INSTITUTE FOR
THE FIDUCIARY STANDARD

Fiduciary Reference

Analysis of Investment Fiduciary Issues

September 9, 2013

Six Core Fiduciary Duties for Financial Advisors

Knut A. Rostad *

Introduction

Fiduciary duties exist to mitigate the information asymmetry (also known as the "knowledge gap") between expert providers of socially important services – such as law, finance and medicine – and the non-expert, consumers of these services. This knowledge gap is neutralized by requiring experts to be fiduciaries. Fiduciaries are bound by an undivided loyalty to clients, to put clients' interests first, ahead of their own interests. Here is the legal and practical basis for investors to rely on the advice of experts, and enter relationships of trust and confidence. Fiduciary law, then, is the foundation on which investor trust is based. [1]

Fiduciary care embodies the highest standard of excellence. Throughout history, fiduciaries have held a unique and important role in law and the investment profession. Fiduciaries possess two sets of attributes distinct from business practitioners meeting a commercial standard of conduct. Fiduciaries possess the technical expertise, experience and specialized knowledge that equip them to render advice (due care). They are also bound by an undivided loyalty to their client.

The Six Core Fiduciary Duties embody the major elements of fiduciary responsibility under the Advisers Act of 1940. The duties are explained, in part, through the principles articulated by the SEC Commissioners in its off-cited 1948 case, *In the Matter of Arlene Hughes*.[2] In *Hughes* the SEC clearly sets out its views on essential aspects of fiduciary responsibility, focusing on the burdens of advisors when conflicts are present.

The six duties are:

Serve the client's best interest
Act in utmost good faith
Act prudently -- with the care, skill and judgment of a professional
Avoid conflicts of interest
Disclose all material facts
Control investment expenses

** Knut A Rostad is president of the Institute for the Fiduciary Standard. The Institute is a non profit that exists to advance the fiduciary standard through research, education and advocacy. For more information see www.thefiduciaryinstitute.org.*

Background

Fiduciary principles have served a vital role in society for centuries. The principles are seen in the Code of Hammurabi (circa.1780 BC), and the writings of Aristotle (in the 4th Century BC). They are central to English Common Law in equity. [3] Modern securities laws were enacted in the 1930s and in 1940. Investment advisors are regulated by the Investment Advisers Act of 1940 (Adviser's Act). In 1963 the U. S. Supreme Court held in *SEC V Capital Gains Research Bureau*. [4] that investment advisors have fiduciary obligations to their clients.

<u>The Supreme Court and the need to avoid conflicts of interest.</u> The Supreme Court in *Capital Gains* acknowledged the importance of avoiding conflicts of interest, based, in part, on the legislative history of the Advisers Act. The Court discussed the lack of fiduciary conduct by many intermediaries in the securities markets in the years preceding the 1929 stock market crash, and concluded it is essential that "the highest ethical standards prevail in every facet of the securities industry." Also quoting extensively from an SEC report, the Court explained the importance of avoiding conflicts of interest to meeting these "highest ethical standards."

> *"The report reflects the attitude – shared by investment advisers and the Commission – that investment advisers could not "completely perform their basic function – furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments – unless all conflicts of interest between the investment counsel and the client were removed. "* [5]

<u>The knowledge gap today.</u> The knowledge gap between experts and retail investors has been continuously noted over time. In 1934, William O. Douglas referred to the knowledge gap when he noted that "those needing investment advice will receive small comfort" from the information provided in the registration statement. [6] Years later, the 1995 Tully Report underscored the limitations of most investors, stating it is a "rare client who truly understands the risks and market behaviors of his or her investments." [7] More recently, independent research suggests many investors fundamentally misunderstand the very basics of their relationships with their advisor or broker regarding costs and services. (Attachment A) In the August, 2012 report, "Study Regarding Financial Literacy Among Investors," the SEC concludes, in part, simply, "U.S. retail investors lack basic financial literacy." [8] This research clearly affirms the knowledge gap stubbornly persists. The rationale for a stringent fiduciary standard today continues.

One: Serve in the Client's Best Interest

Loyalty requires that fiduciaries put the best interests of clients first. Doing so means clients interests are put ahead of the advisor's interests, the interests of their firm, and the interests of all others at all times.

While loyalty is essential to rendering *advice*, it is not required of those who distribute products and provide information and opinions about their products. Here is the key difference: a fiduciary represents and advises clients; a sales professional represents manufacturers and sells products. A product salesperson provides information and opinions about products or services and generally operates with divided loyalties – at best – between the product manufacturer and the client. Fiduciary advisors can not do so; fiduciaries must always act with undivided loyalty. For an advisor to enter into a relationship with a client when an unavoidable and material conflict is present sharply increases the burden on the advisor to be scrupulous in ensuring the client's interests remain first and foremost.

In the client's best interest describes how advisors must act. *Best* means, according to the American Heritage Dictionary, "Surpassing all others in excellence, achievement, or quality; most excellent: *the best performer…* " The advisor must put the client's best interests first and never behind, below or second to the interests of the advisor, his firm or any third parties. A recommendation in the client's best interest means that no materially superior option is available. As one legal scholar explains, the advisor must adopt the goals of the client as his own goals. **9**

Thus, advisors are not allowed to self-deal, or profit from a transaction in a way that undermines the client's goals or is not also entirely fair to the client. Advisors must not favor one client over another. As the SEC articulates clearly in *Hughes:*

> *The very function of furnishing investment counsel …. cultivates a confidential and intimate relationship.*
>
> *… registrant's clients have implicit trust and confidence in her. They rely on her for investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice "in almost every instance." This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis -- learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities -- cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only such recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients. (p. 6)*

The language used to describe both the basis for and the implications of Hughes' fiduciary duty is vividly clear. Fiduciary care is the basis on which Hughes gained a client's trust and confidence and learned the intimate details of a clients financial affairs. Such trust and confidence in Hughes inevitably became a *reliance* on Hughes. The client's reliance is based on trust and confidence that Hughes will only act in the client's best interest. This strong reliance further underscores her solemn duty to do so.

Two: Act in Utmost Good Faith

Utmost good faith is fundamental to being *loyal*. The advisor must be truthful, honest and accurate in all communications. This includes everything the advisor says or writes about himself, his firm, his experience and his recommendations. This is especially important regarding the existence and nature of potential and actual conflicts and any "bad news" about the client's portfolio or mistakes the advisor might make in serving the client. Again, as the SEC stated, in *Hughes:*

> **…** *Disclose all material circumstances fully and completely*
>
> *The duty of loyalty to his principal requires a fiduciary to disclose all material circumstances fully and completely. In the securities field one of the essential facts an investor should generally have before him in determining the desirability of either purchasing or selling a security is the current market price of the security. The disclosure of current market price will usually be of even greater significance than the disclosure of cost because market price is the test by which the value of securities is generally measured. (p. 7)*

Three: Avoid Conflicts of Interest

Conflicts of interest have long been acknowledged as undermining advice that is independent and objective and unbiased. As noted above, the Advisers Act was literally born from concerns of confusion between advisors and product salesperson, as "so-called "tipster" organizations were disguising themselves as legitimate advisory organizations." [10]

Conflicts of interest are generally deemed to be incentives, favors, benefits, and compensation which can reasonably be expected to interfere with unbiased advice. Compensation arrangements which directly alter payment levels to advisors or brokers depending on the investment strategy or product recommendations are clear and well-known conflicts of interest.

Rendering undivided loyalty is difficult. At its heart, loyalty is being sensitive to, and competent at identifying and avoiding conflicts of interest. Conflicts of interest have been likened to a cancer on objective advice. Conflicts can severely undermine objectivity of even the best intentioned advisors. Some researchers go so far to conclude that conflicts essentially make objectivity impossible. At the Institute for the Fiduciary Standard September 9th Fiduciary Forum, 2011, Yale Management Professor Daylian Cain concluded:

> *"Conflicts of interest are a cancer on objectivity. Even well-meaning advisors often cannot overcome a conflict and give objective advice. More worrisome, perhaps, investors usually do not sufficiently heed even the briefest, bluntest and clearest disclosure warnings of conflicts of interest."*

In *Hughes*, the SEC stresses the importance of advisors avoiding conflicts of interest but for allowing an exception when "the principal gives his informed consent."

> *It is the general rule that a fiduciary must not put himself into a position where his own interests may come into conflict with those of his principal.*
>
> *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. The question of law presented here is the extent of disclosure which must be made by a person, in the type of fiduciary relationship assumed by registrant, in obtaining consent to his selling his own securities to his principal. More specifically, the issue is whether such a fiduciary must make any disclosure in addition to the fact that he proposes to deal on his own account. We believe that it is perfectly clear that additional disclosure, and a consent based on such additional disclosure, are necessary before the fiduciary can assume such a conflicting position. (p. 6)*

The SEC speaks clearly. It frames the significance of conflicts to be, inherently and fundamentally, at odds with the duty of loyalty. As a consequence, the SEC underscores "the general rule" that a fiduciary "must not put himself into a position" that is conflicted.

**Four: Disclose All Material Facts and Conflicts;
Manage All Material Conflicts**

Disclosure is a cornerstone of securities regulation. This is well-known and not in dispute. What seems less well known is that the precise nature of the disclosure requirement changes, and changes materially, with the facts and circumstances presented.

Advisors are required to make clear, complete and timely disclosure of all material facts and conflicts. These disclosures are typically set out in Form ADV. Material conflicts, those conflicts defined as being sufficiently significant such as to reasonably influence a client decision to not proceed with the engagement or transaction, require the greatest care.

Managing material conflicts entails several steps. First, there must be clear, complete and timely disclosure. Second, advisors must have a reasonable basis for believing that clients fully understand the disclosure, and the implications of the conflict(s) to the advisor and client. Implications may include the relative merits and risks of options not chosen by the advisor, and the additional fees (if any) earned by the advisor (whether paid out of client funds or not) and any additional expenses incurred.

Third, if a client wishes to accept the recommendation and proceed with the transaction after indicating a full and complete understanding of the conflict's implications, the client must provide this consent before the transaction is completed.

Finally, after receiving this "informed, intelligent, and independent" client consent, the advisor must still demonstrate that, notwithstanding the conflict, the recommendation remains reasonable and fair and consistent with the client's best interest.

In *Hughes*, the SEC carefully describes the burden the Advisor must overcome to complete a transaction when there is s a material conflict of interest.

> *If, but only if, she obtains her client's consent after disclosure… of all other facts which may be material to the formulation of an independent opinion … as to the advisability of entering into the transaction.*
>
> *As a general rule and aside from the limited exception which we have discussed, it would be highly improper for registrant to take a conflicting position in which, on the one hand, she is motivated to sell securities which may be most profitable to her and in her own best interests and, on the other, to recommend the purchase of securities solely on the basis of the best interests of her clients. And, of course, registrant has a free choice to avoid this conflict by confining her activities only to those of investment counsel so that she would be motivated to act only for the best interests of her clients. But, if registrant chooses to assume a role in which she is motivated by conflicting interests, under the exception we have discussed she may do so if, but only if, she obtains her client's consent after disclosure not only that she proposes to deal with them for her own account but also of all other facts which may be material to the formulation of an independent opinion by the client as to the advisability of entering into the transaction.*
>
> *These facts should include, as we have already stated, registrant's own cost of the securities she proposes to sell as well as the market value of the securities where the market price is better than the price asked of the client. This requirement, as we have shown, has its basis in well settled propositions of law and imposes no novel obligation upon the registrant. (p. 8)*

> *Registrant cannot satisfy this duty by executing an agreement with her clients….*
>
> *Registrant 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. And this disclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent. 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. (p. 9, 10)*
>
> *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*
>
> *It is clear from this testimony that certain of registrant's clients did not understand that registrant consistently proposed to, and in fact did, sell her own securities to them. Accordingly, registrant did not fulfill her affirmative obligation to disclose the capacity in which she acted, a duty which even she concedes she must perform. In this connection, 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. 17*

The SEC stresses three points that are particularly relevant. First, even though an advisor is permitted to do so, it is described in *Hughes* as "highly improper" or a very inappropriate choice for an advisor to elect to "take a conflicting position… where she is motivated to sell securities which may be most profitable to her and in her own best interests.."

Second, a blanket disclosure in a contractual agreement does not satisfy the heavy burden placed on the advisor who renders conflicted advice.

Third, and perhaps most pertinent today, there can not be, by the very nature of the facts and circumstances assessment required, any "hard and fast rule" as to what a disclosure entails that is true for all disclosures at all times. The SEC reminds us here, "The method and extent of disclosure depends on the client involved." The reason for this facts and circumstances disclosure rule: The overriding requirement of any disclosure is that the client "understands" the implications of the conflict, and that the advisor is the party held responsible to ensure the client understands.

Five: Act Prudently -- With the Care, Skill and Judgment of a Professional

To act prudently is to act with *due care* and is the standard of a professional. Acting with skill, judgment and care, and in complete consideration of the circumstances of the client must be a fiduciary's second nature. (While acting with due care may appear obvious, independent research suggests that many investors are advised to invest in vehicles that are not the result of a prudent process and due care and not necessarily in their best interest.)

Due care requires following a prudent process and having the knowledge to make appropriate recommendations. A prudent process requires investigating and assessing an investment's or firm's characteristics (not just performance) based on objective criteria and, preferably, with quantifiable data.

Therefore, a prudent process means taking all the necessary analytical and research steps to determine the most appropriate recommendations. For investment products, advisors are required to use industry best practices to investigate, evaluate, and construct a portfolio. Relying solely on third party rankings, fundamental analysis, or scoring schemes should not be confused with a prudent due care process in selecting and recommending investment or portfolio construction. The key is the rigor of the process undertaken, not the performance of the portfolio.

While following a prudent process is essential, it is not sufficient. Advisors must also have and continuously update their knowledge, expertise, education and experience. Faithfully developing and monitoring an investment or financial strategy based on a client's objectives and essential investment criteria requires these attributes.

The advisor's professional judgment based on a well-developed prudent process alone must determine whether investment managers, mutual funds, custodians and other vendors are competent and reasonably priced. Consistent due care must be undertaken irrespective of any financial incentives favoring any investment or product recommendation. Due care separates fiduciary advisors from sales professionals, and entails more stringent responsibilities over and above what constitutes a suitable recommendation. This distinction between suitable recommendations required of brokers and the higher standard of fiduciary recommendations in the client's best interest have been acknowledged by FINRA CEO, Richard Ketchum. [11]

Six: Control Investment Expenses

The duty to control investment expenses is inherent in the duty of loyalty. Recommendations with inappropriate or unnecessary expenses represent prima facie breeches of the duty of loyalty. Advisors are required to ensure that all vendor and investment expenses --- all fees, costs and expenses passed on to the investor -- are fair and reasonable in relation to the services and investments offered.

Conclusion

The Six Core Fiduciary Duties reflect principles that have served society for centuries. In recent times, the legislative history of the Advisers Act set out in the 1930's underscored the need for fiduciary principles as the backbone of "competent, unbiased and continuous advice." They echo in the SEC's practice today to urge advisors to avoid conflicts of interest, and in a thoughtful speech by the then SEC Director, Office of Compliance and Inspections, Carlo V. De Florio, in October 2012. De Florio called conflicts, "viruses that threaten the organization's well being."

The Duties are plainly evident through *Hughes*, an SEC opinion focused on the challenges created when an advisor puts herself in a conflicted position. Hughes transcends legal nuances to focus on the core challenge of conflicted advice and the need for self-restraint. *Hughes*' vigor is its clarity. It applies and expresses basic principles to common circumstances, and states clearly what it means to be a fiduciary, to be held accountable.

Take the circumstances around the nature of the advisor-client relationship. The SEC notes in *Hughes*, "Learning.. personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities -- cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients."

Or what loyalty means. "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." And why one must avoid "a conflicting position." To avoid being, "Motivated to sell securities which may be most profitable to her and in her own best interests .."

This common sense in plain language pervades *Hughes*, and helps illuminate four points at the center of today's discussion of the Advisers Act and a potential "uniform" fiduciary standard:

- the core nature of an advisors/client relationship of trust and confidence;
- the incompatibility between loyalty and conflicts of interest;
- the regulatory burden placed on a fiduciary advisor who chooses to align with material conflicts of interest; and
- the advisor's responsibility to make sure the client understands the conflict.

Hughes articulation of the meaning of fiduciary does not presume regulation alone is at issue. "Choice," the advisor's freedom to choose is paramount. The opinion speaks of the advisor's "free choice" either to avoid or to not avoid conflicts. And if the advisor "chooses to assume a role where she is motivated by conflicting interests," she then accepts the additional responsibilities implicit in that role. To exercise self-restraint -- or to not -- is the choice at hand.

The case for fiduciary principles indispensable role runs through history. The SEC in *Hughes* parallels and amplifies this case. The logic, tone and texture of the discussion in *Hughes* describes what it means to be a fiduciary, in practical terms in a manner that is meaningful to regulators, the profession and individual fiduciaries alike. It deserves close attention.

NOTES

1. For a discussion of the rationale for fiduciary law, see "Fiduciary Duties of Brokers-Advisers- Financial Planners and Money Managers," Tamar Frankel http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/FrankelT101009Revsep2010.pdf

2. SECURITIES AND EXCHANGE COMMISSION
SECURITIES EXCHANGE ACT OF 1934
Release No. 4048/February 18, 1948
In the Matter of: ARLEEN W. HUGHES doing business as E.W.HUGHES & COMPANY, 515 Exchange National Bank Building, Colorado Springs, Colorado

BROKER-DEALER REGISTRATION
Grounds for Revocation or Suspension
Failure to Make Full Disclosure

Where registered broker-dealer, who is also a registered investment adviser, sells her own securities to clients to whom she purportedly renders impartial investment advice and fails to disclose fully to such clients the nature and extent of her adverse interest, including her cost of the securities and the best price at which the security might be purchased in the open market, held, willful violation of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. ……

Generally, the registrant handles a client's entire account, advises the client with respect to an investment program, and, from time to time, recommends the purchase or sale of particular securities on the basis of information which she collects and analyzes. When recommending a particular security as a suitable investment, registrant furnishes her clients detailed information covering the business and financial data of the issuer and informs them as to the approximate price the securities will cost them. The client usually gives the registrant leeway up to a point or so from the approximate price. Where the actual price would exceed this margin of a point or so, registrant re-consults the client. Registrant's clients invariably follow her advice.

In filling a client's order for the purchase of a security, registrant either supplies the security from inventory or purchases the security "for her own account" and then as "principal" confirms the sale to the client. …..

Unless the client specifically requests the information, the registrant does not at any time disclose the current bid and asked quotations or her own cost of the securities she recommends and sells to the client. Nor does she advise the client whether the securities are supplied from inventory or from a purchase made by her to cover the client's order. Registrant uses the mails and instrumentalities of interstate commerce in the sale of these securities. (p. 1 – 5)

(NOTE: While a long standing case, Hughes continues to be cited by the SEC. This point was noted, recently by Melissa A. Roverts, SEC Branch Chief, Office of Investment Adviser Regulation at the Investment Adviser Association Compliance Conference, March 7, 2013.)

3. For a general discussion of the role of the fiduciary from an historic perspective see, Blaine F. Aikin, Kristina A. Fausti, "Fiduciary: A Historically Significant Standard."

4. 375 U. S. 180.

5. Id at 184.

6. http://www.sec.gov/news/speech/1934/030034douglas.pdf (Article in *Yale Law Review*.)

7. See: http://www.sec.gov/news/studies/bkrcomp.txt

8. http://www.sec.gov/news/press/2012/2012-172.htm

9. Professor Arthur Laby, "The Fiduciary Obligation as the Adoption of Ends," Buffalo Law Review, Vol 56, 99.

10. Professor Arthur Laby, "Selling Advice and Creating Expectations: Why Brokers Should be Fiduciaries." Washington Law Review, Vol. 87:707, at 720.

11. http://www.finra.org/Newsroom/Speeches/Ketchum/P120289

Rick Ketchum, CEO, FINRA, October 27, 2009

Here, Ketchum draws the contrast between a "minimum standard of acceptability" and an investor's "best interest" with a "true fiduciary spirit".

In recent years, business practices have evolved to a point where for some firms products and services were being offered not on the basis of whether they were in the best interest of the customer, but whether they met a minimum standard of acceptability. We've seen this with a variety of structured products, in which there was no change in the business model despite a dramatic change in the business climate.….. there needs to be a shift in the way some firms approach their development of new products and the way they market these products to the public. Your integrity and commitment to good business practices should be the first line of defense in investor protection, and I urge you to view your responsibilities in a true fiduciary spirit.

Attachment A

Investor Confusion or Investor Disengagement: What Does the Research Suggest?

Independent research of investors' understanding of investing, investment services, service providers and investing costs have widely been characterized to suggest that investors are "confused." However, a closer look at the research suggests a different phenomenon may be at play. Researchers Alan Palmiter and Ahmed Taha, who reviewed the academic literature on mutual fund investors, lament "Fund investors are unaware of the basics of their funds, pay insufficient attention to fund costs, and chase past performance despite little evidence that high past returns predict future returns." http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1098991

AARP. The 2007 AARP report, "401(k) Participant's Awareness and Understanding of Fees" underscores 401 (k) participants' lack of awareness of plan fees. Key findings: 83% of participants admit "they do not know how much they pay for fees and expenses associated with their own plan, while 65% reported they pay no fees,… (and) 17% stated they do pay fees." [a]

RAND. The SEC's 2008 Rand Report, "Investor and Industry Perspectives on Investment Advisers and Broker Dealers," is widely cited for revealing that investors are unaware of the basic different legal requirements of brokers and registered investment advisers. [b]

"Overall, we found that many survey respondents and focus group participants do not understand key distinctions between investment advisers and broker-dealers – their duties, the titles they use, the firms for which work, or the services they offer." Rand also reports that investors are generally satisfied with the services they receive, and "this satisfaction was often reported to arise from the personal attention the investor receives." Regarding investment expenses, "Survey respondents also indicate confusion about fees."

The Rand report found that 25% of the survey respondents who reported using a financial service provider also report that they paid "$0" for advisory or brokerage services.

Envestnet. The more recent Envestnet Fiduciary Standards Study serves to reinforce concerns about investors' understanding of advisors and brokers. [c] The report characterizes investors as being "foggy" about brokers' and advisors' roles and obligations. Of particular note regarding investors' knowledge of investment expenses and broker or advisor compensation, only 15% of investors state they can "very well" "assess how your advisor gets paid." (39% state "well" and the 53% state "not too well," "not well at all"or "don't know".)

That only 15% of investors indicate they understand how (and perhaps by implication, what) their broker or advisor is paid suggests there is far more than mere "confusion" involved; it suggests a level of "disengagement" [d] from the services and service provider. As a point of comparison, the question might be asked whether there is any other profession or group of service providers where 85% of their clients or customers acknowledge that they do not know, "very well," how much they pay for the services rendered.

Conclusions. These research studies offer insight into the nature of investor "misunderstanding," and the consequent level of investor risk. The level of the general lack of awareness of the fees and expenses investors pay for their brokerage and advisory services and the prevalence of the belief that these services are "free" suggests a picture that should, at minimum, raise red flags to the profession and regulators alike.

a. See http://assets.aarp.org/rgcenter/econ/401k_fees.pdf

b. See http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf

c. See http://www.thefiduciaryopportunity.com/

d. To suggest that investors are merely *confused,* in light of research findings, may be to understate general investor misunderstandings with their service providers. It is true that investors "confuse IAs from BDs." But this particular confusion is just part of the picture.

   A dictionary definition of "confuse" serves to suggest that the investor behavior noted here extends beyond *confusion*. The definition of confuse includes "perplex," "bewilder," or "to fail to distinguish." As examples, of using *confuse* or *confusion* in a sentence, these definitions offer, for example: "He always confuses the twins." Or, "Try not to confuse the papers on the desk." (See Dictionary.com)

   The scale of investor unawareness of fees, expenses and compensation reflects such a fundamental "gap" that it seems far more appropriate to associate this phenomenon as an indicator of *disengagement* more than of *confusion*. Examples of definitions of *disengage* include: "To release or become released from a connection," or, to "detach," disconnect" or "uncouple." (See Dictionary.com for further examples.)

   By only suggesting that investors are *confused*, we may be framing the circumstances far more positively than the evidence actually warrants. In doing so, we may be understating the gravity of investors' misunderstandings of investing and their advisor or broker.