

COMMON SENSE;
ADDRESSED TO
POLICYMAKERS and PARTICIPANTS
O F T H E
FINANCIAL ADVISORY COMMUNITY
ON THE FOLLOWING INTERESTING
S U B J E C T S.

- I. Of the Origins of Fiduciary Duties in General, and when Financial Advisors assume Fiduciary Status.
- II. The Specific Fiduciary Duties of Financial Advisors.
- III. Thoughts on the Present State of Affairs for American Consumers.
- IV. Of the Present Opportunities for Change, with some Miscellaneous Reflections.

In the era that lies ahead, the trusted businessman, the prudent fiduciary, and the honest steward must again be the paradigms of our great American enterprises. It won't be easy, but if we all work long enough and hard enough at the task, we can build ... a fiduciary society in which the citizen-investors of America will at last receive the fair shake they have always deserved from our corporations, our investment system, and our mutual fund industry. – John Bogle

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I N T R O D U C T I O N .

“PERHAPS the sentiments contained in the following pages, are not yet sufficiently fashionable to procure them general favor; a long habit of not thinking a thing wrong, gives it a superficial appearance of being right, and raises at first a formidable outcry in defence of custom. But the tumult soon subsides. Time makes more converts than reason.” - Thomas Paine, 1776

Change is not necessary for individuals to embrace; financial services intermediaries are free to become obsolete and vanish if they so desire. Yet the instinct to survive is strong. It compels individuals to undertake conscious choices.

This pamphlet is an appeal to our better selves. It is a calling to something more than the members of the financial advisory community are today. This vision is not new. It was given birth many decades ago by a few, and it has since been cultivated and expanded upon by many. As a vision it represents intense desires of those clients whom financial advisors endeavor to serve. Too few financial advisors currently act within this vision; too many financial advisors are presently excluded from it.

America faces an uncertain economic future. Many challenges lie ahead for our country and in the financial lives of our fellow citizens. The vision set forth herein is but one part of a greater answer to these economic challenges. Nevertheless, the vision expressed herein conveys a significant path for reform – empowered by common sense. This vision can be transformed into a better reality through the leadership of our legislative, regulatory and industry association policy makers. The achievement of this vision, or some outcome akin to it, will require their courage and fortitude.

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I. Of the Origins of Fiduciary Duties in General, and when Financial Advisors assume Fiduciary Status.

The origins of the fiduciary principle. The fiduciary principle is of great antiquity. It is clearly reflected in the provisions of the code of Hammurabi nearly four millennia ago, which set forth the rules governing the behavior of agents entrusted with property. Ethical norms arising from relationships of trust and confidence existed in Judeo-Christian traditions, in Chinese law, and in the Roman era. Cicero stated, “Anyone who betrays such a trust is undermining the entire basis of our social system.” Likewise, one of the three basic questions of self-examination attributed to Confucius is the following: “In acting on behalf of others, have I always been loyal to their interests?”

Fiduciary law has evolved over the centuries to refer to a wide range of situations in which courts have imposed duties on persons acting in particular situations that exceed those required by the common law duties of ordinary care and fair dealing. Today fiduciary status attaches to many different situations, including actors in relationships based upon trust and confidence.

Fiduciary status is determined by law, not the parties’ agreement. The law plays a crucial role in the establishment of fiduciary status for a financial advisor. To a substantial extent, the law (whether it be statutory law or common law) rather than the parties (and the terms of their contract) determines entry into fiduciary status for a financial advisor. In other words, once the financial advisor establishes a certain relationship with a client, that relationship’s classification as either “arms-length” or “fiduciary” in nature, and its legal consequences, are primarily determined by law rather than by an understanding or written agreement of the parties.

Arms-length vs. fiduciary relationships. Generally, relationships between two parties fall into one of two categories. The first category is that in which arms-length negotiations between the parties take

place. Sometimes the consumer is aided by specific laws which impose some additional duties on the other party, such as the requirement that investment products sold to an investor be “suitable,” at least as to the risks associated with that investment. By contrast, the fiduciary relationship arises in situations where the law has clearly recognized that fiduciary duties attach, such as principal and agent relationships, or where there exists the actual placing of trust and confidence by one party in another and a great disparity of position and influence between the parties.

Ten paths to fiduciary status. It is curious that so many financial intermediaries today are unaware of their fiduciary status, or those situations in which it might attach. Paths to fiduciary status include:

1. Investment Advisers Act of 1940 (“IAA”);
2. Limited duties for non-discretionary brokerage accounts;
3. Discretionary brokerage accounts;
4. “Control” amounting to “discretion” over a brokerage account;
5. Common law fiduciary status arising from a relationship of “trust and confidence” between the financial advisor and client;
6. Maryland and Washington state statutory law (financial planners as IAs);
7. ERISA;
8. Express contractual terms;
9. Service as trustee, custodian; guardian, or conservator; and
10. Acting as attorney-in-fact.

The Investment Advisers Act of 1940 (IAA) may have greater breadth in its application than many realize. The U.S. Court of Appeals decision in *Financial Planning Association vs. SEC*, No. 04-1242 (D.C. Cir., March 30, 2007), possesses potentially far-reaching implications. Three times in that decision the Court emphasized that the term “investment adviser” was “broadly defined” by Congress. Additionally, in discussing the exclusion for brokers (insofar as their

advice is solely incidental to brokerage transactions for which they receive no special compensation), the U.S. Court of Appeals stated:

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

As a result of this language, all arrangements in which broker-dealer firms and their registered representatives receive compensation other than commission-based compensation should be reviewed to see if the definition of “investment adviser” found in 15 U.S.C. §80b-2.(a)(11) applies:

“Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities

For example, the issue has recently been raised as to whether the receipt of 12b-1 fees by broker-dealer firms and their registered representatives, which by the SEC’s own admission are asset-based fees and relationship compensation, run afoul of the IAA when received by those outside investment advisory relationships with their customers. The written statements of many brokerage industry representatives acknowledge that 12b-1 fees are utilized in large part to compensate registered representatives (RRs) for the fostering of an ongoing relationship between the RR and the investor, including the provision of advice over time with respect to a customer’s personal circumstances, and including financial planning, estate planning, and investment advice (not specific to any transaction). While industry representatives have argued that

the 12b-1 fee “compensation” received by the broker-dealer firm is not paid by the customer directly, there is no qualification in the definition of investment adviser which says that compensation must be directly paid by an investor. Moreover, there is a common law principle which attorneys were taught when they were in law school: “You cannot do indirectly what you cannot do directly.” In other words, “if it walks like a duck....” While admittedly Class C shares in particular, and fee-based compensation in general, better align the interests of investors with those of financial intermediaries, such an alignment is not the basis of any exclusion from the application of the IAA. Given the significance of this issue, all ongoing payments to advice-providers deserve close scrutiny.

Finding “discretion” exists over a (“non-discretionary”) brokerage account: the application of the law of agency. Are broker-dealer firms and their RRs fiduciaries? Yes, as to the scope of their agency. In this regard 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 RRs owe “limited fiduciary duties” or “quasi-fiduciary duties” to the customer, including those to: (1) recommend a stock only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (2) carry out the customer’s orders promptly in a manner best suited to serve the customer’s interests; (3) inform the customer of the risks involved in purchasing or selling a particular security; (4) refrain from self-dealing; (5) disclose any personal interest the broker may have in a particular recommended security; (6) refrain from misrepresenting any fact material to the transaction; and (7) transact business only after receiving prior authorization from the customer. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F.Supp. 951, 952 (E.D.Mich.1978) aff’d, 647 F.2d 165 (6th Cir.1981); *Patsos v. First Albany Corp.*, 433 Mass. 323, 741 N.E.2d 841, 848-49 (2001). However, it should be noted that the agency relationship between the broker-dealer (and its RRs) and the customer ceases at

the conclusion of each transaction. No broad fiduciary duties to exist with respect to most RRs and their broker-dealer firms, under the law of agency, at least with respect to non-discretionary accounts.

Fiduciary duties expand when the broker-dealer firm (through its RR) assumes discretion over an account. While the SEC has yet to reveal (following the *Financial Planning Association vs. SEC* decision) whether it continues to opine that discretionary brokerage accounts are subject to the IAA and its fiduciary duties, it is clear that *common law* fiduciary duties arise from the principal-agent relationship, and that these duties will be interpreted quite broadly. In essence, since the scope of the agency is expanded to include the exercise of discretionary authority to undertake sales and purchases in the account, the agent (RR) owes a fiduciary duty to the principal (the customer) in the actions undertaken which exercise that discretion. Some state courts go further and 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. 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.” “When a stock broker or financial advisor is providing financial or investment advice, he or she is required to exercise the utmost good faith, loyalty, and honesty toward the client. The broker or advisor implicitly represents to the client that he or she has an adequate basis for the opinions or advice being provided.” *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006) citing *Hanly v. S.E.C.*, 415 F.2d 589, 596-97 (2d Cir. 1969); *Univ. Hill Found. v. Goldman*, 422 F. Supp. 879, 893 (S.D.N.Y. 1976).

Even though an account may be “non-discretionary” on paper, some state courts find that the RR 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. For example,

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, and 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 vs. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F.Supp. 528, 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.

In *Patsos*, the Massachusetts Supreme Judicial Court recognized that the relationship between a stockbroker and a customer may be either a fiduciary one or an ordinary business one, and the court enumerated a number of factual considerations that can determine whether a fiduciary duty has arisen between a stockbroker and a customer; the Court noted that a "customer's lack of investment acumen may be an important consideration, where other factors are present" especially when "the broker holds himself out as an expert in a field in which the customer is unsophisticated." *Patsos*, 433 Mass. at 334-5, 741 N.E.2d at 850-1.

Common law findings of fiduciary status: relationships built upon trust and confidence. Regardless of how a financial advisor is registered – as an investment adviser (representative), RR of a broker-dealer, dual registrant, or insurance agent – another body of law serves to impose fiduciary status upon the financial advisor – the “common law.”

What is the “common law”? 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.

Fiduciary status – two main branches. The recognition of the existence of a fiduciary relationship under the common law is said to consist of two main branches.

First branch: generally accepted and prescribed relationships. 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 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. Some of these relationships were recognized to involve fiduciary status for several centuries or longer (such as trustee relationships), while other relationships were only recently universally recognized as such (director or officers of corporations, for example).

Second branch: relationships deemed fiduciary on basis of specific facts and circumstances. 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.

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 Frankel, “Courts, legislatures, and administrative agencies increasingly draw on fiduciary law to answer problems caused by these social changes.” Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795, 796 (1983). With the passage of time it is probable, and indeed highly likely, that certain types of relationships deemed fiduciary on the basis of specific facts and circumstances (such as those of financial advisors) may arise to the level of generally accepted and prescribed relationships.

No contract is needed which expressly sets forth fiduciary status. Courts have held that a fiduciary relationship need not be created by contract. It 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.” *In re Clarkeies Market, L.L.C.*, 322 B.R. 487, 495 (Bankr. N.H., 2005). 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.” Tamar Frankel, “Fiduciary Law,” 71 Calif. L. Rev. 795, 817 (1983).

When is fiduciary status found for financial advisors under the common law? Several recent cases indicate that fiduciary status may be found for financial advisors through the actual provision of advice on asset allocation and investment manager selection, by actually providing financial advisory services, or by committing to or actually monitoring a customer’s investment portfolio. Other recent cases find fiduciary status when one “holds out” as a “financial planner” or “financial advisor” or “estate planner” or “investment counselor,” or as one possessing experience in the field of investment consulting and management. In addition, a dual registrant who undertook the monitoring of variable annuity sub-accounts and to give financial advice, and who held out as a “financial advisor” was held to be a fiduciary. A summary of several cases follows.

The provision of advice regarding asset allocation, portfolio manager selection, investment objectives, and investment guidelines, and holding out as experienced in the field of investment consulting and management, was held by a New York state court to be sufficient to raise a factual issue regarding the existence of fiduciary relationship based upon trust and confidence. *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 4430 (NY 6/2/2005) (NY, 2005).

When a bank held out as either an “investment planner,” “financial planner,” or “financial advisor,” the Wisconsin Supreme Court held that a fiduciary duty may arise in such circumstances. *Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 2005)

Actually acting as a financial advisor could lead to a finding of fiduciary status. “[A] fiduciary relationship can arise in fact regardless of the relationship in law between the parties. . . . For example, acting

as an advisor may contribute to the establishment of a fiduciary relationship.” *Hatheway vs. U.S. Trust Company, N.A.* (Ct. of Appeals, Washington State, unpublished decision, case no. 33966-8-II, *citing Micro Enhancement Intern., Inc., v. Coopers & Lybrand*, 110 Wn. App. 412, 433-34, 40 P.3d 1206 (2002), which case in turn cites *Liebergessell v. Evans*, 93 Wn.2d 881, 613 P.2d 1170 (Wash., 1980), stating in pertinent part: “A confidential or fiduciary relationship between two persons may exist either because of the nature of the relationship between the parties historically considered fiduciary in character ... or the confidential relationship between persons involved may exist in fact. *McCutcheon v. Brownfield*, 2 Wash.App. 348, 356-57, 467 P.2d 868, 874 (1970). *See also* Restatement Contracts § 472 Comment C (‘A fiduciary position . . . includes not only the position of one who is a trustee, executor, administrator, or the like, but that of ... trusted business adviser, and indeed any person whose relation with another is such that the latter justifiably expects his welfare to be cared for by the former’).” *Liebergessell* at 890-1.

Insurance agents who introduced themselves as “investment counselors or enrollers” and who tailored retirement plans for each person depending on the individual’s financial position, and who led the customers to believe that an investment plan was being drafted for each customer according to each customer’s needs, was held by a federal court, apply Iowa state common law, to lead to the possible imposition of fiduciary status. *Cunningham vs. PLI Life Insurance Company*, 42 F.Supp.2d 872 (1990).

In another case, a federal court, applying New York state law, found that the customer “relied upon superior knowledge. Asset Alliance allegedly was plaintiff’s investment advisor and committed to ‘monitor the status and performance of [Beacon Hill and Bristol] at least once a month and [to] promptly inform Sanpaolo if, for any reason, it believes that [Beacon Hill or Bristol] should be de-selected.’ These allegations are sufficient to plead a fiduciary relationship.” *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385, 414 (S.D.N.Y., 2005).

In a very recent case, a dual registrant crossed the line in "holding out" as a financial advisor, and in stating that ongoing advice would be provided, and other representations, and in so doing the dual registrant, who sold a variable annuity, was found to have formed a relationship of trust and confidence with the customers and was held to a fiduciary duty. The decision also states in part: "Obviously, when a person such as Hutton is acting as a financial advisor, that role extends well beyond a simple arms'-length business transaction. An unsophisticated investor is necessarily entrusting his funds to one who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his investor/entrustor. The relationship goes well beyond a traditional arms'-length business transaction that provides 'mutual benefit' for both parties." *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007).

No General Preemption of State Common Law by IAA. It is clear that neither the 1934 Act nor the IAA of 1940 Act preempt state common law. In other words, the federal securities acts, such as the IAA of 1940, do not in any way disturb or interfere with the development of fiduciary principles under state law. [Note, however, that SLUSA preempts state common law as to certain class actions, and ERISA preempts certain state law claims based on fiduciary duties.] Often, statutory law follows in the footsteps of the ongoing development of common law, and hence it should not be surprising to see an expansion of the application of fiduciary duties by future federal or state legislation.

Other paths to fiduciary status. Certain paths to fiduciary status are both clear and undisputed. If the financial advisor serves as trustee, or custodian of a UTMA or UGMA account, or as guardian or conservator, then he or she are a fiduciary. If the financial advisor agrees (either in writing or verbally) to act as a fiduciary, then he or she has assumed fiduciary status by contract. If a financial advisor provides advice to plan participants or plan sponsors as to ERISA plans, he or she is a fiduciary.

In addition, a person holding himself or herself out as a “financial planner” or “financial consultant,” or who actually provides financial advice for compensation, and who is subject to the laws of the State of Maryland or the State of Washington, is an investment adviser and hence is a fiduciary with respect to activities carried on in that state, barring the application of various exclusions provided by law or regulations promulgated thereunder.

In conclusion – fiduciary status for many financial advisors is highly likely to already exist. Common law continues to expand upon the situations in which fiduciary status attaches to those who provide financial advice. Holding out as a financial advisor (or the use of similar terms) manifests an acceptance of trust and confidence. Actually undertaking a financial plan (whether comprehensive or segmented) and providing financial advice, especially on an ongoing basis, also manifests an acceptance of trust and confidence. In either situation – “holding out” as a “financial advisor” or the provision of either comprehensive or focused “financial planning” or “financial advice,” a fiduciary relationship is likely to result under the common law. Additionally, as many observers of the law note, where there is a substantial wrong the courts seem to find a way to impose liability. Fiduciary duties may be utilized to fill gaps in the law, especially where the law of contracts is insufficient to protect the interests of an innocent victim.

Financial advisors must always remember what financial advisors are called upon to do – provide their expertise to *other people’s money*. It is right and just in such circumstances that broad fiduciary duties be applied to those in whom our fellow citizens place their trust and confidence. Financial advisors should be ready to accept the important stewardship of our client’s goals, hopes, and dreams.

II. The Specific Fiduciary Duties of Financial Advisors

I set forth in the previous section the likelihood, under the common law (if not through broader application of the Investment Advisers Act), that many financial advisors are already fiduciaries, even though they do not yet know it. In this section, I seek to foster greater understanding of the major fiduciary duties.

I often reflect upon the resistance by some in the securities industry to the promulgation of more specific fiduciary duties for financial advisors. This is especially so when many financial advisors of today, seeking to adhere to the highest standard under the law, both desire and need additional guidance in understanding fiduciary duties. It is true that fiduciary duties are applied to fill a gap, through our courts of equity, to right wrongs which principles of contract or tort law may fail to adequately address. It is also true that fiduciary duties are – in a sense – elastic, and are molded to fit the profession or environment to which they are applied. Nevertheless, establishing contours for the fiduciary duties of those who provide financial and investment advisory services is both reasonable and proper. Guidance is warranted – otherwise legislation by enforcement, which would result from the absence of more specific standards - would inadvertently occur to the detriment of practitioners.

With an aim of furthering understanding of fiduciary duties, following are some of the specific duties which flow from the commonly-referred-to triad of the fiduciary duties of due care, loyalty, and utmost good faith.

The duty of due care.

- *Generally.* A financial advisor shall, in the performance of services for a client, act with the due care expected of prudent financial advisors in like situations, applying the requisite knowledge, experience, and attention to the engagement.
 - The duty of care has been considered to involve both process and substance. Procedural due care is often

met through the application of an appropriate decision-making process, and outcomes are judged under the standard of procedural prudence, not necessarily by the end result. Substantive due care is also required, under which the financial advisor is bound to exercise good judgment, applying his or her education, skills, and expertise to the financial planning issue at hand.

- The standard of prudence is relational; it follows that the standard of care for a financial advisor is the standard of a prudent financial advisor.
- *Competence.* A financial advisor shall provide services to clients competently.
 - A financial advisor is competent only when he or she has attained and has maintained an adequate level of knowledge, skill, and experience, and is able to apply that knowledge, skill, and experience effectively in providing services to clients.
 - Consultation or referral by the financial advisor with other professionals shall be required when a professional engagement exceeds the personal competence of the financial advisor and the competencies of others who might support the financial advisor from within the financial advisor's firm or otherwise.
 - Due to ever-changing laws, regulations, and the development of new strategies, services, and products, the maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a financial advisor's professional life.

- *Diligence.* Financial advisors shall be diligent in discharging responsibilities to clients, employers, and the public. Diligence imposes the responsibility upon financial advisors to render services reasonably, promptly, and carefully and with a reasonable level of thoroughness.
 - The financial advisor should gather necessary factual information regarding the client as necessary and appropriate to provide the recommendations. In recommending securities or investment products to clients, the financial advisor must determine that the security or investment product is suitable for that customer in light of the customer's financial status and investment objectives.
 - The financial advisor should undertake due diligence as to investment products recommended to the client, seeking to select those investments which best meet the client's needs. In this regard, a financial advisor shall reasonably ensure that the total fees and costs borne by the client in connection with the financial advisor's services and investment recommendations are reasonable.
 - Financial advisors shall also reasonably consider and recommend to the client such strategies and investment products which may reduce the tax burdens imposed upon the client over time.

The duties of loyalty and utmost good faith.

- *Generally.* A financial advisor, who is given the highest degree of trust and confidence by the financial advisor's client, is a fiduciary and possesses the duty of undivided loyalty to the client. A financial advisor shall at all times act in the best interests of his or her clients, in utmost good faith, and honestly.

- The greater the knowledge, experience, and required degree of expertise of the fiduciary, relative to the knowledge and experience of the client, the more significant the fiduciary association becomes as a protector of the client's interest.
- Clients in receipt of financial planning services will nearly always start off, in discussions with their financial advisors, from a position of contractual weakness and, as to the complexities of tax law, financial planning issues, estate planning issues, insurance, risk management issues, and investments, from the position of relative ignorance. Fiduciary status is thereby imposed by the law upon the party with the greater knowledge and expertise in recognition by the law that the client is in need of protection and care.
- *Maintaining Objective Judgment.* A financial advisor must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities; accordingly, financial advisors must reasonably act to avoid conflicts of interest.
 - A fiduciary cannot serve two masters. The existence of conflicts of interest, even when they are fully disclosed, can serve to undermine the fiduciary relationship and the relationship of trust and confidence with the client. The existence of substantial or numerous conflicts of interest, which otherwise could have been reasonably avoided by the financial advisor, may lead to not only an erosion of the financial advisor's relationship with the client, but also an erosion of the reputation of the profession of all financial planners and advisors.
- *Compensation.* Financial advisors must not charge an excessive fee. Financial advisors must not offer, solicit, or

accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise the financial advisor's own or another's independence and objectivity.

- Many types of compensation are permissible for financial advisors, including commission-based, a percentage of assets under management, a flat or retainer fee, hourly fees, or some combination thereof. However, the term "independence" requires that the financial advisor's decision is based on the best interests of the client rather than upon extraneous considerations or influences that would convert an otherwise valid decision into a faithless act.
- To avoid disputes with clients relating to conflicts of interest involving compensation, all compensation should be fully and specifically disclosed, in dollar or percentage amounts, in writing and in advance.
- Conflicts of interest involving commission-based compensation might be best addressed through a "level compensation" or "maximum compensation" agreement entered into with the client prior to any recommendation of an investment product.
- *Disclosures and Management of Conflicts.* Financial advisors shall disclose to clients and properly manage all material conflicts of interest which remain following financial advisors' reasonable efforts undertaken to avoid conflicts of interest.
 - Disclosure of conflicts of interest does not defeat the continuing duty to act in the best interests of the client.
 - Financial advisors shall adopt and adhere to reasonable policies and procedures for the management of remaining conflicts of interest in order that the financial advisor may continue to act in the best

interests of the client. This includes, but is not limited to, the adoption and periodic revision of a code of ethics, appropriate compliance policies and procedures, and sound client engagement practices.

- *Fairness.* Financial advisors shall reasonably seek to not favor the interests of any one client over the interest of another client. Since situations may arise in which the financial advisor's ability to treat all of the financial advisor's clients with equal fairness is compromised, or where it may appear that the interest of one client is favored over that of another client, financial advisors shall inform clients in writing and (where possible) in advance of the limitations which financial advisors possess and how the financial advisors will address the situation.
- *Honesty.* Financial advisors must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities. Financial advisors must not engage in any professional conduct involving dishonesty, fraud, or deceit, or commit any act that reflects adversely on their professional reputation, integrity, or competence.
- *The Duty of Loyalty Extends Throughout The Relationship.* The duty of a financial advisor to act in the best interests of a client cannot be waived by the client; it extends to all aspects of the relationship between the financial advisor and client.
 - Fiduciary duties apply to all of the advice and recommendations provided by the fiduciary to his or her client; fiduciary duties cover the entire *relationship*, not just specific accounts.
 - Fiduciary duties, once established, cannot be terminated except through termination of the whole of the relationship.

- The term "fiduciary" is utilized to mark certain relationships where a party with superior knowledge and information acts on behalf of one who usually does not possess such knowledge and information. Financial planning and financial advisory services involve such relationships, as learning the personal details of clients' financial affairs, their hopes, dreams, and aspirations cultivates confidential and intimate relationships.
- *Preserve Confidences.* Financial advisors shall keep all information about clients (including prospective clients and former clients) in strict confidence, including the client's identity, the client's financial circumstances, the client's security holdings, and advice furnished to the client by the firm, unless the client consents otherwise or except as required by the provisions of law.
- *No Reckless Behavior.* A financial advisor shall act responsibly at all times.
 - Traditionally, the duty of utmost good faith has been closely related to the concept of loyalty. However, reckless, irresponsible, or irrational conduct – but not necessarily self-dealing conduct – may implicate concepts of good faith.

Why is there resistance to the application of fiduciary duties by so many participants in the securities industry? Perhaps it is fear of liability or an unwillingness to undertake the effort required of a fiduciary. However, once fiduciary status is both embraced and understood by a financial advisor, it becomes surprisingly easy to adhere to fiduciary principles while fostering rewarding, long-lasting relationships with clients.

III. Thoughts on the Present State of Affairs for American Consumers

We have a problem in America.

The world is far more complex for individual investors today than it was just a generation ago. There exist a broader variety of investment products, including many types pooled and/or hybrid products, employing a broad range of strategies. This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor's portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true "total" fees, costs, investment characteristics, tax consequences, and risks. Additionally, U.S. tax laws have increasingly become more complex, presenting both opportunities for the wise through proper planning, but also traps for the unwary.

As the sophistication of our capital markets, as well as portfolio construction and management methodologies, have increased, so has the knowledge gap between individual consumers and knowledgeable financial advisors. Investment theory continues to evolve, with new insights gained from academic research each year. In constructing an investment portfolio today a financial advisor must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

Proper financial planning is essential to encourage both an increase in household savings and in order to invest those funds more effectively. If people do not make careful, rational decisions about how to provide for their financial security over the course of their lifetimes, then the government will have to step in to save people from the consequences of their poor planning.

In the vast majority of the well-regulated capital markets in the world, it is recognized that the imposition of high standards of conduct upon financial intermediaries is necessary to provide protection to consumers from unfair, improper, and fraudulent practices. Such protection fosters confidence in the capital markets by investors, which in turn promotes increased investor participation in efficient capital markets.

In the United States “financial advisors” might refer to several types of financial services intermediaries – registered representatives of broker-dealer firms, registered investment advisers or their representatives, and insurance agents. The term “financial planner,” while descriptive of a planning and advisory relationship, is largely unregulated. Of these four types of actors, only registered investment advisers and their representatives are known to always possess broad fiduciary duties of due care, loyalty, and utmost good faith toward their clients.

Federal securities laws and regulations protect investors largely through requiring the disclosure of information – whether it be of material facts regarding an issuer of a security, or of compensation paid to a financial services intermediaries, or of conflicts of interest which exist as to financial services intermediaries. However, disclosure does not address investors’ difficulties in dealing with the psychological issues of risk aversion, overconfidence, and cognitive dissonance. Moreover, many investors do not enjoy the intended protections of securities laws because disclosures are either inadequate (as to the quality or quantity of information provided), incomprehensible to the individual consumer (in terms of the language or terminology utilized), or deficient in timing (i.e., coming only after the consumer makes a decision). While efforts have been made to formulate disclosures in “plain English,” this may have exacerbated a related problem – one in which individual investors receive a large volume of disclosure documents to the point of being overwhelmed.

Furthermore, to accept the premise that investors are responsible for understanding what they read and acting prudently thereafter, it is

necessary to conclude that investors are not only armed with timely and adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them, both intellectually and unhampered by behavioral biases. Consumer ability to understand is not only difficult due to the enormous knowledge base required to undertake decisions in dealing with a highly complex financial world, but also due to bounds upon human behavior that limit the extent to which people actually and effectively pursue utility maximization. Individuals possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure. See Prentice, “Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future,” 51 Duke L. J. 1397 (2002). 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.” Prentice, “Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis, 2003 U.Ill.L.Rev. 337, 343-4 (2003). As evidence of the foregoing, this author has been trained to establish a relationship with a prospective client based upon trust and confidence, long before any discussion of fees or products; such training is commonplace in the securities industry. Once such a relationship is accomplished, the “sale” is easily accomplished.

The fact is that we should no more expect the vast majority of individual consumers to be able to successfully navigate today’s complex financial world than we would expect them to act as their own attorney or physician.

While various studies have been undertaken to discern the total costs of intermediation (i.e., all of the costs surrendered by consumers to financial services intermediaries), the data in such studies is usually incomplete. Nevertheless, it would be reasonable to conclude that 25% to 40% of the total returns offered by the capital markets to individual investors are consumed by financial services intermediaries. No one disputes that financial advisors, possessing great skill, deserve reasonable compensation; however, the fact is that a huge amount of

the returns of the capital markets do not reach individual consumers, and they are usually unaware of much of this interception and diversion. The way to cure this problem is not only through better disclosures, but also through embracing the notion of purchaser's representatives (fiduciaries), who possess the duty to keep total fees and costs reasonable for their clients. Financial advisors, armed with knowledge of the many "hidden" costs found in investment products, and bound by a duty to act in the best interests of the client (and not as the representative of the product manufacturer), can and will apply economic pressure on product providers to lower fees and costs.

Powerful economic forces oppose the imposition of fiduciary status upon financial intermediaries. This opposition is fueled by billions of dollars excessively diverted each year from the financial futures of individual Americans. Some of our regulators have, from time to time, inadvertently promulgated policies in opposition to the inevitable march of disintermediation. In the face of enormous influence from securities industry participants, leadership and courage will be required by the makers and enforcers of our public policy. Only common sense can counter the self-serving arguments of many in the securities industry who, armed with billions of profits each year, seek to wield their influence in the halls of Washington, D.C. and beyond.

IV. Of the Present Opportunities for Change, with some Miscellaneous Reflections.

The year 2007 has already seen several major developments which add to the foundation for a fuller transition to fiduciary status for all financial advisors. First, the U.S. Court of Appeals ruled in *Financial Planning Association vs. SEC* that the Investment Advisors Act and its imposition of fiduciary status should be broadly applied. Second, the Certified Financial Planner Board of Standards, Inc. announced that it will apply fiduciary duties to its many certificants engaged in material elements of financial planning, effective July 1, 2008. The U.S. Securities and Exchange Commission and the U.S. Department of Labor (as to ERISA accounts) continue to review issues of concern, including the propriety of 12b-1 fees, point-of-sale disclosures, and the proper standards of conduct which should be applied to the provision of financial advice. And the Financial Planning Association's Fiduciary Task Force, building on the prior work of many others, issued its Final Report, which concluded: "We request that a very important dimension of the lives of our fellow citizens – that which relates to each person's own financial security and planning for the achievement of lifetime financial goals – be empowered by consistent professional conduct through the engagement of financial planners held to the highest standards of conduct." (Final Report, June 1, 2007).

The provision of financial advice should be elevated to that of a profession. A profession is a calling. It requires specialized knowledge and often long and intensive preparation, including instruction in skills and methods as well as in the scientific, historical, or scholarly principles underlying such skills and methods. A profession should maintain high standards of achievement and conduct. A profession should commit its members to continued study and to a kind of work which has for its prime purpose the rendering of public service. A true profession embraces the fiduciary standard, the highest standard of conduct under the law.

It is now possible to envision a future for the regulation of financial advisors containing many diverse elements, including the following:

1. *Functional regulation of financial advisors.* Only financial advisors subject to broad fiduciary duties of due care, loyalty, and utmost good faith should be licensed to provide personal financial advisory services (including any advice relative to the suitability of any investment or insurance product to meet a client's needs).
 - a. The world should be clearly divided – arms-length transactions with product providers, and fiduciary relationships in which clients put their trust and confidence in trusted advisers.
 - b. Product providers, promoters, and wholesalers, and their representatives, should be clearly identified as such. The use of terms such as “financial,” “estate,” and “wealth” in combination with “advisor,” “planner,” or “consultant,” or similar terms, should only be permitted by fiduciary advisors in order that consumer confusion is abated.
 - c. Discussions of the features and characteristics of a product may occur by product sellers, but any advice relating to that product as to whether or not it is suitable for, or fulfills a need of, a client, or as to asset allocation, or other personal financial advice, should be prohibited unless it occurs under a fiduciary standard of conduct.
2. *Uniform or national standards.* As financial advisors often operate across state lines, efforts should continue to establish for financial advisors uniform or national standards of conduct.
3. *State regulation of individual financial advisors.* Professional financial advisors require peer oversight in order to evaluate the professional advisor's adherence to his or her duty of due care in accordance with professional standards of conduct. For this reason, state regulation of individual personal financial advisors

should exist, and state regulatory authorities should be assisted by boards of review comprised of financial advisors.

4. *Split oversight of financial advisory firms.* The SEC and the various states should retain split, but not preemptive, oversight jurisdiction for all financial advisory firms.

While reform rests in large degree with our federal and state legislators and regulators, it must also come from within. Simply put, many financial advisors need to do a better job in serving their clients. Additional educational requirements should be embraced, both for those entering the profession and also for those already within the profession. The provision of fundamental tax advice should never be subject to disclaimers by financial advisors or their firms, as tax advice is an integral part of the financial planning process. All financial advisors must become experts, and the profession of financial advisors must become perceived as a profession of trusted experts.

Reform efforts must also prohibit the wearing of a multitude of hats. It defies logic that a financial consultant can act as a fiduciary for an investment advisory account but also as a non-fiduciary for a brokerage account for the same client. Fiduciary status attaches to the relationship; it is not a function of the legal description of the account upon which advice is given, nor is it a function of the contract between the parties. Moreover, the switching of hats should be prohibited, for it inevitably leads to “bait and switch” activities and substantial confusion by, and harm to, individual consumers. Additionally, it is a gross fiction that individual consumers, faced with complex financial decisions, and unable to discern between financial advisors who are fiduciaries and those whom are not, and burdened with various behavioral biases, can provide informed consent to a change from fiduciary to non-fiduciary status.

In any efforts dedicated to the process of these reforms, the highest standard under the law – that of the fiduciary – must be preserved. Chief Judge Cardozo of the Court of Appeals of the State of New York, in an often quoted passage from his opinion in *Meinhard v. Salmon*,

249 N.Y. 458, 164 N.E. 545, 546 (1928), described a fiduciary's duty of loyalty as follows:

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.

As reform efforts continue and are increasingly set in motion, there are many unanswered questions along the way which deserve the attention and scrutiny of our leaders. How should fiduciary duties be more specifically set forth? To what extent can the scope of a financial advisory engagement be limited? What are the best practices which can be followed? How can entry into the profession of financial planning be limited to trained financial advisors, such as through better regulatory educational and testing standards? How long a transition should be afforded to those current financial intermediaries to re-train to practice under the higher standards (or to seek employment elsewhere)? Answers to these questions will arise only from a combination of ongoing research, analyses, and discussion among the many interested parties and policy makers who will aid the process of reform.

Progress in the course of human affairs often requires disruption of a kind which poses inconvenience to many. The road ahead may be difficult, and may be long. However, the challenges of the path ahead should not deter a collective march toward a better future for all Americans.

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Please submit any comments or suggestions regarding this publication to rrhoades@josephcapital.com. Thank you.

A more detailed treatment of the topics set forth in this pamphlet can be found in “Financial Intermediaries: Opportunities To Enhance Standards of Conduct” (April 2007), available at www.JosephCapital.com under “Resources” and then under “SEC Comments.”

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