INSTITUTE FOR THE FIDUCIARY STANDARD

Fiduciary Reference

Analysis of Investment Fiduciary Issues

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The SEC March 1 Release* assumptions about a possible uniform fiduciary standard and the duty of loyalty sharply restrict when fiduciary duties are applied. If these assumptions are adopted in rulemaking, fiduciary duties would effectively be removed for brokers and advisers giving investment advice to retail investors

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Over the past four years, individual SEC commissioners and SEC staff have expressed various views regarding a possible uniform fiduciary standard (UFS). The March 1 release represents the first time the Commission has expressed views suggesting how it may approach this subject. This paper focuses on two parts of the SEC Release; 1) the SEC assumptions on a possible UFS, and 2) the discussion of the duty of loyalty.

Background

The SEC Release, among other matters, seeks to 1) request additional information generally regarding the costs and benefits of a potential UFS and 2) set out specific assumptions and parameters for such a standard. It notes the SEC seeks information "to assist the agency in considering whether to make new rules" regarding the standards of conduct for broker-dealers and investment advisers. SEC Chair, Elisse Walter, notes "few investors" realize advisers and brokers are held to two different standards, or whether, in fact, the intermediary they work with is an adviser or broker. The reason for seeking additional information, is to "better understand the relationship between standards of conduct and the experiences of retail customers." (See SEC Release page13)

Dodd Frank also provides pertinent parameters. It stipulates that if the SEC proceeds with rulemaking the UFS requires advice be "in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing advice." Dodd Frank further stipulates that the UFS "shall be no less stringent than the standard applicable to investment advisers under sections 206 (1) and 206 (2) of the Advisers Act." Also, commission compensation structures, proprietary products, and principal trading are not prohibited.

* http://www.sec.gov/news/press/2013/2013-32.htm

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The starting point for developing a new standard "no less stringent" than the Advisers Act of 1940 should be the Advisers Act, and section 202(a) (11) specifically, where the term "Investment Adviser" is defined. This definition is broad and includes, in part, "the business of advising others ….as to the advisability of investing … or promulgates analyses or reports concerning securities …" Further, the broker exclusion is explicit and narrow. Brokers are only excluded when their advice is "incidental" and is not compensated. (For further discussion, see Tamar Frankel's *Fiduciary Law*, (Oxford University Press; November, 2010.)

Potential Uniform Fiduciary Standard General Assumptions

The SEC Release sets out explicit assumptions regarding a potential UFS. Although it states these assumptions should not be presumed to represent the views of the SEC, the assumptions are noteworthy for at least two reasons. First, they are quite explicit and, second, they closely mirror many of the recommendations of the Wall Street lobby, The Securities Industry and Financial Markets Association (SIFMA) set forth in a July, 2011 letter to the SEC. https://www.sifma.org/issues/item.aspx?id=8589934675. Following are comments on four general assumptions set out in the SEC Release:

Assumption 1. Personalized Investment Advice. The SEC Release explains that not all advisor communications of opinions would be deemed "fiduciary advice." It sets out guidance that seeks to distinguish between the types of advice that would be deemed "fiduciary advice" as distinct from advice that would not be deemed "fiduciary advice." Overall, the UFS would only apply to "personalized investment advice about securities." "Personalized advice" would follow the broker-dealer definition of "recommendation" and the investment adviser's definition of advice that is "personalized advice." It would exclude advice that is deemed "impersonal investment advice." The BD "recommendation" is deemed a communication targeted to a particular customer explicitly regarding the purchase, sale, or trading strategy of a particular security or group of securities. As explained in the SEC 2011 "Study on Investment Advisers and Broker-Dealers" recommendations are generally "communications that constitute a 'call to action'" or those that might influence a client to initiate a "particular transaction" or a "particular trading strategy." (Study, page.124) http://www.sec.gov/news/studies/2011/913studyfinal.pdf

This naturally implies that generalized advice absent a "call to action" by a broker will not constitute a "recommendation," and therefore not be deemed "fiduciary advice." This generalized advice might best be called "non-fiduciary advice". For example, information and opinions regarding the merits or weaknesses of an employer-sponsored retirement plan, or regarding asset allocation models, would not be deemed a "recommendations" and thus would thus not be considered "fiduciary advice." (Study, page 125) Any "non-fiduciary advice" would not be required to be in the best interest of the client.

As noted above, "impersonal investment advice" would be deemed "non-fiduciary advice." According to the SEC, advice is deemed "impersonal," when provided by advisers in writing or orally and does not "purport to meet the objectives or needs of specific individuals or accounts."

This definition leaves significant ambiguity, as delineation between “personal” and “impersonal” investment advice will “depend on the facts and circumstances.” (Study, page 123)

In sum, the UFS “personalized investment advice” requirement sharply narrows what advice is clearly “fiduciary advice,” and also creates questions about what other advice constitutes “fiduciary advice.” It appears that only communications that recommend a transaction or advise on discretionary accounts would be clearly deemed “fiduciary advice.” Other advice would fall into a gray zone of uncertainty and ambiguity, with its fiduciary status depending on an exploration of the facts and circumstances.

Yet, despite introducing this new gray zone of uncertainty and ambiguity, there is no mention of how a broker should address it. There is no mention of a broker duty to clearly communicate to clients that some of his/her advice may be “fiduciary advice” and some may be “non-fiduciary advice,” and there is no mention of a broker duty to explain the differences, why these differences are important to clients, and to ensure that clients understand these differences.

Assumption 2. “Retail” Investors. The UFS would only apply to "retail" investors. “Retail” investors are defined as investors who use these recommendations "primarily" for "personal, family or household purposes." This mean, for example, recommendations made to individuals regarding their business or non profit organization assets would not necessarily be required to be fiduciary advice and, thus, not be required to be in the best interest of the client.

Assumption 3. Different Business Models. The UFS would be designed to “accommodate different business models and fee structures” Consistent with Dodd Frank, broker-dealers would be permitted to receive commissions and compensation from principal trades. In setting out this topic, however, the SEC release makes a point that casts doubt on whether principal trading is presumed to be a conflict of interest. The release suggests, regarding principal trades and commissions, “At a minimum, a broker-dealer or investment adviser would need to disclose material conflicts of interest, *if any* (emphasis added), presented by its compensation structure.” This language seems to suggest that commissions and / or principal trades should not explicitly be presumed to be conflicts of interest.

Assumption 4. Continuing Duty of Care. This discussion of the UFS assumes there is no general requirement of a continuing duty of care or loyalty after making explicit recommendations regarding the purchase, sale or trading strategy of specific securities.

This discussion includes two different issues which should be considered separately. The first issue is the scope of the engagement. It is fair and reasonable to align fiduciary duties with the scope of the engagement between the BD and the client. On this point there appears to be wide agreement. However, separate and distinct from defining the scope of the engagement is the question of whether fiduciary duties within the scope of the engagement may be waived or eliminated by a simple contract provision, or separately, through disclosure.

Fiduciary duties within the parameters of the scope of engagement, according to the SEC Release: “would depend on the contractual or other arrangement or understanding between the retail customer and the broker-dealer or investment adviser, including the totality of the circumstances of the relationship and course of dealing between the customer and the firm, including, but not limited to contractual provisions, disclosure and marketing documents, and reasonable customer expectations arising from the firms course of conduct."

This language presents major questions, two of which stand out. First, the language suggests that fiduciary duties may be restricted, perhaps effectively removed, with relative ease, without an informed consent requirement. Indeed, clients may not even be aware that fiduciary duties have been restricted or removed at all.

Second, as noted above regarding "personalized" advice, though there is an additional new gray zone of uncertainty and ambiguity created here, there is also no mention of any broker duty to address this ambiguity sand uncertainty. There is no mention of a duty to explain that his/her communications will include "fiduciary advice" and "non-fiduciary advice," and what this means to the client.

'Duty of Loyalty'

The 'duty of loyalty' is the very heart of the fiduciary standard under the Advisers Act. The explicit language in Dodd Frank (noted above) that a UFS must be in the "best interest" of the client "without regard" to the financial interest of the broker or the firm is essential to understanding the heavy burden that must be overcome when a conflict is not eliminated. Disclosure and client consent alone do not suffice. The conflict must not undercut the recommendation. The conflict must be managed such that the recommendation remains in the client's best interest, irrespective of the disclosure. This point underscores that disclosure is not a duty, but is a "relief from a duty of avoiding a conflict." (Frankel) A "relief" does not substitute for advice only serving the best interest of the client.

The importance of the duty of loyalty and the seriousness of conflicts of interest in the Advisers Act is underscored in a thoughtful speech by Carlo V. Di Florio, SEC Director, Office of Compliance Inspections in October (http://www.sec.gov/news/speech/2012/spch103112cvd.htm) Di Florio discusses the importance of conflicts in depth. He explains why conflicts of interest are so important to the SEC's exam program, why he views conflicts as "viruses that threaten the organizations well-being" and how "conflicts of interest can do great harm.... (and) a failure to manage conflicts of interest has been a continuing theme of financial crises and scandals since before the inception of the federal securities laws." Di Florio provides a vivid reminder of the inherent destructive nature of conflicts to firms and investors alike.

In this context the discussion on the 'duty of loyalty' assumptions and possible prescriptions the SEC may consider is of particular importance. Two assumptions stand out.

"Loyalty" and "Disclosure" The first assumption regards the meaning of "loyalty." As the term is used in this discussion, "loyalty" effectively takes on a very different meaning. It is described as "disclosure." The act of *disclosure* is deemed to fulfill the duty of "loyalty." The nature of the conflict – the conduct or recommendation being disclosed is not discussed. The option of avoiding the conduct is not even mentioned. The entire discussion regards disclosure, and includes the following:

"we should facilitate ***disclosures*** *to retail customers about the terms of their relationship," …"a general relationship guide akin to the new part 2a of form ADV"… the rule "would expressly impose certain* ***disclosure*** *requirements," …. "****disclosure*** *of all material conflicts of interest" … "an overarching general obligation to* ***disclose*** *all such conflicts of interest" …. "this* ***disclosure*** *largely could be made through the general relationship guide," … "oral or written* ***disclosure*** *… at the time of service … of any new material conflicts or any material change of an existing conflict."*

The entire focus in the SEC Release on disclosing conflicts at the exclusion of avoiding conflicts could be interpreted to imply that disclosure is clearly superior to avoiding conflicts, as an investor protection measure. This implication would be plainly false. Merely disclosing conflicts is neither superior to -- nor equivalent to -- avoiding conflicts, and it is not a duty. It is a "relief from the duty to avoid conflicts." The one instance where disclosure can provide meaningful protection from conflicts, is where there is truly informed and independent client consent, such that the client can fairly be deemed to understand the implications of the conflict. In any case, the conflict must be managed or mitigated such that the proceeding with the recommendation remains in the best interest of the client.

Weakening Disclosure. The second assumption entails weakening the disclosure requirement by simultaneously making disclosure more "efficient" for the firm to deliver and less effective for the client. This second assumption is evident from both what is explicitly stated and what is omitted. Explicitly, the SEC Release states the UFS "would treat conflicts of interest arising from principal trades the same as other conflicts of interest …. And make clear that it would not incorporate the transaction-by-transaction disclosure and consent requirements" as required of investment advisers.

Here, the SEC Release envisions a stark departure from established regulatory opinion that acknowledges principal trading as a material conflict of interest that merits a stringent disclosure requirement, towards a less serious conflict that merits a less stringent disclosure requirement.

What is omitted is also important. What is omitted in the SEC Release is any mention of a broker's duty to obtain client consent, or a duty to obtain *informed* client consent, or a duty to manage the conflict and ensure, irrespective of client consent, that the recommendation remains in the client's best interest.

Duty of Loyalty, Conflicts in Historic Context. The significance of embracing these two assumptions is better appreciated in a broader historic context. The SEC Release makes no mention of why conflicts of interest are today – and historically have been – considered major impediments to unbiased advice. There is no mention of how and why conflicts of interest can cause great harm to investors, much less that the Advisers Act of 1940 itself was, in large part, a response to widespread concerns about conflicts of interest and the need to protect investors from "misrepresentations of unscrupulous tipsters and touts." (See Arthur Laby's discussion, in *Selling Advice and Creating Expectations: Why Brokers Should be Fiduciaries,* pages 720-722.)

Further, there is no mention of the longstanding practice of the SEC urging advisors to avoid conflicts of interest. There is also no mention of any of the independent research that underscores the harms of conflicts to investors, or the general ineffectiveness of disclosure. Most fundamentally, there is no mention of why the fiduciary duty of loyalty exists, is essential to inspiring investor trust in the capital markets and cannot be replaced by disclosure, due to the knowledge gap between investors and brokers or advisers. It is this point which was clearly noted in the 1995 Tully Report, named for Merrill Lynch Chairman Daniel P. Tully. The report noted, in unambiguous terms, how, it is a "rare client who truly understands the risks and market behaviors of his or her investments." http://www.sec.gov/news/studies/bkrcomp.txt

In short, longstanding legal, academic and industry views – views articulated from Supreme Court justices and SEC Chairmen alike – of the harms of conflicts and vital role of loyalty, the limitations of investors – are not expressed in this release. These views have been omitted. They have been replaced with rules for disclosure.

These assumptions sharply restrict when fiduciary duties are applied to brokers or advisers rendering investment advice. If these assumptions are adopted in rulemaking, fiduciary duties will be effectively removed

The SEC Release provides guidance through its expressed assumptions regarding the UFS and the duty of loyalty. While (as noted above) the SEC Release states these assumptions may not represent the views of the SEC, their guidance matters.

The SEC Release provides a picture of fiduciary duties that are different in kind from and far more restricted and far less stringent than the fiduciary duties required by the Investment Advisers Act of 1940 Act. In a few short pages, this guidance effectively upends established legal precedent developed over 73 years. In summary, it:

1. Sharply restricts communications clearly deemed fiduciary advice; creates new uncertainty about what may be fiduciary advice. It narrowly defines written or oral communications and circumstances that are clearly deemed "fiduciary advice," limiting much investment advice and excluding many investors from the fiduciary standard. In suggesting a 'facts and circumstances' exploration is necessary to determine whether communications constitute fiduciary advice, creates new uncertainty and ambiguity that is certain to confuse investors. Yet, the SEC Release does not address this issue. It does not require a broker explain the difference between fiduciary and non fiduciary language, and does not require a broker explain the importance of these differences to clients.

2. Allows fiduciary duties be waived. It allows fiduciary duties to be waived through contract provisions, marketing materials or disclosure, disclosure that does not include informed consent, to ensure the client is aware when duties are waived.

3. Suggests disclosure is the optimum action for addressing conflicts; omits acknowledging that disclosure and management of conflicts alone is insufficient. Discussing disclosing conflicts at the exclusion of discussing avoiding conflicts may be interpreted to suggest disclosure is the optimum course of action to address conflicts. This interpretation would be plainly false. Further, the failure to acknowledge and reaffirm that irrespective of the disclosure, the recommendation must still be deemed in the best interest of the client, implies disclosure alone is generally or always sufficient.

4. Omits mention or discussion of the most rigorous disclosure requirement that can provide meaningful investor protection; instead weakens disclosure requirements. It allows more casual disclosure and oral disclosure (disclosure that is more "efficient" for the firm to deliver) while, not requiring either "client consent" or "informed client consent" of material conflicts of interest (disclosure which are more effective for the client).

5. Rebrands *conflicts*. It minimizes the stigmas associated with conflicts. It rebrands them. It questions whether principal trading is, in fact, always a conflict. It omits any mention that harms are associated with conflicts. It omits any mention of associated benefits or appropriateness of avoiding conflicts. It omits urging broker dealers and investment advisers to avoid conflicts of interest. By these omissions, conflicts of interest are deemed to be less problematic, less harmful.

6. Redefines *loyalty*. By minimizing the importance of conflicts, it effectively redefines *loyalty*. In its essence, the 'duty of loyalty' today means "do the right thing." In this discussion it means "disclose doing the wrong thing."

Individually, each of these assumptions – restricting the broad concept of advice implicit in the Advisers Act, permitting the waiver of fiduciary duties, framing disclosure as the optimum measure of loyalty, and omitting the strongest disclosure requirement (of informed consent) – could materially undermine the stringency of the UFS as compared to the Advisers Act fiduciary standard.

Together, these assumptions represent a profound departure from the Advisers Act. If adopted in rulemaking, fiduciary duties would be effectively removed for brokers and advisers giving investment advice to retail investors. The issue of whether such a uniform standard is consistent with the Dodd Frank requirement that the uniform standard be "no less stringent" than the Advisers Act is clear. It is not.