for whom the potential benefits may justify the risks.²⁹ Whether the advice is ~~in a client's best interest suitable for a client~~ must be evaluated in the context of the portfolio that the adviser manages for the client and the client's investment profile. For example, when an adviser is advising a client with a conservative investment objective, investing in certain derivatives may be in the client's best interest when they are used to hedge interest rate risk in the client's portfolio, whereas investing in certain directionally speculative derivatives on their own may not. For that same client, investing in a particular security on margin may not be in the client's best interest, even if investing in that same security may be in the client's best interest. When advising a financially sophisticated investor with a high risk tolerance, however, it may be consistent with the adviser's duties to recommend investing in such directionally speculative derivatives or investing in securities on margin.

²⁹ We note that Item 8 of Part 2A of Form ADV requires an investment adviser to describe its methods of analysis and investment strategies and disclose that investing in securities involves risk of loss which clients should be prepared to bear. This item also requires that an adviser explain the material risks involved for each significant investment strategy or method of analysis it uses and particular type of security it recommends, with more detail if those risks are significant or unusual.

The cost (including fees and compensation) associated with investment advice and the recommended investments¹⁴¹ would generally be one of many important factors – such as the investment product's or

¹⁴¹ It is well known that, on average, mutual fund returns are negatively related to fund expense ratios. ¹⁴¹ *See* Brad M. Barber, Terrance Odean, and Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows* (2003) (analyzing new money flowing into mutual funds from 1970 through 1999) (“Though there is no discernible relationship between performance and expenses for the majority of funds, investors clearly pay a large price for investing in funds with the highest expenses. These funds underperform by an economically large margin (26 to 37 basis points *per month*).” [*Emphasis in original.*])

Moreover, the presence of other fund costs – transaction and opportunity costs within the fund – also can lead to underperformance by stock mutual funds. While different academic studies debate the actual net impact of fees and costs, a substantial majority of the academic studies reveals that fees and costs, whatever form they take, negatively impact investors' returns. These academic conclusions run contrary to the understanding of many individual investors, who often assume that higher fund fees lead to improved performance. A *Forbes Magazine* survey found that eighty-four percent of the surveyed investors believed that higher fund expenses result in higher performance by the fund. Neil Weinberg, *Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs*, *Forbes Magazine*, Oct. 14, 2002, at 220.

strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions – to consider when determining whether a security or investment strategy involving a security or securities is in the best interest¹⁴² of the client. Accordingly, the fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy.¹⁴³ We believe that an adviser could not

In essence, the higher the fees and costs of a mutual fund, the lower its likely returns will be (on average) when compared to other similar mutual funds. Mark Carhart finds that net returns are negatively correlated with expense levels, which are generally much higher for actively managed funds. Worse, Carhart finds that the more actively a mutual fund manager trades, the lower the fund's benchmark-adjusted net return to investors. Carhart, Mark, "On persistence in mutual fund performance," *Journal of Finance* 52, 57–82 (1997). A more recent paper also highlights the importance of keeping costs low. "The more rigorous academic studies find that annual expense ratios generally detract from fund performance (see, for example, Elton, Gruber, Das and Hlavka (1993), Gruber (1996), and Carhart (1997)). On average, fund managers are unable to recoup the expenses that funds pay via better performance. Wermers (2000) finds that the underlying equity holdings of equity mutual funds do outperform the market, but that cash drag, annual expenses and transaction costs more than offset this outperformance. These findings suggest that basing fund investment decisions at least partially on fees is wise. Lower cost funds have a smaller drag on performance that active managers must overcome. Taken to their logical conclusion, these results may suggest that index funds, accompanied by the lowest expense ratios in the mutual fund industry, are a more logical long-run investment choice than more expensive actively-managed funds." Karceski, Livingston, and O'Neal, "Portfolio Transaction Costs at U.S. Equity Mutual Funds" (2004), available at http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf.

Moreover, it is not just the annual expense ratio of a fund that matters; large portfolio transaction costs in a mutual fund can consume a large portion of the mutual fund's potential gross returns. Professor Ian Domowitz considered the impact of mutual fund transaction costs and provided a hypothetical example of their impact. "Consider, for example, an equally weighted global portfolio of stocks. Over 1996:3 through 1998:3, one-way total trading costs for this portfolio average 71 basis points (bps). If the portfolio turns over twice a year, 285 bps in total costs are incurred. Average annual portfolio return over the period is 1228 bps. On this basis, trading costs alone account for 23 percent of returns." Domowitz, Ian, "Liquidity, Transaction Costs, and Reintermediation in Electronic Markets" (2001), available at http://www.smeal.psu.edu/ebrc/publications/res_papers/2001_04.pdf.

¹⁴² Most individual investors don't know the fees and costs associated with their investments. For example, a 2004 survey by AARP found that "more than 80 percent of defined contribution pension participants would be categorized as self-reporting that they did not know how much they were paying in fees."¹⁴²

¹⁴³ However, the impact of fees and costs should not be overlooked, and should be considered a primary factor in choosing pooled investment vehicles, with a stronger weight afforded to this factor than other factors. Many have observed that fees and costs in pooled investment vehicles are the most important factor in determining future returns. See, e.g., Russel Kinnel, Fund Fees Predict Future Success or Failure, Morningstar (May 5, 2016) ("If you've been following Morningstar's research for long, you know how important we think expense ratios are to the fund selection equation. The expense ratio is the most proven predictor of future fund returns. We find that it is a dependable predictor when we run the data. That's also what academics, fund companies, and, of course, Jack Bogle, find when they run the data.")

As fiduciaries, investment advisers must weigh the expected benefits that may result from a higher-cost investment product. For example, two mutual funds may hold very similar assets, but a higher-cost tax-managed version of the fund may result in a greater net return for the client when taxes are considered. Or a higher-cost fund may provide an investor's exposure to a different asset class (such as emerging markets) where the cost of operating the mutual fund may be generally greater, and exposure to the asset class may be desired due to such factors as higher returns and/or a lowering of risk (of which there exists many forms) for the portfolio as a whole.

reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance. ~~For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client's return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict.~~³⁰¹⁴⁴ Furthermore, an adviser would not satisfy its fiduciary duty to provide advice that is in the client's best interest by simply advising its client to invest in the least expensive or least remunerative investment product or strategy without any further analysis of other factors in the context of the portfolio that the adviser manages for the client and the client's investment profile. For example, it might be consistent with an adviser's fiduciary duty to advise a client with a high risk tolerance and significant investment experience to invest in a private equity fund with relatively high fees if other factors about the fund, such as its diversification and potential performance benefits, cause it to be in the client's best interest. We believe that a reasonable belief that investment advice is in the best interest of a client also requires that an adviser conduct a reasonable investigation¹⁴⁵ into the investment sufficient to not

Investment advisers should exercise a high degree of caution in utilizing past performance as a substantial factor in their selection, where the investment product possesses higher fees and costs. For example, it may be asked whether higher fees are justified when past returns (adjusting for style differences) of a selected fund are superior. Substantial academic evidence reveals that past performance is seldom, alone, a predictor of future long-term results for stock mutual funds. As one recent academic paper asserts, "more than half of the best funds are simply lucky ... [and] only a tiny fraction of 2.1% of all funds yield truly positive alphas." L. Barras, O. Scaillet, and R. Wermers, "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas" (2006).

¹⁴⁴ See discussion of the limited role disclosure plays, and the necessity for both informed consent and that the transaction be substantively fair to the client. Recommending a higher-cost share class of a mutual fund, when a lower-cost share class is available, would be a breach of the advisers' fiduciary duties of due care and loyalty. The higher share class will possess lower returns for the client. Disclosure does not cure this breach of fiduciary duty, as explained elsewhere herein. No client would ever provide informed consent to be harmed. Clients who are informed, and who have achieved true understanding of the conflict of interest posed in this situation – and understanding of its impact upon the clients' returns – would never consent to such a transaction. Clients are simply not so gratuitous to their investment adviser, at their own expense.

¹⁴⁵ While the duty of due diligence is a high one, it is not without boundaries. For example, "ERISA imposes the highest standard of conduct known to law on fiduciaries of employee pension plans. *Reich v. Valley National Bank of Arizona*, 837 F.Supp. 1259, 1273 (S.D.N.Y.1993), quoting *Donovan v. Bierwirth*, 680 F.2d 263 (2nd Cir.1982); *Kuper v. Iovenko*, 66 F.3d 1447, 1453 (6th Cir.1988). However, this is not equivalent to a standard of absolute liability, as ERISA fiduciaries are only required to exercise prudence, not prescience or omniscience. *Frahm v. Equitable Life Assurance Society of the United States*, 137 F.3d 955, 960 (7th Cir.1998); *DeBryne v. Equitable Life Assurance Society of the United States*, 920 F.2d 457, 465 (7th Cir.1990)." *Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818, 863 (C.D. Ill., 2004).

Another case "addressed, in the context of determining liability under federal securities laws, whether an investment advisor has a duty to investigate the accuracy of statements made in an offering memorandum not prepared by itself and which its client relies upon in making an investment. The court declined to impose such a duty "when there is nothing that is obviously suspicious about those statements." *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385, 413 (S.D.N.Y., 2005), citing *Gabriel Capital, L.P. v. Natwest Finance, Incorporated*, 137 F.Supp.2d 251, 262 (S.D.N.Y.2000). ("An investment advisor is retained to suggest appropriate investments for its clients, but is not required to assume the role of accountant or private investigator and conduct a thorough investigation of the

base its advice on materially inaccurate or incomplete information.³¹ We have brought enforcement actions where an investment adviser did not independently or reasonably investigate securities before recommending them to clients.³² This obligation to provide advice that is suitable and in the best interest applies not just to potential investments, but to all advice the investment adviser provides to clients, including advice about an investment strategy or engaging a sub-adviser and advice about whether to rollover a retirement account so that the investment adviser manages that account.

~~³⁰ See *infra* notes 48–52 and accompanying text (discussing an adviser’s duties related to disclosure and consent).~~

³¹ See, e.g., Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052 (July 14, 2010) (stating “as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information”).

³² See *In the Matter of Larry C. Grossman*, Investment Advisers Act Release No. 4543 (Sept. 30, 2016) (Commission opinion) (imposing liability on a principal of a registered investment adviser for recommending offshore private investment funds to clients without a reasonable independent basis for his advice).

Assessment of an investment adviser’s exercise of due care is undertaken by assessing both process and substance. In reviewing the conduct of an investment adviser in adherence to the investment adviser’s fiduciary duty of due care, the review would likely involve an analysis as to whether the decision made by the investment adviser was informed (procedural due care). The very word “care” connotes a process. 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. But it is not enough to just possess a process; the steps in the process cannot be constructed nor implemented recklessly; the exercise of sound judgment must occur during the creation of the process and then as each step of the process is undertaken.¹⁴⁶

A review of an investment adviser’s exercise of due care also includes an assessment of the substance of the transaction or advice given (substantive due care).

accuracy of the facts contained in the documents that it analyzes for the purpose of recommending an investment.”). *Id.* at 263. Of course, if a representation is made that the accuracy of documents will be verified, then such a duty of due diligence, voluntarily assumed by the investment adviser, will likely exist. See *Fraternity Fund* at p.415 (“Here, however, Asset Alliance allegedly represented to Sanpaolo that it ‘ensure[d] that the portfolios’ marks are consistent with market values.’ By making this representation, Asset Alliance took on a duty to review and check Beacon Hill’s prices.”).

¹⁴⁶ Sound criteria should be established to guide the investment adviser’s decision-making. For example, if an investment adviser were to adopt a process that ignores the relative fees and costs of the products to be recommended, substantive due care – in this instance – the exercise of informed and good judgment – has not been undertaken. While adherence to a proper process is necessary, at each step along the process the investment adviser is required to act prudently. In other words, the investment adviser must at all times exercise good judgment, applying his or her education, skills, and expertise to the issue at hand. 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, both in the creation of the process and at each stage of applying the process.

In assessing the due care undertaken by the investment adviser, the investment adviser is judged as an expert, as the standard of due care is relational.¹⁴⁷ Industry association standards are often highly probative when further defining the standard of care.¹⁴⁸

ii. Duty to Seek Best Execution

We have addressed an investment adviser's duty of care in the context of trade execution where the adviser has the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts). We have said that, in this context, an adviser has the duty to seek best execution of a client's transactions.³³ In meeting this obligation, an adviser must seek to obtain the execution of transactions for each of its clients such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances. An adviser fulfills this duty by executing securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction. As noted below, maximizing value can encompass more than just minimizing cost. When seeking best execution, an adviser should consider "the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness" to the adviser.

³³ See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006) (stating that investment advisers have "best execution obligations"); Investment Advisers Act Release 3060, supra note 10 (discussing an adviser's best execution obligations in the context of directed brokerage arrangements and disclosure of soft dollar practices). See also Advisers Act rule 206(3)-2(c) (referring to adviser's duty of best execution of client transactions).

³⁴ In other words, the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution. Further, an investment adviser should "periodically and systematically" evaluate the execution it is receiving for clients.

¹⁴⁷ 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.

¹⁴⁸ Expert witnesses in cases involving financial and investment advisers often turn to the standards adopted by various organizations, such as the Certified Financial Planner Board of Standards, Inc., the CFA Institute, and the AICPA's Personal Financial Planning division. Generally, evidence of industry standards, customs and practices is "often highly probative when defining a standard of care." 57A Am.Jur.2d Negligence § 185 (2002). Such evidence may be relevant and admissible to aid the trier of fact in determining the standard of care in a negligence action "even though the standards have not been imposed by statute or promulgated by a regulatory body and therefore do not have the force of law." *Ruffiner v. Material Serv. Corp.*, 506 N.E.2d 581, 584 (1987); *Elledge v. Richland/Lexington School District Five*, 534 S.E.2d 289, 291 (Ct. App. S.C. 2000).

³⁵ *Id.* The Advisers Act does not prohibit advisers from using an affiliated broker to execute client trades. However, the adviser's use of such an affiliate involves a conflict of interest that must be fully and fairly disclosed and the client must provide informed consent to the conflict.

iii. Duty to Act and to Provide Advice and Monitoring over the Course of the Relationship

An investment adviser's duty of care also encompasses the duty to provide advice and monitoring over the course of a relationship with a client.³⁶ An adviser is required to provide advice and services to a client over the course of the relationship at a frequency that is both in the best interest of the client and consistent with the scope of advisory services agreed upon between the investment adviser and the client. The duty to provide advice and monitoring is particularly important for an adviser that has an ongoing relationship with a client (for example, a relationship where the adviser is compensated with a periodic asset-based fee or an adviser with discretionary authority over client assets). Conversely, the steps needed to fulfill this duty may be relatively circumscribed for the adviser and client that have agreed to a relationship of limited duration via contract (for example, a financial planning relationship where the adviser is compensated with a fixed, one-time fee commensurate with the discrete, limited-duration nature of the advice provided).³⁷ An adviser's duty to monitor extends to all personalized advice it provides the client, including an evaluation of whether a client's account or program type (for example, a wrap account) continues to be in the client's best interest.

³⁶ See *SEC v. Capital Gains*, *supra* note 2 (describing advisers' "basic function" as "furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments" (quoting 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, at 28)). *Cf.* Barbara Black, *Brokers and Advisers-What's in a Name?*, 32 *Fordham Journal of Corporate and Financial Law* XI (2005) ("[W]here the investment adviser's duties include management of the account, [the adviser] is under an obligation to monitor the performance of the account and to make appropriate changes in the portfolio."); Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 *Villanova Law Review* 701, at 728 (2010) ("Laby Villanova Article") ("If an adviser has agreed to provide continuous supervisory services, the scope of the adviser's fiduciary duty entails a continuous, ongoing duty to supervise the client's account, regardless of whether any trading occurs. This feature of the adviser's duty, even in a non-discretionary account, contrasts sharply with the duty of a broker administering a non-discretionary account, where no duty to monitor is required.") (internal citations omitted).

³⁷ See Laby Villanova Article, *supra* note 36, at 728 (2010) (stating that the scope of an adviser's activity can be altered by contract and that an adviser's fiduciary duty would be commensurate with the scope of the relationship).

B. Duty of Loyalty

[Formatting note: the original paragraph in the proposed interpretation has been divided into separate numbered subparagraphs in order to provide space to clarify, add to, and comment upon the requirements that exist when a conflict of interest occurs with a client. Some re-ordering of the original text has also occurred.]

(1) Generally.

The duty of loyalty, the most distinctive of the duties imposed upon a fiduciary,¹⁴⁹ requires an investment adviser to put its client's interests first.

Under the fiduciary duty of loyalty, as developed over centuries of case law, there is a duty to not possess a conflict of interest, and also a duty to not profit off of the client.¹⁵⁰ In other words, fiduciaries owe the obligation to their client to not be in a position where there is a substantial possibility of conflict between self-interest and duty.¹⁵¹ This is called the “no-conflict” rule, derived from English law. Fiduciaries also possess the obligation not to derive unauthorized profits from the fiduciary position. This is called the “no profit” rule, also derived from English law.¹⁵²

Because an adviser must serve the best interests of its clients, it has an obligation not to subordinate its clients' interests to its own.

(2) Examples of Non-Subordination of Interests: Trade Allocations; Favoring Higher-Fee Clients.

For example, an adviser cannot favor its own interests over those of a client, whether by favoring its own accounts or by favoring certain client accounts that pay higher fee rates to the adviser over other client accounts.⁴¹

⁴¹ The Commission has brought numerous enforcement actions against advisers that unfairly allocated trades to their own accounts and allocated less favorable or unprofitable trades to their clients' accounts. *See, e.g., SEC v. Strategic Capital Management, LLC and Michael J. Breton*, Litigation Release No. 23867 (June 23, 2017) (partial settlement) (adviser placed trades through a

¹⁴⁹ “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).]

¹⁵⁰ Under English law, from which American law is derived, the broad fiduciary duty of loyalty includes these three separate rules:

- 1) *The “No Conflict” Rule:* A fiduciary must not place itself in a position where its own interests conflict with those of its client.
- 2) *The “No Profit” Rule:* A fiduciary must not profit from its position at the expense of the client. This aspect of the fiduciary duty of loyalty is often considered a prohibition against self-dealing.
- 3) *The “Undivided Loyalty” Rule:* A fiduciary owes undivided loyalty to its client and therefore must not place itself in a position where his or her duty toward one client conflicts with a duty that it owes to another client.

These separate rules are alive and well in the United States.

¹⁵¹ *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 v. Capital Gains Research Bureau*, 375 U.S. at 191-92.

¹⁵² *See* 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), at 23: “Second, investment advisers, as fiduciaries, generally are prohibited from receiving any benefit from the use of fund assets”

master brokerage account and then allocated profitable trades to adviser's account while placing unprofitable trades into the client accounts.).

(3) Not Preferring the Interests of One Client Over Another.

An investment adviser must not favor its own interests over those of a client¹⁵³ or unfairly favor one client over another.³⁸

³⁸ See Investment Advisers Act Release 3060 (“Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients’ interests to its own,” citing Investment Advisers Act Release 2106 supra note 9). See also 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), available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf> (“913 Study”).

[Note: The Text Associated With Footnotes 39-41 Of The Original Release Has Been Moved To A Latter Section Of This Comment Letter.]

Accordingly, the duty of loyalty includes a duty not to treat some clients favorably at the expense of other clients. Thus, we believe that in allocating investment opportunities among eligible clients, an adviser must treat all clients fairly.⁴² This does not mean that an adviser must have a pro rata allocation policy, that the adviser’s allocation policies cannot reflect the differences in clients’ objectives or investment profiles, or that the adviser cannot exercise judgment in allocating investment opportunities among eligible clients. Rather, it means that an adviser’s allocation policies must be fair and, if they present a conflict, the adviser must fully and fairly disclose the conflict such that a client can provide informed consent.

⁴² See also Barry Barbash and Jai Massari, The Investment Advisers Act of 1940; Regulation by Accretion, 39 Rutgers Law Journal 627 (2008) (stating that under section 206 of the Advisers Act and traditional notions of fiduciary and agency law an adviser must not give preferential treatment to some clients or systematically exclude eligible clients from participating in specific opportunities without providing the clients with appropriate disclosure regarding the treatment).

(4) The Necessity to Seek to Avoid Conflicts of Interest.

~~In addition, an~~ An adviser must seek to avoid conflicts of interest with its clients.¹⁵⁴

¹⁵³ It has long been the Commission’s position that the “an investment adviser must not effect transactions in which he has a personal interest in a manner that could result in preferring his own interest to that of his advisory clients.” SEC Rel. No. IA-1092, October 8, 1987, 52 F.R. 38400, citing *Kidder, Peabody & Co., Inc.*, 43 S.E.C. 911, 916 (1968).

¹⁵⁴ While this statement may appear harsh to some commentators, it is reflective of the vast disparity of knowledge and expertise between the investment adviser and the client, and also reflects the important public policy reasons that support the imposition of the fiduciary standard upon investment advisers. The investment adviser-client relationship is closely analogous to the attorney-client relationship. See, e.g., Julia Smith, Out with “TCF” and in with “fiduciary”?, *Butterworths Journal of International Banking and Financial Law* (June 2012), P.344 [U.K.] [“On 23 February 2012, the FSCP proposed an amendment to the Financial Services Bill because: “Customers of banks should be owed the same fiduciary duty as those seeking the advice of a lawyer or an MP, with providers prohibited from profiting from conflicts of interest at the expense of their customers...The new Financial Conduct Authority

The “no-conflict rule” states, in essence, that fiduciaries owe the obligation to their client to not be in a position where there is a substantial possibility of conflict between self-interest and duty.¹⁵⁵

The no-conflict rule is firmly embedded in the federal fiduciary standard. In *SEC vs. Capital Gains* the U.S. Supreme Court explained the no conflict rule and provided the rationale 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.’¹⁵⁶

In an ideal world, no conflicts of interest between an adviser and its clients would ever exist. Indeed, the avoidance of conflicts of interest was a principal reason behind the enactment of the Advisers Act:

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.’¹⁵⁷

(FCA) should be given powers to make rules to ensure that the industry would have to take their customers’ interests into account when designing products and providing advice.”]

Similar to the fiduciary duties imposed upon an attorney-at-law, the investment adviser’s fiduciary standard also treats the maintenance of conflicts of interest severely. “Conflicts of interest are broadly condemned throughout the legal profession because of their potential to interfere with the undivided loyalty that a lawyer owes to his or her client. The representation of adverse interests can likewise quickly erode the bond of trust between the attorney and his or her client.” Matthew R. Henderson, Chapter 7, “Breach of Fiduciary Duty,” *Attorneys Legal Liability* (2012), at p.7-8.

¹⁵⁵ *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 v. Capital Gains Research Bureau*, 375 U.S. at 191-92.

¹⁵⁶ *SEC vs. Capital Gains*. at p.____, fn. 50, citing *United States v. Mississippi Valley Co.*, 364 U.S. 520, 550, n. 14

¹⁵⁷ *Financial Planning Association v. Securities and Exchange Commission*, No. 04-1242 (D.C. Cir. 3/30/2007) (D.C. Cir., 2007), citing *SEC vs. Capital Gains* at 187.

It should again be noted that when an adviser is a fiduciary under ERISA, conflicts of interest must generally be avoided,¹⁵⁸ absent a class or other exemption from the prohibited transaction rules.

However, while avoidance of a conflict of interest is the best method to adhere to an investment adviser's fiduciary duty of loyalty,¹⁵⁹ and even other securities laws or regulations require the avoidance of certain conflicts of interest (even in non-fiduciary relationships),¹⁶⁰ it must be acknowledged that not all conflicts

¹⁵⁸ “When a conflict exists for fiduciaries of a retirement plan that is governed by ERISA, two distinct sets of ERISA requirements are implicated: (1) the rules governing breaches of fiduciary duty found in ERISA §404(a) and (2) the prohibited transaction rules in ERISA §§406(a) and (b) ... Fiduciaries are obligated under ERISA’s fiduciary responsibility rules to (1) identify conflicts (or potential conflicts) that may impact the management of a plan; (2) evaluate those conflicts and the impact they may have on the plan and its participants; (3) determine whether the conflicts will adversely impact the plan; (4) consider protections that would protect the plan and participants from any potential adverse effect of the conflict (for instance, appointing an independent fiduciary to evaluate the investment or proposed service provider) and; (5) if the conflict adversely impacts the plan and its participants, change service providers, investments or other circumstances related to the conflict.

Although a conflict of interest may exist in connection with a proposed transaction, entering into the transaction may or may not be a breach of fiduciary duty – the determining factors are whether the fiduciary prudently evaluates the conflict, and acts solely in the interest of the participants and for the exclusive purpose of providing benefits. If material adverse impact on the participants cannot be avoided or properly mitigated, entering into the transaction would not be prudent and would trigger a fiduciary breach.

Furthermore, if a conflict of interest is precluded under ERISA's prohibited transaction rules, the fiduciaries cannot, as a matter of law, allow the plan to become a party to the transaction – even if the action were otherwise reasonable or profitable to the plan.” C. Frederick Reish And C. Faucher, *The Fiduciary Duty to Avoid Conflicts of Interest in Selecting Plan Service Providers* (April 2009), available at <http://www.reish.com/publications/pdf/whitepprmar09.pdf>.

¹⁵⁹ “Avoidance is perhaps the best solution to conflict situations. Persons having a duty to exercise judgment in the interest of another must avoid situations in which their interests pose an actual or potential threat to the reliability of their judgment. Although avoidance of conflict situations is an important duty of decision-makers, a flat prescription to avoid all conflicts of interest is not only mistaken, but also unworkable. On the one hand, not all conflicts of interest are avoidable. Some conflict situations are embedded in the relation, while others occur independently of decision-maker’s will.” *Fiduciary Duties and Conflicts of Interest: An Inter-Disciplinary Approach* (2005), at p.20, available at <http://eale.org/content/uploads/2015/08/fiduciary-duties-and-conflicts-of-interestaugust05.pdf>.

¹⁶⁰ “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

of interest can be avoided. In this regard, the “best interests” fiduciary standard is not as strict as the “sole interests” fiduciary standard applicable under the trust law of many states (and under ERISA), in that conflicts of interest may exist at times. However, even when a conflict of interest exists, actions must be taken to ensure that the client is not harmed. In other words, the conflict of interest, even when affirmatively and fully disclosed, must be properly managed through a process that includes obtaining the client’s informed consent¹⁶¹ and, even then, that the transaction remain substantively fair to the client.

In the large financial services firm of today, there exists multiple areas where conflicts of interest might arise. As a result, at least one commentator has incorrectly interpreted the *SEC vs. Capital Gains* decision as a “pragmatic recognition by the Court of the complexities of the operations of contemporary investment advisers.”¹⁶² But, the fiduciary standard of conduct should be lessened in order to adapt to the functions of the marketplace; rather, the marketplace should conform to the fiduciary standard of conduct. Indeed, the fiduciary duty of loyalty is not abrogated merely because of the size or nature of the firm or its diverse activities. “The standard of conduct required of the fiduciary is not diminished by reason of its organizational structure.”¹⁶³

(5) Procedures to Follow When a Conflict of Interest is Still Present.

~~and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship. The disclosure should be sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest.~~⁴⁰

~~⁴⁰ *Arleen Hughes, supra* note 13, at 4 and 8 (stating, “[s]ince loyalty to his trust is the first duty which a fiduciary owes to his principal, it is the general rule that a fiduciary must not put himself into a position where his own interests may come in conflict with those of his principal. To prevent any~~

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.

¹⁶¹ *See* In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948, at 4 and 8, stating: “Since loyalty to his trust is the first duty which a fiduciary owes to his principal, it is the general rule that a fiduciary must not put himself into a position where his own interests may come in conflict with those of his principal. To prevent any conflict and the possible subordination of this duty to act solely for the benefit of his principal, a fiduciary at common law is forbidden to deal as an adverse party with his principal. An exception is made, however, where the principal gives his informed consent to such dealings”

¹⁶² *See, e.g.,* comment letter of the Committee on Investment Management Regulation of the New York City Bar, dated June 26, 2018, stating in pertinent part: “[T]he Supreme Court rejected the idea proposed by some that an investment adviser must eliminate all conflicts of interest with its clients. That was a pragmatic recognition by the Court of the complexities of the operations of contemporary investment advisers, which provide many types of services and products to clients that implicate the adviser’s resources and services but that could be deemed to give rise to actual or potential conflicts of interest.” For reasons set forth later in my comment letter, this conclusion is based upon a substantially incorrect interpretation of *SEC vs. Capital Gains*.

¹⁶³ Tuch, Andrew, “The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife with Conflicts of Interest” (January 2008) (Australia) (noting “When an investment bank performs one of its traditional functions – underwriting securities offerings or providing financial advisory services to clients involved in mergers, acquisitions and other strategic transactions – it may under general law be a fiduciary of its client and thereby be required to avoid positions of conflict without its client’s informed consent. Yet the conglomerate structure of the firm may make conflicts of interest an inescapable feature of its doing business.”

conflict and the possible subordination of this duty to act solely for the benefit of his principal, a fiduciary at common law is forbidden to deal as an adverse party with his principal. An exception is made, however, where the principal gives his informed consent to such dealings,” and adding that, “[r]egistrant has an affirmative obligation to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent.”). *See also Hughes v. Securities and Exchange Commission*, 174 F.2d 969 (1949) (affirming the SEC decision in *Arleen Hughes*).

See also General Instruction 3 to Part 2 of Form ADV (stating that an adviser’s disclosure obligation “requires that [the adviser] provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest [the adviser has] and the business practices in which [the adviser] engage[s], and can give informed consent to such conflicts or practices or reject them”); Investment Advisers Act Release 3060, *supra* note 10 (same); Restatement (Third) of Agency §8.06 (“Conduct by an agent that would otherwise constitute a breach of duty as stated in §§ 8.01, 8.02, 8.03, 8.04, and 8.05 [referencing the fiduciary 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 reasonably affect the principal’s judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal; and (b) the principal’s consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship”)

Should a conflict of interest exist, the law provides for a multi-stage process¹⁶⁴ designed to ensure that the client’s best interests are not subordinated to those of the adviser. We discuss each of these steps, or requirements, these aspects of the duty of loyalty below.

(A) STEP ONE: Affirmative Disclosure of the Conflict of Interest, All Material Facts Relating Thereto, and the Ramifications to the Client.

An adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure to its clients of all material conflicts of interest that could affect the advisory relationship.⁴³

¹⁶⁴ Under the RESTATEMENT (THIRD) OF AGENCY, Section 8.06 allows an agent to obtain its principal’s consent to conduct by the agent that would otherwise be a breach of duty under one of sections 8.01 to 8.05. But, the agent is subject to various procedural restrictions in obtaining an effective consent from its principal. The agent must have “(i) act[ed] in good faith, (ii) disclose[d] all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal’s judgment . . . and (iii) otherwise deal[t] fairly with the principal.” The consent also may not extend beyond “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.” Contained within Comment b to this section is the important qualification that:

an agreement that contains general or broad language purporting to release an agent in advance from the agent’s general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent’s fiduciary duty may not reflect an adequately informed judgment on the part of the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent’s position in ways not foreseeable by the principal at the time the principal agreed to the release.

~~⁴³ See *SEC v. Capital Gains*, *supra* note 2 (advisers must fully disclose all material conflicts, citing Congressional intent “to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested”). See also Investment Advisers Act Release 3060, *supra* note 9.~~

Disclosure of a conflict alone is not ~~always~~ sufficient to satisfy the adviser’s duty of loyalty and section 206 of the Advisers Act.⁴⁴ However, disclosure of a conflict of interest is one part of a multi-stage process which, if effectively followed by an investment adviser, may result in a defense to the breach of the fiduciary duty of loyalty that arises from the existence of a conflict of interest.

⁴⁴ See *SEC v. Capital Gains*, *supra* note 2 (in discussing the legislative history of the Advisers Act, citing ethical standards of one of the leading investment counsel associations, which provided that an investment counsel should remain “as free as humanly possible from the subtle influence of prejudice, conscious or unconscious” and “avoid any affiliation, or any act which subjects his position to challenge in this respect” and stating that one of the policy purposes of the Advisers Act is “to mitigate and, so far as is presently practicable to eliminate the abuses” that formed the basis of the Advisers Act). Separate and apart from potential liability under the antifraud provisions of the Advisers Act enforceable by the Commission for breaches of fiduciary duty in the absence of full and fair disclosure, investment advisers may also wish to consider their potential liability to clients under state common law, which may vary from state to state.

The disclosure of the conflict of interest, and material facts concerning same, must be specific to that conflict of interest. Communications that generally disclose existing or potential conflicts of interest fail to provide clients with an appreciation of all material facts and are generally ineffective as a basis for a client’s informed consent.¹⁶⁵

All material facts must be disclosed, when a conflict of interest is present. A material fact is “anything which might affect the (client’s) decision whether or how to act.”¹⁶⁶ 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.¹⁶⁷

A material conflict of interest is always a material fact requiring disclosure.¹⁶⁸

¹⁶⁵ See, e.g., Andrew F. Tuch, Disclaiming Loyalty: M&A Advisors and Their Engagement Letters: In response to William W. Bratton & Michael L. Wachter, *Bankers and Chancellors*, 93 Texas L.Rev. 211, 220-1 (2015) (“Moreover, provisions that generally disclose existing and potential conflicts of interest may be ineffective in obtaining a client’s informed consent. These generalized disclosure provisions may fail to provide clients with a full appreciation of all material facts—as necessary to constitute effective consent. Confirming these doubts in a related context, the *Law Governing Lawyers* provides that a “client’s consent will not be effective if it is based on an inadequate understanding of the nature and severity of the lawyer’s conflict”)

¹⁶⁶ *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 227 Va. 441 (Va., 1984).

¹⁶⁷ *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Basic, Inc. v. Levinson*, 485 U.S. 224, 233 (1988). See also *SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992).

¹⁶⁸ 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 disclosure must be timely given. “[D]isclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time¹⁶⁹ that he is asked to give his consent.”¹⁷⁰

Disclosure must be affirmatively undertaken. The duty to disclose is an affirmative one and rests with the advisor alone.¹⁷¹ As conveyed by a recent statement of SEC Staff, clients do not generally possess a duty of inquiry in such circumstances: “The [Commission] 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.”¹⁷²

The fiduciary is required to ensure that the disclosure is received by the client; the “access equals delivery” approach adopted by the Commission in connection with the delivery of a full prospectus to a consumer¹⁷³ would not likely qualify as an appropriate disclosure by a fiduciary investment adviser to her or his client of material facts.

¹⁶⁹ Delivery of the investment advisers Part 2 of Form ADV may not result in timely disclosure, especially when the transaction occurs days, weeks, or months after the transaction is proposed to the client. “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. Note, as well, that the investment adviser must ensure client understanding; a client should not be presumed to have read and understood the disclosures contained in Part 2 of Form ADV.

¹⁷⁰ *In the Matter of Arleen W. Hughes*, SEC Release No. 4048 (February 17, 1948), *affirmed* 174 F.2d 969 (D.C. Cir. 1949).

¹⁷¹ 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.

¹⁷² The Commission’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.

¹⁷³ *See* SEC Release No. 33-8998, “Enhanced Disclosure And New Prospectus Delivery Option For Registered Open-End Management Investment Companies,” (Jan. 13, 2009) (“The Commission is also adopting rule amendments that permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site.”)

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).]

Actual disclosure must occur, rather than readiness to disclose.¹⁷⁴ Constructive knowledge of the conflict of interest by the client is insufficient.¹⁷⁵

Disclosure must be sufficient to obtain client understanding. 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.¹⁷⁶

As stated in an early decision by the 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.]¹⁷⁷

¹⁷⁴ 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).

¹⁷⁵ 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.

¹⁷⁶ *See, e.g.,* Julia Smith, Out with “TCF” and in with “fiduciary”?, *Butterworths Journal of International Banking and Financial Law* (June 2012), P.344 [U.K.] [“In order to obtain B’s fully informed consent: (1) A must make full and frank disclosure of all material facts which might affect B’s consent (*New Zealand Netherlands Society Oranje Inc v Kuys* [1973] 1 WLR 1126 at 1132) and the extent of disclosure required depends upon the sophistication and intelligence of B (*Farah Construction Pty Ltd v Say-Dee Pty Ltd* [2007] HCA 22 at [107] to [108]). (2) A must disclose the nature as well as the existence of the conflict (*Wrexham Assoc Football Club Ltd v Crucialmove Ltd* [2007] BCC 139 at [39]).] (3) The burden of establishing informed consent lies on the fiduciary (*Cobbetts LLP v Hodge* [2009] EWHC 786).

Consent is only informed if the client has the ability to fully understand and evaluate the information. For example, many complex products (such as CMOs, structured products, options, security futures, margin trading strategies, some alternative investments, and the like) may be appropriate only for sophisticated and experienced investors. It is not sufficient for a firm or an investment professional to make full disclosure of potential conflicts of interest with respect to such products. The investment adviser, therefore, must make a reasonable judgment that the client is fully able to understand and evaluate the product and the potential conflicts of interest that the transaction presents. Fiduciary law reposes this burden to ensure client understanding primarily upon the adviser, not the client.

¹⁷⁷ In re the Matter of Arleen Hughes, SEC Release No. 4048 (1948).

The disclosure must not be combined with attempts to unduly influence or coerce the client. Informed consent cannot be obtained through coercion nor sales pressure.¹⁷⁸

Any disclosure must be clear and detailed enough for a client to make a reasonably informed decision to provide informed consent to such conflicts and practices or reject them.⁴⁵

⁴⁵ See Arlene Hughes, supra at 13 (in finding that registrant had not obtained informed consent, citing to testimony indicating that “some clients had no understanding at all of the nature and significance” of the disclosure).

An adviser must provide the client with sufficiently specific facts so that the client is able to understand the adviser’s conflicts of interest and business practices well enough to make an informed decision.⁴⁶ The ramifications of the conflict of interest must be disclosed, so that the client understands the significance of the conflict of interest as it bears upon the client’s affairs.¹⁷⁹

⁴⁶ See General Instruction 3 to Part 2 of Form ADV. Cf. Arleen Hughes, supra note 13 (Hughes acted simultaneously in the dual capacity of investment adviser and of broker and dealer and conceded having a fiduciary duty. In describing the fiduciary duty and her potential liability under the antifraud provisions of the Securities Act and the Exchange Act, the Commission stated she had “an affirmative obligation to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent.”).

The disclosure must be frank. As stated by Justice Benjamin Cardoza: “If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity of reservation, in all its stark significance”¹⁸⁰

¹⁷⁸ 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.

¹⁷⁹ 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].

¹⁸⁰ *Wendt v. Fischer*, 243 N.Y. 439, 154 N.E. 303 (1926). See also “Will the Investment Company and Investment Advisory Industry Win an Academy Award?” remarks of Kathryn B. McGrath, then-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). See also BOGERT ON TRUSTS, Paul D. Finn, FIDUCIARY OBLIGATIONS

The disclosure must be full¹⁸¹ and forthright. Even reasonably anticipated conflicts of interest must be disclosed.¹⁸² However, an adviser disclosing that it “may” have a conflict is not adequate disclosure when the conflict actually exists.⁴⁷

⁴⁷ We have brought enforcement actions in such cases. *See, e.g.*, In the Matter of The Robare Group, Ltd., et al., Investment Advisers Act Release No. 4566 (Nov. 7, 2016) (Commission Opinion) (appeal docketed) (finding, among other things, that adviser’s disclosure was inadequate because it stated that the adviser may receive compensation from a broker as a result of the facilitation of transactions on client’s behalf through such broker-dealer and that these arrangements may create a conflict of interest when adviser was, in fact, receiving payments from the broker and had such a conflict of interest).

(B) STEP TWO: Understanding by the Client, and the Client’s Grant of Informed Consent.

Following receipt of the disclosures provided, the client must achieve an understanding of the conflict of interest and its ramifications to the client, as well as an understanding of material facts disclosed. With such understanding, the client must then provide informed consent.¹⁸³

Early on the U.S. Securities and Exchange Commission, and the courts, acknowledged that in applying the fiduciary requirements of the Advisers Act a client must provide informed consent.¹⁸⁴ Informed

(1977); J.C. Shepherd, THE LAW OF FIDUCIARIES (1981). See also Scott, The Fiduciary Principle, 37 Calif. L. Rev. 539, 544 (1949).

¹⁸¹ 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.*)

¹⁸² The Commission has stated that disclosure must occur not only of conflicts of interest, but also of potential conflicts of interest. *See* Release No. IA-1396, In the Matter of: Kingsley, Jennison, McNulty & Morse Inc. (Dec. 23, 1993).

¹⁸³ 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).

¹⁸⁴ *Hughes v. SEC*, No. 9853, COURT OF APPEALS OF DISTRICT OF COLUMBIA, 174 F.2d 969; 85 U.S. App. D.C. 56; 1949 U.S. App. LEXIS 2138; Fed. Sec. L. Rep. (CCH) P90,449, January 14, 1949, observing in pertinent part: “The acts of petitioner which constitute violations of the antifraud sections of statutes and of regulations thereunder are acts of omission in that petitioner failed to fully disclose the nature and extent of her adverse interest ... The best price currently obtainable in the open market and the cost to registrant are both

consent provides the client with the opportunity, should the client so choose, to waive the conflict of interest¹⁸⁵ If a conflict of interest is not avoided and does exist in a fiduciary relationship,¹⁸⁶ mere

material facts within the meaning of the above-quoted language and they are both factors without which informed consent to a fiduciary's acting in a dual and conflicting role is impossible.”

See also Leonard I. Rotman, FIDUCIARY LAW 279 (2005) (emphasizing the necessity of obtaining the principal's express and informed consent before a fiduciary may enter into a self- or other-interested transaction).

See also Evan J. Criddle, Liberty in Loyalty: A Republican Theory of Fiduciary Law, 95 Tex.L.R. 993, 1009 (2017), stating in pertinent part: “[T]he no-conflict rule’s categorical prohibition against unauthorized conflicted transactions forces the investment manager to obtain the investor’s fully informed consent *ex ante* or face court-ordered rescission or disgorgement *ex post*.”

See also Robert H. Sitkoff, The Fiduciary Obligations of Financial Advisors Under the Law of Agency (2013): (“The duty of loyalty therefore prohibits A from misappropriating C’s property, and it regulates conflicts of interest in which the interests of A or a third party (such as another client) may be at odds with the interests of C. A is prohibited from undertaking any conflicted action for which A does not first obtain C’s informed consent.”), and citing Restatement (Third) of Agency, §§8.02-8.04, §8.05(1), and §8.06.

¹⁸⁵ *See* *Maplewood Partners, L.P. v. Indian Harbor Ins. Co.*, CASE NO. 08-23343-CIV-HOEVELER, UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF FLORIDA, 295 F.R.D. 550; 2013 U.S. Dist. LEXIS 103309, July 15, 2013 (In a case involving representation of multiple clients by an attorney: “A client can waive a conflict of interest upon informed consent”).

¹⁸⁶ In contrast, in 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”). Section 525 of the Restatement (Second) of Torts provides the general rule for fraudulent misrepresentation: “One who fraudulently makes a misrepresentation of fact, opinion, intention, or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.”

To prove common law fraud in most states, the plaintiff must show that

- the defendant made a material false representation or failed to communicate a material fact, which had the effect of falsifying statements actually made;
- the defendant did this intentionally (the defendant knew that the representation or omission constituted a falsehood) or recklessly (the defendant made the representation without regard to whether it was true or false);
- the defendant intended that the plaintiff act on it; and
- the plaintiff did, in fact, rely on the representation or omission to his or her detriment.

A representation is material if either a substantial likelihood exists that a reasonable person would attach importance to it in making a decision or the person who made the representation has reason to know that the plaintiff is likely to regard it as important in making a decision, even though a reasonable person would not so regard it.

Fraudulent misrepresentation by omission may be actionable if the defendant has a duty to the plaintiff to disclose material facts and fails to do so, and if this failure results in a false impression being conveyed to the plaintiff. A defendant can also be liable for failing to disclose new information that makes previously disclosed information misleading.

To be actionable, a fraudulent misrepresentation generally must concern fact rather than mere opinion, judgment, expectation, or probability. However, a fraud case can be based on a representation of opinion when one or more of the following occurred:

- the defendant knew that the facts on which the opinion was based were false;
- the defendant knew that the opinion was false;

disclosure to the client of the conflict, followed by mere consent by a client to the breach of the fiduciary obligation, does not suffice.¹⁸⁷

Under the law, it is not sufficient to create either a “waiver” of the client nor does it “estop” the client from pursuing a claim for breach of fiduciary duty under state securities statutes.¹⁸⁸

- the opinion was based on the defendant’s special knowledge of information contained in it; and the defendant knew that the plaintiff was justified in relying on this special knowledge;
- the defendant claimed to have special knowledge of facts that would occur in the future; or
- the defendant had special knowledge superior to that of the plaintiff about value.

¹⁸⁷ “[D]isclosure is an effective response if it does not affect the decision-maker’s judgment process and if the beneficiary is able to correct adequately for that biasing influence. Psychological research shows that neither of these conditions may be met. Sometimes both parties may be worse off following disclosure.” *Id.*, citing Daylian M. Cain, George Loewenstein, and Don A. Moore, “The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest” (2005) 34 *Journal of Legal Studies* 1 at 3.

¹⁸⁸ In dealing with the state securities statutes, state courts often disallow the defense of estoppel in order to preserve the protections afforded to retail consumers. *See, e.g., Go2net, Inc. v. Freeyellow.com, Inc.*, 109 P.3d 875 (Wash. App., 2005), stating in pertinent part:

We are persuaded that the better rule is to bar the defenses of estoppel and waiver in an action alleging violation of a securities regulation. The flexibility of such defenses is inconsistent with our Act's foremost objective of protecting investors. The statute provides the clean and surgical remedy of rescission as the sole recourse for an investor who proves a violation. It would upset the balance struck by the statute to allow factfinders to evaluate the investor's conduct on a case-by-case basis to determine whether it excuses the violation. We hold that equitable defenses are not available in an action under the Securities Act of Washington and conclude the trial court properly dismissed Molino’s defenses of estoppel and waiver.

Id. at ____.

See also, e.g., Covert v. Cross, 331 S.W.2d 576, 585 (Mo., 1960), stating:

The theory of estoppel the defendants sought to present 'would tend to nullify and defeat the very purpose of the statute, which is clearly penal in nature . . . The Act was passed to protect investors against their own weaknesses and to prevent the happening of such losses as are shown by this record.'

Covert, 331 S.W.2d at 585.

The concerns expressed in *Covert* were cited and echoed by the dissent in the Illinois appellate court *Logan* decision, which likewise expressed the view that the adoption of an equitable estoppel defense severely undermines the legislation regulating the sale of securities:

The very person sought to be protected, the investor, is denied recovery while the individual violating the law escapes liability. This result neither serves to compensate the innocent purchaser nor does it deter future violations of the Blue Sky Law. In fact, the majority decision could prompt clever promoters of questionable investments to ignore the Blue Sky regulations and, instead, encourage an investor to participate in the management of the company so that an estoppel defense could later be established. Clearly, use of estoppel as a defense in the instant actions is inconsistent with the express terms of the statute, as well as the policy underlying our Blue Sky Law. This law should be strictly enforced, and legal exceptions kept to a bare minimum.

Logan, dissenting opinion at 293 N.W.2d at 364.

See also Gowdy v. Richter, 314 N.E.2d 549, 557 (Ill. App., 1974) ('The penal character of the statute negates the utilization of in pari delicto or estoppel defenses.'). *cited favorably* by *Go2net, Inc. v. Freeyellow.com, Inc.*, 109 P.3d 875 (Wash. App., 2005).

A commentator further opines that the overall effect of allowing estoppel, even in limited circumstances, undermines the deterrent effect of the civil liability provisions:

Courts that allow the defense of estoppel lessen the blue sky laws' deterrent value and thus decrease compliance with the laws by hampering plaintiffs' chances of recovery. Repeated successful use of the defenses will result in decreased compliance with the laws. Courts that disallow estoppel, on the other hand, increase deterrence by allowing for more successful suits and creating a 'general climate of fear of the statutory civil actions.' To the extent that such courts increase deterrence, they further the primary goal of the laws.

Charles G. Stinner, Estoppel and In Pari Delicto Defenses to Civil Blue Sky Actions, 73 Cornell L. Rev. 448, 463 (1988)(footnotes omitted).

Nor is disclosure sufficient to constitute a waiver or estoppel state common law.¹⁸⁹ Nor is disclosure sufficient to constitute waiver or estoppel under the Advisers Act.¹⁹⁰ If this were the case, fiduciary obligations – even core obligations of the fiduciary¹⁹¹ – would be easily subject to waiver.¹⁹²

¹⁸⁹ 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).

However, 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. In other words, “reliance” is not a required element of a claim for constructive fraud (while reliance is required in a claim for actual fraud.)

In fact, 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”).

Estoppel and waiver are not applied freely to operate as a defense to “constructive fraud” (breach of fiduciary duty). A breach of the fiduciary standard is “constructive fraud,” not actual fraud. The role of waiver and estoppel in fiduciary law is different in fiduciary relationships than in its application to arms-length relationships. Under state common law, for estoppel to make unactionable a breach of a fiduciary obligation due to the presence of a conflict of interest, it is required that the fiduciary undertake a series of measures, far beyond undertaking mere disclosure of the conflict of interest. This contrasts with the relative ease in which estoppel and waiver apply to arms-length relationships, in which mere disclosure and consent creates estoppel and a defense against “actual fraud” – for customers generally possess responsibility for their own actions. 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.” W. Page Keeton et al., *PROSSER AND KEETON ON THE LAW OF TORTS* 112 (5th ed. 1992); see also RESTATEMENT (SECOND) OF TORTS § 892A cmt. a (1977) (asserting that one does not suffer a legal wrong as the result of an act to which, unaffected by fraud, mistake or duress, he freely or apparently consents).

Traditionally, the fiduciary duty of loyalty has been treated with a high degree of reverence. Because violations of the fiduciary duty of loyalty often involve self-dealing, waivers of the duty of loyalty are permitted under state common law far less often than waivers of the duty of care. See Darren Guttenberg, *Waiving Farewell Without Saying Goodbye: The Waiver of Fiduciary Duties in Limited Liability Companies in Delaware, and the Call for Mandatory Disclosure*, 86 S.Cal.L.Rev. 869, 877 (2013).

¹⁹⁰ Sections 206(1) and 206(2) of the Advisers Act make it unlawful for any investment adviser to employ any device, scheme, or artifice to defraud, or to engage in any transaction, practice, or course of business that operates as fraud or deceit on clients or prospective clients. Those antifraud provisions may be violated by the use of a hedge clause or other exculpatory provision in an investment advisory agreement which is likely to lead an investment advisory client to believe that he or she has waived non-waivable rights of action against the adviser that are provided by federal or state law. See, e.g., *In the Matter of William Lee Parks*, Investment Advisers Act Release No. 736 (Oct. 27, 1980) and *In the Matter of Olympian Financial Services, Inc.*, Investment Advisers Act Release No. 659 (Jan. 16, 1979). See also Opinion of General Counsel Roger S. Forster Relating to the Use of Hedge Clauses by Brokers, Dealers, Investment Advisers and Others, Investment Advisers Act Release No. 58 (Apr. 10, 1951).

The Commission has previously taken the position that hedge clauses that purport to limit an investment adviser's liability to acts involving gross negligence or willful malfeasance are likely to mislead a client who is unsophisticated in the law into believing that he or she has waived non-waivable rights. *See* Auchinloss & Lawrence Incorporated, SEC Staff No-Action Letter (Feb. 8, 1974). This is true even if the hedge clause explicitly provides that rights under federal or state law cannot be relinquished. *See* Omni Management Corporation, SEC Staff No-Action Letter (Dec. 13, 1975) and First National Bank of Akron, SEC Staff No-Action Letter (Feb. 27, 1976). Such a hedge clause might read, in the context of an adviser-client contract for advisory services:

Non-Waiver of Rights: Notwithstanding the foregoing, nothing contained in this paragraph or elsewhere in this Agreement shall constitute a waiver by Client of any of its legal rights under applicable U.S. federal securities laws or any other laws whose applicability is not permitted to be contractually waived.

The Commission has stated that the use of hedge clauses in investment advisory agreements which purport to remove potential advisor liability for gross negligence or willful malfeasance is not a per se violation of the anti-fraud provisions of the Advisers Act, but rather depends upon the facts and circumstances. In a case involving institutional investors, where the adviser represented to the Commission that institutional investors often dictated the terms of investment advisory contracts, the Commission opined:

We believe that whether an investment adviser that uses hedge clauses in investment advisory agreements that purport to limit that adviser's liability to acts of gross negligence or willful malfeasance violates sections 206(1) and 206(2) of the Advisers Act would depend on all of the surrounding facts and circumstances. In making this determination, we would consider 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.⁷ For instance, when a hedge clause is in an investment advisory agreement with a client who is unsophisticated in the law, we would consider factors including, but not limited to, whether: (i) the hedge clause was written in plain English; (ii) the hedge clause was individually highlighted and explained during an in-person meeting with the client; and (iii) enhanced disclosure was provided to explain the instances in which such client may still have a right of action. In addition, we would consider the presence and sophistication of any intermediary assisting a client in his dealings with the investment adviser and the nature and extent of the intermediary's assistance to the client.

Release No. IA-_____, Heitman Capital Management, LLC (Feb. 12, 2007).

¹⁹¹ An "irreducible core" of fiduciary duties exist, which are not subject to waiver by disclosure and consent under any circumstances. *See* A. Trukhtanov, *The Irreducible Core of Fiduciary Duties* (2007) 123 LQR 342.

¹⁹² Note that the contractarian view of fiduciary law has no place in fiduciary relationships in which there is a great superiority in knowledge held by the fiduciary. 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).

Rafael Chodos further 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.

The client must provide informed consent, not mere consent, in order for the consent to cure the conflict of interest and the potential for damage caused by such conflict.

Why is the tougher standard of informed consent, rather than mere consent, imposed? “By prohibiting all self-interested transactions and profit taking without a beneficiary’s informed consent – regardless of a fiduciary’s intent and irrespective of whether the beneficiary has suffered actual harm—fiduciary law eliminates a fiduciary’s incentives to abuse her position for her own gain.”¹⁹³

To be informed consent, 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.”¹⁹⁴ [*Emphasis added.*].

A client’s informed consent can be either explicit or, depending on the facts and circumstances, implicit. We believe, however, that it would not be consistent with an adviser’s fiduciary duty to infer or accept client consent to a conflict where either (i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict, or (ii) the material facts concerning the conflict could not be fully and fairly disclosed.⁴⁸

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 to 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.”)

“Many courts deny the contractual approach.” Arthur Laby, *Fiduciary Obligations of Broker-Dealers*, 55 Villanova L.Rev. 701, 711 (2010).

¹⁹³ Evan J. Criddle, *Liberty in Loyalty: A Republican Theory of Fiduciary Law*, 95 Tex.L.R. 993, 1011 (2017), citing: *See In re Primedia Inc. Derivative Litig.*, 910 A.2d 248, 262 (Del. Ch. 2006) (“[T]he duty of loyalty ‘does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for purposes of removing all temptation, extinguishes all possibility of profit flowing from the breach of confidence imposed by the fiduciary relation.’” (*quoting Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939))).

¹⁹⁴ Frankel, Tamar, *Fiduciary Law*, 71 Calif. L. Rev. 795 (1983).

For example, in some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflict necessary to obtain informed consent and satisfy an adviser's fiduciary duty. In other cases, disclosure may not be specific enough for clients to understand whether and how the conflict will affect the advice they receive. With some complex or extensive conflicts, it may be difficult to provide disclosure that is sufficiently specific, but also understandable, to the adviser's clients. In all of these cases where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed.

⁴⁸ See Arleen Hughes, *supra* note 13 (“Registrant cannot satisfy this duty by executing an agreement with her clients which the record shows some clients do not understand and which, in any event, does not contain the essential facts which she must communicate.”) Some commenters on Commission requests for comment agreed that full and fair disclosure and informed consent are important components of an adviser's fiduciary duty. See, e.g., Financial Planning Coalition 2013 Letter, *supra* note 21 (“[C]onsent is only informed if the customer has the ability fully to understand and to evaluate the information. Many complex products ... are appropriate only for sophisticated and experienced investors. It is not sufficient for a fiduciary to make disclosure of potential conflicts of interest with respect to such products. The fiduciary must make a reasonable judgment that the customer is fully able to understand and to evaluate the product and the potential conflicts of interest that it presents – and then the fiduciary must make a judgment that the product is in the best interests of the customer.”).

Assuming full, frank and affirmative disclosure of a conflict of interest and its ramifications for the client, and assuming the client provides full consent, only provides a limited defense for the fiduciary against breach of fiduciary duty if the proposed transaction is also substantively fair to the client, as will be discussed in the next section. In other words, disclosure and informed consent do not terminate the fiduciary character of the relationship. Rather, the fiduciary remains subject to fiduciary duties and remains obligated to act loyally and with due care.¹⁹⁵

***(C) STEP THREE: THE PROPOSED TRANSACTION MUST BE AND
REMAIN SUBSTANTIVELY FAIR TO THE CLIENT***

Even if the procedural safeguards of full, complete and affirmative disclosure leading to client understanding and to the client's grant of informed consent all occur, a remaining mandatory substantive

¹⁹⁵ See, e.g., Andrew F. Tuch, Disclaiming Loyalty: M&A Advisors and Their Engagement Letters: In response to William W. Bratton & Michael L. Wachter, *Bankers and Chancellors*, 93 Texas L.Rev. 211, 217 (2015) (“When a fiduciary obtains its client's informed consent for conduct that would otherwise breach a fiduciary duty, the consent shelters the fiduciary from liability for that conduct. However, it does not terminate the fiduciary character of the relationship. Rather, the fiduciary remains subject to fiduciary duties and thus generally obliged to act loyally within the scope of and for the duration of the relationship—but sheltered from liability for conduct to which its client consented.”)

requirement exists – that the fiduciary deal fairly with the client.¹⁹⁶ This is because no client would be presumed to authorize a fiduciary to act in bad faith.¹⁹⁷ As stated by one court:

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

[Emphasis added.]¹⁹⁸

In other words, at all times, the transaction must be substantively fair to the client. This last requirement looks not at the procedures undertaken, but rather casts view upon the transaction itself. It requires that, even if the previous steps involving disclosure, client understanding, and informed consent are followed, at all times the proposed transaction must be and remain substantively fair to the client. If this is not so, the courts will set aside the transaction between the fiduciary and the client.¹⁹⁹

For example, 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.

¹⁹⁶ See Robert H. Sitkoff, *The Fiduciary Obligations of Financial Advisors Under the Law of Agency* (2013): ([T]here are mandatory rules within the fiduciary obligation that cannot be overridden by agreement. For example, the principal cannot authorize the fiduciary to act in bad faith. Even if the principal authorizes self-dealing, fiduciary law provides substantive safeguards, requiring the fiduciary to act in good faith and deal fairly with and for the principal ...”

¹⁹⁷ See Robert H. Sitkoff, *Economic Structure of Fiduciary Law*, 91 *Boston Univ.L.Rev.* 1039, 1046 [“To be sure, there is a mandatory core to the fiduciary obligation that cannot be overridden by agreement. For example, the principal cannot authorize the fiduciary to act in bad faith.” and *citing* See, e.g., UNIFORM POWER OF ATTORNEY ACT § 114(a) (2006); UNIFORM TRUST CODE § 105(b)(2) (2000); RESTATEMENT (THIRD) OF TRUSTS § 78, cmt. c(2) (2007); RESTATEMENT (THIRD) OF AGENCY § 8.06(1)(a), (2)(a) (2006).j]

¹⁹⁸ *Bimbaum v. Bimbaum*, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986).

¹⁹⁹ 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).

The relationship between an unfair or unreasonable transaction, and whether informed consent has occurred, is a close one. 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.

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.²⁰⁰ As stated by Professor Tamar Frankel, for decades the leading scholar on the application of fiduciary law to investment advisers, “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.”²⁰¹

(6) Understanding the Distinction: The “Best Interests” vs. “Sole Interests” Fiduciary Standards.

The fiduciary standard of conduct is a tough standard, often called “the highest standard under the law.” How the fiduciary standard of conduct is applied (when it is found to exist) is surprisingly uniform. Yet, distinctions do exist in some contexts, such as between the regulatory regimes of state common law and the Advisers Act (applying a “best interests” fiduciary standard) and the regulatory regime of ERISA (applying, generally, a “sole interests” fiduciary standard, enhanced with prohibited transaction restrictions, as modified through class or other exemptions).

²⁰⁰ See *Matter of Gordon v. Bialystoker Center and Bikur Cholim*, 45 N.Y. 2d 692, 698 (1978) (2006 WL 3016952 at *29).

Note that in the attorney-client fiduciary relationship, which is similar to the investment-adviser fiduciary relationship in that fiduciary duties are imposed in recognition of the vast disparity of knowledge between the fiduciary and the client, not only are informed consent of the client and substantive fairness of the transaction required, but independent legal counsel must be sought before certain transactions can be entered into with clients. 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.

The Commission could adopt a similar rule – requiring that before any transaction is entered into for the purchase of a proprietary mutual fund, a security underwritten by an affiliate of the investment advisory firm, or certain other transactions, independent investment advice must be received. But this is not part of my recommendation at present.

²⁰¹ Frankel, Tamar, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, further stating: “Where the beneficiaries are all *sui juris* and consent to the sale, it cannot be set aside if the trustee made a full disclosure and did not induce the sale by taking advantage of his relation to the beneficiaries or by other improper conduct, and if the transaction was in all respects fair and reasonable. On the other hand, the sale can be set aside if the trustee did not make a full disclosure, or if he improperly induced the sale, or if the transaction was not fair and reasonable ... In order to transform the fiduciary mode into a contract mode, four conditions must be met: (1) entrustors must receive notice of the proposed change in the mode of the relationship; (2) entrustors must receive full information about the proposed bargain; (3) the entrustors' consent should be clear and the bargain specific; (4) the proposed bargain must be fair and reasonable.” *Id.*

The Advisers' Act fiduciary standard of conduct is generally described as a "best interests" fiduciary standard of conduct. The Advisers Act has always adopted the "best interests" standard²⁰² as a codification of state common law applicable to relationships based upon trust and confidence.

In contrast, the "sole interests" standard of conduct found in trust law and (with some modification) under ERISA, is generally believed to be somewhat stricter, particularly with regard to the fiduciary's obligations with respect to conflicts of interest. Generally, under state common law in which a "sole interests" standard is applied (generally, in trustee-beneficiary relationships), any form of self-dealing is essentially prohibited.²⁰³ [ERISA therefore has stricter prohibitions against self-dealing, and also possesses additional restrictions in the form of the prohibited transaction rules.]

²⁰² As to the "best interests" standard being present under the Advisers Act, see *S.E.C. v. Moran*, 922 F.Supp. 867, 895-6 (S.D.N.Y., 1996) ("the SEC alleges that by allocating Liberty stock to his personal and family accounts and requiring his clients to pay a higher price for the stock the next day, Moran Sr. and Moran Asset placed their own interests ahead of their clients thereby violating the fiduciary duty owed to those clients ... Section 206 of the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17, 100 S.Ct. 242, 246, 62 L.Ed.2d 146 (1979); *Burks v. Lasker*, 441 U.S. 471, 482 n. 10, 99 S.Ct. 1831, 1839 n. 10, 60 L.Ed.2d 404 (1979); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 n. 11, 97 S.Ct. 1292, 1300 n. 11, 51 L.Ed.2d 480 (1977); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 84 S.Ct. 275, 282-83, 11 L.Ed.2d 237 (1963) ... [T]he court interprets Section 206 to establish a fiduciary duty which in addition to applying to misrepresentations and omission, also requires the investment advisor to act in the best interests of its clients. See e.g., *SEC v. Capital Gains Bureau*, 375 U.S. at 195, 84 S.Ct. at 284-85 ("Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes.') ...")

²⁰³ A more elaborate explanation of the difference between the "sole interests" standard and "best interests" standard can be found in Professor John Langbein's article: "The sole interest rule prohibits the trustee from "plac[ing] himself in a position where his personal interest . . . conflicts or possibly may conflict with" the interests of the beneficiary. The rule applies not only to cases in which a trustee misappropriates trust property, but also to cases in which no such thing has happened—that is, to cases in which the trust "incurred no loss" or in which "actual benefit accrued to the trust" from a transaction with a conflicted trustee. The conclusive presumption of invalidity under the sole interest rule has acquired a distinctive name: the "no further inquiry" rule. What that label emphasizes, as the official comment to the Uniform Trust Code of 2000 explains, is that "transactions involving trust property entered into by a trustee for the trustee's own personal account [are] voidable without further proof." Courts invalidate a conflicted transaction without regard to its merits—"not because there is fraud, but because there may be fraud." "[E]quity deems it better to . . . strike down all disloyal acts, rather than to attempt to separate the harmless and the harmful by permitting the trustee to justify his representation of two interests . . . I compare the trust law duty of loyalty with the law of corporations, which originally shared the trust law sole interest rule but abandoned it in favor of a regime that undertakes to regulate rather than prohibit conflicts . . . I recommend (in Section II.C) reformulating the trust law duty of loyalty in light of these developments. I would generalize the principle now embodied in the exclusions and exceptions, which is that the trustee must act in the beneficiary's best interest, but not necessarily in the beneficiary's sole interest. Overlaps of interest that are consistent with the best interest of the beneficiary should be allowed. What is needed to cure the overbreadth of the sole interest rule is actually quite a modest fix: reducing from conclusive to rebuttable the force of the presumption of invalidity that now attaches to a conflicted transaction." Langbein, John H., *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*. Yale Law Journal, Vol. 114, p. 929 (2005), available at SSRN: <http://ssrn.com/abstract=696801>

(7) Application of the Procedures: Principal Trading.

Principal trading is expressly permitted in limited circumstances under Section 206(3) of the Investment Advisers Act of 1940. However, under the express language of the statute, principal trades can only occur with full disclosure to the client in writing before the completion of the transaction of the capacity in which the investment adviser is acting and obtaining the consent of the client to such transaction.²⁰⁴ The “ultimate goal” of Section 206(3) is to “prevent trades which are disadvantageous to clients of fiduciary advisors.”²⁰⁵

As the courts have stated:

“[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.’”²⁰⁶

In an address entitled “The SEC and the Broker-Dealer” by Louis Loss, Chief Counsel, Trading and Exchange Division, U.S. Securities and Exchange Commission on March 16, 1948, before the Stock Brokers’ Associates of Chicago, the fiduciary duties arising under the Advisers Act, as applied in the *Arleen Hughes* release, were elaborated upon:

The doctrine of that case, in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to *make a scrupulously full disclosure of every element of its adverse interest in the transaction.*

²⁰⁴ Section 206 provides in pertinent part: “It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly – (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.”

²⁰⁵ Comment letter of Mercer Bullard, Founder and President, Fund Democracy, and Barbara Roper, Director of Investor

Protection, Consumer Federation of America, Nov. 30, 2007, available at <http://sec.gov/comments/s7-23-07/s72307-18.pdf>, at

p.1.

²⁰⁶ *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)).

In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses. This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law 'acts not on the possibility, that, in some cases the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.' Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine 'has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.'"

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

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

C. THE DUTY TO AVOID UNREASONABLE COMPENSATION.

[Surprisingly, the Commission has not addressed the fiduciary duty to not receive unreasonable compensation. While this is a marketplace standard, for the most part, some commentary appears to be warranted. Given the time constraints imposed by the Commission in providing this and other comment letters to several concurrently issued releases, I will not address this aspect of the fiduciary duties of investment advisers in this comment letter, despite its importance.]

D. ADDITIONAL FIDUCIARY DUTIES.

"A comprehensive list of an adviser's fiduciary duties is not found in either the common law or the Advisers Act. However, duties of care and loyalty are among the basic fiduciary duties advisers are

generally held to owe their clients, at a minimum. Some authorities also list a duty of obedience. Still others refer to a duty to act in good faith, and a duty of disclosure. ... See, for example, “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 (“McGrath Remarks”), citing Scott, *The Fiduciary Principle*, 37 *Calif. L. Rev.* 539, 544 (1949), at p.7: “The words ‘fiduciary duty’ refer to the duties, of first, obedience to the terms of one's trust, second, diligence and care in the carrying out of one's fiduciary functions, and third, undivided loyalty to the beneficiaries of one's trust.” Other authorities do not list the duty of obedience separately, but rather consider it within the framework of the other basic duties of care and loyalty.” 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>.

(1) Duty of Confidentiality.

The Restatement (Third) of Agency §8.05(2) states that an agent has a duty “not to use or communicate confidential information of the principal for the agent’s own purposes or those of a third party.” While some legal commentators regard the duty of confidentiality as a separate duty, others believe it to be a subset of the duties of due care and loyalty.

(2) Is There a Fiduciary Duty to Disclose (Absent a Conflict of Interest?)

Does there exist, under the state common law applying fiduciary principles, a general duty “to disclose” material facts? Generally, no. Rather, the disclosure of material facts is seen as an element of the defense of the fiduciary when a conflict of interest exists. In other words, where a conflict of interest exists, a duty of disclosure of that conflict of interest arises, along with other duties – including the need to undertake such disclosure thoroughly and affirmatively, and the necessity of obtaining the client’s informed consent. However, Sect. 206(3) of the Advisers Act does impose an obligation of disclosure when investment advisers enter into principal trades with their clients. But, even then, a broad obligation of disclosure is not expressly set forth in the Advisers Act.

Notwithstanding the foregoing, the Commission has implemented a wide variety of specific disclosure obligations, even in situations where no conflict of interest exists. For example, in seeking to meet its duty of loyalty, the Commission has opined that an investment adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship.³⁹

³⁹ Investment Advisers Act Release 3060, *supra* note 6 (“as a fiduciary, an adviser has an ongoing obligation to inform its clients of any material information that could affect the advisory relationship”). See also General Instruction 3 to 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.”)

Full and fair disclosure of all material facts that could affect an advisory relationship, including all material conflicts of interest between the adviser and the client, can help clients and prospective clients in evaluating and selecting investment advisers. Accordingly, we require advisers to deliver to their clients a “brochure,” under Part 2A of Form ADV, which sets out minimum disclosure requirements, including disclosure of certain conflicts.⁴⁹ Investment advisers are required to deliver the brochure to a prospective client at or before entering into a contract so that the prospective client can use the information contained

in the brochure to decide whether or not to enter into the advisory relationship.⁵⁰ ~~In a concurrent release, we are proposing to require all investment advisers to deliver to retail investors before or at the time the adviser enters into an investment advisory agreement a relationship summary which would include a summary of certain conflicts of interest.~~⁵¹

⁴⁹ Investment Advisers Act Release 3060, supra note 10; General Instruction 3 to 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. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them.”).

⁵⁰ Investment Advisers Act rule 204-3. Investment Advisers Act Release 3060, supra note 10 (adopting amendments to Form ADV and stating that “A client may use this disclosure to select his or her own adviser and evaluate the adviser’s business practices and conflicts on an ongoing basis. As a result, the disclosure clients and prospective clients receive is critical to their ability to make an informed decision about whether to engage an adviser and, having engaged the adviser, to manage that relationship.”).

⁵¹ ~~Form CRS Proposal, supra note 6.~~

“In Australian law, there is no distinct and freestanding fiduciary obligation requiring a fiduciary to disclose information to their principal ... Despite the fact that fiduciaries, qua fiduciaries, owe no obligation of disclosure, questions of disclosure are often central in cases entailing fiduciary relationships ... Given the significance of questions of disclosure in fiduciary cases, it is important to be clear about the role that disclosure plays in fiduciary law. The editors of *Meagher, Gummow and Lehane’s Equity Doctrines and Remedies* describe that role in the following terms:

If a person occupying a fiduciary position wishes to enter into a transaction which would otherwise amount to a breach of duty, he must, if he is to avoid liability, make full disclosure to the person to whom the duty is owed of all relevant facts known to the fiduciary, and that person must consent to the fiduciary’s proposal.

In other words, a breach of fiduciary obligation — either the obligation not to be in a position of conflict of interest and duty or the obligation not to make unauthorised profits—may be averted or cured by the consent of the principal to whom the obligation is owed, and the principal’s consent will be effective only if the fiduciary has first disclosed to the principal any relevant material information. Rather than constituting the discharge of a fiduciary obligation, disclosure which leads to informed consent confers on a fiduciary immunity from liability for the consequences of actions that would ordinarily amount to breaches of fiduciary obligation. And the immunity-conferring function of disclosure and informed consent provides a complete explanation of the role of disclosure in fiduciary law.”²⁰⁷

²⁰⁷ Matthew Harding, *Two Fiduciary Fallacies* (2007).

IN CONCLUSION.

The Commission should be aware of the judgments made by history, as it seeks to further refine its interpretation of an investment adviser's fiduciary standard of conduct.

Justice Benjamin Cardozo in *Meinhard v. Salmon* famously wrote:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court."²⁰⁸

I fear that the Commission's interpretation, especially its incorrect application of the *SEC vs. Capital Gains* decision regarding the effect of disclosure of a conflict of interest, and also in its omission of so many important observations regarding the fiduciary duties listed that can be gleaned from the state common law that informs the Advisers Act's federal fiduciary standard, could well lead to that *disintegrating erosion* of the fiduciary standard Justice Benjamin Cardozo warned about so long ago.

Moreover, since the remedies for violation of the Advisers Act lie primarily through enforcement mechanisms of federal and state regulators, while state common law fiduciary standards of conduct for investment advisers provide the basis of client claims for an investment adviser's breach of its fiduciary obligations, I fear that any failure by the Commission to provide a more robust interpretation of the fiduciary duties of investment advisers could possess the perverse effect of subjecting investment advisers to liability for conduct. As I have suggested in my edits of the SEC's proposed interpretation, in this comment letter, much greater clarity regarding the fiduciary duties of investment advisers is both possible, and should be welcomed by all.

I urge the Commission to head "back to the drawing board" and to re-formulate its interpretation, accordingly.

Thank you.

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²⁰⁸ *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).