INSTITUTE FOR
THE FIDUCIARY STANDARD

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Panel Two: The Fiduciary Duty Standard for Brokers-Dealers and Investment Advisers: How to Implement the Standard in a Meaningful Way

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"The Disappearing Fiduciary Standard in the Federal Regulation Of Investment Advice; The Uncertain Promise of Dodd Frank Section IX"

Summary

The fiduciary standard has served a vital role in history that is well established and widely viewed as instrumental in preserving trust and confidence in investment professionals and the capital markets. These sentiments are evident in the legislative background of the Advisers Act of 1940.

Regulatory and market changes in the 1970s spurred many broker-dealers to start holding themselves out as "advisors, " and offering "advice," without being required by the SEC to register; rampant investor misunderstandings followed, as catalogued in the Rand Report.

Dodd Frank authorized the SEC in 2010 to establish a uniform fiduciary standard for brokers and IAs; SEC published a request for information with "potential" assumptions that, if reflected in rulemaking, would effectively remove fiduciary duties as a requirement for rendering investment advice.

Background

- The Vital Role of the Fiduciary Standard

Fiduciary law exists * to restrain the conduct of experts who render socially important services or advice in relationships of trust and confidence. Fiduciary duties serve to mitigate the knowledge gap or information asymmetry that separates the two parties. The fiduciary is obligated to be loyal, render due care and act in utmost good faith. The fiduciary must adopt the client's ends or objectives[1]. Fiduciary conduct facilitates investor *trust,* the central pillar on which capital markets and the market economy depend.

" The beneficiary has entrusted the fiduciary with the power to oversee his well-being. The beneficiary is dependent upon the fiduciary due to his reliance on a specific service… the beneficiary ordinarily has very little or no control over the relationship or its subject matter …" (See Hazen, below.)

"The strictness of fiduciary law conflict-of-interest rules depends mainly on the level of entrustors' (clients) risks from the fiduciaries abuse of trust."[2] Fiduciary duties increase as the knowledge gap widens, and the gap between brokers and retail investors is widely acknowledged as large. Research reveals retail investors are sharply limited in their understanding of investing, markets and the role of advisors and brokers, suggesting a firm legal basis for applying the most stringent fiduciary duties.[3]

* For further discussion of the fiduciary standard and the contrast between the Investment Advisers 40 Act and positions advocated by the Securities Industry Financial Markets Association (SIFMA), seethe April 2012 comment letter to the SEC from the Institute for the Fiduciary Standard: http://www.sec.gov/comments/4-606/4606-2972.pdf

- The Supreme Court in 1963 in Capital Gains Research Bureau v. the SEC reflected these longstanding views in commenting on the Advisers Act of 1940

"… investment advisers could not completely perform their basic function – furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments -- unless all conflicts of interest between the investment counsel and the client were removed…. The Investment Advisers Act of 1940 thus reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship." (187)

- Federal Regulation of Investment Advice, Fiduciary Care, Lags Market Place, Deteriorates Over Decades

While brokers originally were deemed to be fiduciaries when rendering investment Advice, according to SEC…..

….. The end of fixed commissions (May, 1975), opening of first Schwab branch office (September 1975) and launch of Vanguard first index fund (December 1975) helped transform the market place, spur migration of sales brokers to offer advisory services, rebrand themselves as "financial consultant, advisor" without being required *to register as and to be investment advisers*.

Financial Planning Association (FPA) sues the SEC in July 2004 over 1999 "temporary rule" exempting broker-dealers from 40 Act.

The Rand Report in 2008 affirms widespread investor shortcomings in understanding financial services and intermediaries; that most investors wrongly believe broker-dealers are required to meet the fiduciary standard;

March 1, 2013 SEC Release

- Introduction

  The SEC March 1, 2013 Release (http://www.sec.gov/news/press/2013/2013-32.htm) provides guidance through its expressed assumptions regarding a potential uniform fiduciary standard (UFS). While 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. 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."

- Conclusion

  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.

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Notes

1. For a discussion of the fiduciary obligation as adopting the ends or objectives of the principal, see: Arthur Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 Buffalo Law Review, 99, 104—129.

   Further, see "Stockbroker Fiduciary Duties …." Thomas Lee Hazen, at 60:

   …. Although there is no clear definition of fiduciary relationship,55 some important generalizations can provide good guidance. A fiduciary relationship consists of two parties, the fiduciary and the beneficiary. It is generally understood that in such a relationship, the fiduciary has the duty to be loyal and act in the interest of the
   beneficiary. 56 The beneficiary has entrusted the fiduciary with the power to oversee his well-being.57 The beneficiary is dependent upon the fiduciary due to his reliance upon a specific service the fiduciary provides under the arrangement in question.58 The
   beneficiary ordinarily has very little or no control over the relationship or its subject matter, and thus the beneficiary is forced to rely on the fiduciary's expertise in the specific area.59 In other words, a fiduciary relationship often exists when one person places his trust and confidence in another. There is reliance upon the fiduciary that the fiduciary will not abuse this trust and confidence.60 Described in yet another way, a fiduciary relationship is said to exist when any person instills a power of some type in another (the fiduciary) with the intention that the fiduciary act to further the beneficiary's best interests.61

   55. *See, e.g.*, Franklin Supply Co. v. Tolman, 454 F.2d 1059, 1065 (9th Cir. 1972) ("A 'fiduciary relation' is an elusive status to define."); Keenan v. D.H. Blair & Co., Inc., 838 F. Supp. 82, 89 (S.D.N.Y. 1993) ("The precise contours of
   a fiduciary relationship are incapable of expression."); Farragut Mortgage Co., Inc. v. Arthur Andersen, LLP, No. 95-6231-B, 1999 WL 823656, at *14 (Mass. Super. 999) (there is no all-inclusive definition of a fiduciary relationship; the existence of such a relationship is a question of fact).
   56. *See, e.g.*, Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L. J. 879, 882 (1988); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 624 (1997).
   57. *See, e.g.*, Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 240 (2009).
   58. *See* Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 800 (1983).
   59. *See* Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L.
   239, 241 (2009). *See also*, *e.g.*, Frankel, *supra* note 58.
   60. *See* Alces, *supra* note 59, at 240-42. *See also*, *e.g.*, DeMott, *supra* note 56, at
   902; D. Gordon Smith, *supra* note 56, at 1413.
   61. *See* Alces, *supra* note 59, at 260.

2. Tamar Frankel, Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers, Boston University School of law Working Paper No. 09-36, August10, 2009, Revised February 17, 2010.

3. Examples of this research include a 2007 AARP study http://assets.aarp.org/rgcenter/econ/401k_fees.pdf of 401(k) plan participants that revealed 83% admitted "they do not know how much they pay" in fees and expanses; 65% reported they pay no fees. The 2008 RAND study http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf is widely cited for revealing that investors are unaware of the basic legal differences between the requirements of advisers and brokers. The RAND study also revealed that 25% of respondents who reported using an advisor or broker also reported they pay $0 for these services. Also, 2009 Envestnet http://www.thefiduciaryopportunity.com/ study found that only 15% of investors said they can "very well" assess how their "advisor gets paid." These data are conventional wisdom; they are not in dispute. Seventeen years ago in a report commissioned by then-SEC Chairman Arthur Levitt produced by industry leaders led by Merrill Lynch Chairman & CEO Daniel B. Tully, the implications of this asymmetry were affirmed: Registered reps and their customers are "Separated by a wide gap of knowledge .. this knowledge gap represents a potential source of client abuse."

   In the 1995 *Report of the Committee on Compensation Practices* (aka The Tully Report, for its Chairman, Daniel B. Tully), the report points out in clear terms the level and importance of investors' lack of knowledge of investment products and confusion derived from misunderstanding what's written in prospectuses. The report states that registered representatives and their clients are:

   "Separated by a wide gap of knowledge – knowledge of the technical and financial aspects of investing. The pace of product innovation in the securities industry has only widened this gap. It is a rare client who truly understand the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many. It also makes communication between a registered representative and investor difficult and puts too much responsibility for decision-making on the shoulders of RRs – a responsibility that belongs with the investor."