

COMMON SENSE II

ADDRESSED TO
POLICYMAKERS and PARTICIPANTS
O F T H E
FINANCIAL SERVICES INDUSTRY
ON THE FOLLOWING INTERESTING
S U B J E C T S

- I. On the “Financial Crisis” and the Need for Regulatory Reform
- II. Principles to Guide Regulatory Reform Efforts
- III. Thoughts on the Present State of Affairs for American Consumers
of Financial Services and Products
- IV. Understanding Financial Services Business Models, and
Arms-Length vs. Fiduciary Relationships
- V. Legislative Reform Efforts: Enhance Protections for the
American Consumer

“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

Our legislators rightfully seek change to the regulation of financial services industry. Through gaps have emerged various poor business practices, motivated by greed. These practices have shaken the foundations of our financial system and placed at risk the very existence of many of our financial institutions. The harm extends to diminishing the prosperity and happiness of millions of Americans.

Yet legislative change for change's sake alone is not sufficient. Nor will simply filling gaps effect prudent legislation. New gaps will just emerge, leading to potential future disruption and harm.

Something more is needed. Renewed efforts by legislators must seek to install systems to guard against regulatory capture. Principles must also be established to guide the agencies of government, who must be empowered to respond to new threats as they emerge.

Key among these principles is the need to facilitate participation in the capital markets by individual Americans. But upon the heels of many scandals, trusting of the capital markets is at an all-time low. As will be seen herein, through the application of the model of fiduciary relationships, this trust can - and must - be restored.

The vision set forth in these pages is not new. It was given birth many decades ago; it has since been cultivated and expanded upon by many. It is more relevant today than ever before. The achievement of this vision, or some outcome akin to it, will require the courage and fortitude of our legislative leaders.

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I. On the “Financial Crisis” and the Need for Regulatory Reform

The seeds of the current financial crisis were sewn many years ago. With the demise of fixed brokerage commission rates in 1975, the large investment banks sought new ways to make profits. Vertical distribution channels were established, as broker-dealer firms acquired or created investment product manufacturers. In more recent years both investment banks and commercial banks have sought new ways to reap profits, often through accumulating positions in the very securities they created.

Along the way risk became mispriced, and greater leverage was undertaken. Often driven by greed and the safety of a golden parachute, leaders of our financial institutions chose to ignore the warning signs of the impending burst of an asset bubble which they, themselves, helped to create.

It might seem just that many of the financial institutions which created these systemic risks then imploded as a result of those risks, or were forced to merge with institutions perceived to be stronger. But the disruption the deleveraging process has caused extends far beyond these financial institutions. Good, sound companies often became unable to secure credit, so necessary to fund their continued operations. Family businesses failed, and continue to do so. A great many homeowners, “under water” due to unsound mortgage lending practices, have and will face foreclosure. Individual investors struggle with money market funds they are unable to access due to frozen credit markets. Millions and millions of our fellow citizens have seen their 401(k) and other investment accounts suffer horrendous losses. Beyond the statistics lie great pain and suffering for many in this world. Looking past reported economic numbers we can only begin to ascertain the heartache of so many have lost their dreams.

Could this have been prevented? Yes. But no one individual, nor institution, nor agency of government, nor sector of an industry, is to blame.

The undeniable truth is that capitalism runs on opportunism. In his landmark work, *The Wealth of Nations*, Adam Smith described an economic system based upon self-interest. This system which later became known as capitalism is described in this famous passage:

It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.

(Smith, p. 14, Modern Library edition, 1937).

As Adam Smith pointed out, capitalism has its positive effects. Actions based upon self-interest often lead to positive forces which benefit others or society at large. As capital is formed into an enterprise, jobs are created. Innovation is spurred forward, often leading to greater efficiencies in our society and enhancement of standards of living. As Adam Smith also noted, a person in the pursuit of his own interest “frequently promotes that of the society more effectually than when he really intends to promote it.” (Smith, p. 423)

Taken to excess, however, the self-interest which is so essential to capitalism can lead to opportunism, defined by Webster’s as the “practice of taking advantage of opportunities or circumstances often with little regard for principles or consequences.” A stronger word exists when consequences to others are ignored - “greed.” We might define “greed” in this context as the selfish desire for the pursuit of wealth in a manner which risks significant harm to others or to society at large. Whether through actions intentional or neglectful, when ignorance of material adverse consequences occurs, the term “greed” is rightfully applied.

Gordon Gekko in the film *Wall Street*, who famously declared that “Greed, for lack of a better word, is good,” got it wrong. Opportunism itself - acting in pursuit of one’s self-interest - does not always lead to greed. Rather, it is only when the pursuit of wealth causes significant

undue harm to others does such activity arise to the level of greed, and in such circumstance greed is not “good.”

As witnessed with recent events, unfettered capitalism can lead to greed, which in turn can cause great harm. Hence there exists the need for regulation. Regulation imposes a constraint upon the actions of persons and institutions. Good regulation permits opportunities to be pursued. It recognizes that economic activity by one person often benefits many others. Hence, good regulation encourages self-interest leading to positive effects, and may even foster benevolent behaviors toward others. Sound regulation also, when necessary, prohibits actions which materially jeopardize the welfare of our fellow citizens.

It is now readily apparent to our legislators, as well as our fellow citizens, that greed was permitted to run amuck, especially as “gaps” in our regulatory system emerged. These gaps failed to establish an environment which fostered benevolence, and failed to restrain conduct which led to great harm. In response our legislators are now faced with the prospect of “regulatory reform.” The scope of such reform efforts is unclear, but a massive restructuring of the entirety of U.S. financial services regulation is being contemplated.

It is undisputed that a well-functioning financial system is essential for a well-functioning economy. And it is altogether right to re-examine the entire regulatory structure of our financial system. As Alice Rivlin recently noted, “Like a machine gun or chainsaw or a nuclear reactor, [market capitalism] has to be inspected frequently to see that it is working properly and used with caution according to carefully thought out rules.” [Testimony, Committee on Financial Services, U.S. House of Representatives, October 21, 2008.]

But how best should regulation ensure a well-functioning financial system? How can trust between institutions be restored and maintained? How can distorted incentive structures, which led to opportunistic behaviors (arising to the level of greed) and excessive risk taking, be dismantled? And how can individuals again be given the confidence to participate in our capital markets?

II. Principles to Guide Regulatory Reform Efforts

It must first be recognized that a well-functioning financial system is not the ends, but rather the means. Our financial institutions and their products and services can and must perform several vital functions in our society, including:

- ◆ The financial system should enable savings, an essential step toward the accomplishment of individual financial goals as well as the fostering of the formation of capital.
- ◆ Through trust in financial institutions individuals should utilize a portion of their savings to participate in the capital markets. And through government incentives in situations where necessary, but by self-interest alone when government incentives are unnecessary, capital should be allocated to worthwhile endeavors.
- ◆ Through specialization of function, our financial system should promote efficiencies in modern society, enabling the entire economy to grow larger and stronger.
- ◆ Various structures seek to manage risk, and when working correctly these systems should adequately transfer risk from those less able to bear it to those more able.

To enable these functions to occur, prudent regulation is required. The overriding goal of prudent regulation is to serve to better align private rewards with the collective interest. To achieve this primary goal, legislative and government regulatory efforts should follow a set of core principles:

The principle of “smart regulation.” Prudent regulation is neither about “more” or “less” regulation, but rather the most efficient means to align private self-interest with societal needs. While all legislators should seek to make regulation simpler and more efficient, at times more regulation is needed, not less. The difficult task of weighing the costs of regulation, versus its benefits, is one reason our legislative representatives are compensated well.

The principle of “continuous fine-tuning.” Innovations in financial systems and products abound. Market structures evolve rapidly. With every set of rules prohibiting certain conduct, there will exist self-interested market participants, motivated by profit, who employ new ways to get around the rules. Recognizing that legislation often fails to quickly respond to these advances, government agencies must be provided with the authority, and encouragement, to discern new risks and rapidly address them. Given the need for delegation of authority by legislatures to government agencies, oversight of regulatory agencies by legislative bodies then becomes essential as a means of ensuring the public good.

Regulation should foster innovation, and never inhibit it.

Regulation should serve to foster, and not stifle, innovation. Moreover, the process of transformation that accompanies radical innovation – creative destruction – should not be deterred through legislative or government agency intervention (which is often requested by those practicing in dying business models).

The principle of federalism, and guarding against regulatory capture. The concept of competition between the federal government and the states was central to the framers' vision of our constitutional structure. The benefits of split, and even duplicative, oversight of the financial services industry, are readily apparent. For example, the states, rather than the SEC, have led recent enforcement efforts in the Wall Street analyst conflicts, the mutual fund trading investigations, auction rate securities, and abuses involving fee-based brokerage accounts. While there may be multiple reasons for the lack of federal agency leadership in these areas, the existence of multiple layers of government makes regulatory capture a more arduous task for interest groups – and it is well known that various players in the financial services industry devote millions and millions of dollars seeking to influence both legislative and regulatory outcomes.

Moreover, the federal-state regulatory competition has ensured, with or without regulatory capture, an alternative regime to citizens

dissatisfied with either regulator's performance. When dealing with the lifetime savings of our fellow citizens, fraud (both actual and constructive) is rampant. Consumers need to possess the means to seek the assistance of regulators in combating such fraud.

While certain areas dealing with systemic risk to the financial system may best be administered at the federal level, federal preemption of state authority to combat fraud should rarely exist. This is particularly true when dealing with the conduct of financial intermediaries in direct contact with individual consumers. In such circumstances, the states have long possessed a keen interest in protecting their citizens against harm which can be caused by actors in the financial services industry. Securities fraud is pervasive, and any federal legislation which proposes to preempt the states' ability to combat fraudulent activities should be viewed with a great deal of suspicion. Given the extent of actual and constructive fraud when *other's people money* is targeted by financial intermediaries, there should be as many "cops on the street" – both state and federal – as possible. All financial intermediaries who provide products or services in direct contact with the American consumer should be subject to regulation, inspection and oversight – by both federal and state regulators.

The principle of transparency. Enhanced disclosure obligations should be applied to a broad range of financial products and services. Disclosures should be offered in both summary form (containing key material information) and in detailed format (for consumers who desire greater information to compare). Where possible, information should be presented in formats which enable easy comparisons. All consumer disclosures should be written in plain English.

The need to foster competition. Consumers should possess choices as to the means by which they access the capital markets and receive information and advice. However, calls for "competition" should not be utilized to cloud the need for consumers to also possess a clear understanding of the duties owed (or not owed) by the financial product provider or financial services intermediary. Moreover,

functional regulation requires that those performing the same functions be subject to the same standards of conduct.

The recognition that information asymmetry is vast and will never disappear. Disparities in the availability of information, or its quality, or its understanding, lead to advantages by those endowed with the ability to decipher, discern and apply the information correctly. It must be recognized that efforts to enhance financial literacy, while always worthwhile and important, will never transform the ordinary American into a wholly knowledgeable consumer of financial products and services. Given the sophisticated nature of modern financial markets and complex array of investment products, it is not just the uneducated that are placed at a substantial disadvantage. Hence, other means are necessary to negate advantages brought on by information asymmetry

The need to embrace fiduciary principles for certain actors. Because of the vast information asymmetry, and the many behavioral biases consumers possess which deter them from effectively spending the time and effort to read and understand mandated disclosures, there exists a great need for financial and investment advice. In such situations, our fellow citizens place trust and confidence in their personal financial advisor. It is right and just in such circumstances that broad fiduciary duties be applied to these financial intermediaries, as well as competency standards establishing an appropriate baseline for the vast knowledge a personal financial advisor must possess to deliver quality advice to individual consumers. The absence of appropriate high educational and ethical standards for all providers of personal financial advice is a glaring current gap in the financial services regulatory structure.

The need to ensure distinctions between the types of financial intermediaries. Individual consumers should be empowered to more easily identify the difference between the financial advice role (to which fiduciary status should attach) and the product marketing role (an arms-length relationship, to which only certain lesser obligations,

such as ensuring suitability, apply). Currently these roles are closely intertwined, and it is exceedingly difficult for consumers to distinguish between them (in part because the product marketer type of intermediary possesses no incentive to make that distinction clear).

The need to ensure adequate consumer redress. Effective dispute resolution and disciplinary processes should occur under a statutory based regime, including penalties for non-compliance by actors in the financial services industry. In addition to government sanctions, effective remedies for consumers, through independent dispute resolution mechanisms, are crucial to the promotion of consumer confidence in the financial services industry and, by extension, the participation by consumers in the capital markets.

The need to guard against regulatory ineffectiveness, often a byproduct of reform efforts. Government agencies which possess a greater focus on a particular area of regulation often better regulate that area than broader agencies, which are often hampered by the need or desire to divert resources elsewhere. At the same time, the effectiveness of regulation is also served by reducing the number of responsible agencies so as to eliminate overlap and reduce jurisdictional disputes over the regulation of gaps. The key is to find the correct balance. Each call for regulatory consolidation must be carefully considered. In such regard, legislators should focus their examination not just on regulatory weaknesses or gaps, but also on areas that are working well. The expertise needed to oversee a complex area of regulation must be maintained. Calls for efforts to transform or consolidate existing agencies should not diminish agencies' resources in the continuation of regulatory efforts that are proceeding well at present. The perceived need for a "crisis manager" – an overriding federal agency to coordinate efforts in times of crisis – does not lead to the inevitable conclusion that all government agencies should be melded into one. Nor should the independence of certain agency heads or commissioners (who by design, are sometimes not subject to termination by the executive) be sacrificed casually.

III. Thoughts on the Present State of Affairs for American Consumers of Financial Services and Products

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 and 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 had increased, so has the knowledge gap between individual consumers and 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 then will act 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. However, 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, many financial advisors have been trained by consultants to first 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” of either the product or the service 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 that consumers 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 "hidden fees and costs" found in many 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. Policies have been adopted which have exacerbated, rather than solved, consumer confusion.

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. Understanding Financial Services Business Models, and Arms-Length vs. Fiduciary Relationships

Three Distinct Business Models. There exist three business models for the delivery of financial services and products to consumers:

1. Issuer or product manufacturer → Customer

Under the first model, the issuer of a security or financial product (whether it be a certificate of deposit, stock, bond, mutual fund, insurance product, or otherwise) engages in marketing of the product directly to the consumer. In this situation an arms-length (“caveat emptor”) relationship exists between the parties.

2. Issuer or Product Manufacturer → Broker-Dealer or Insurance Agent → Customer

Under this second model, a registered representative (i.e., stockbroker) or insurance agent functions as the representative of multiple issuers of products. Generally the financial intermediary is compensated by the product issuer. This situation also involves an arms-length relationship between the parties.

3. Client → Investment Adviser → Issuers or Product Manufacturers

In this third business model, the client engages a trusted advisor for financial and/or investment advice. The investment adviser acts as the client’s representative in choosing the best investment products to meet the client’s needs.

Arms-Length vs. Fiduciary Relationships. As indicated by the foregoing discussion, there are two types of relationships between product and service providers and their customers or clients, under the law. The first form of relationship is an “arms-length” one. This type applies to the vast majority of service provider – customer engagements. In these relationships, the doctrine of “caveat emptor” generally applies, although this doctrine is always subject to the

requirement of commercial good faith. Additionally, this doctrine may be modified by imposition of specific rules or doctrines by law, such as the “full disclosure” regime contemplated by securities laws and “suitability” requirements imposed upon registered representatives of broker-dealer firms (i.e., stockbrokers).

The second type of relationship is a fiduciary relationship. This involves a relationship of trust, which necessarily involves vulnerability for the party who is reposing trust in another. In such situations one's guard is down; one is trusting another to take actions on one's behalf. Under such circumstances, to violate a trust is to violate grossly the expectations of the person reposing the trust. Because of this, the law creates a special status for fiduciaries, imposing duties of loyalty, care, and full disclosure upon them. Hence the law creates the “fiduciary relationship,” which requires the fiduciary to carry on with their dealings with the client (a.k.a. “entrustor”) at a level far above ordinary, or even “high,” commercial standards of conduct.

The fiduciary relationship is characterized by the fact that the specific conduct of the fiduciary cannot be circumscribed by the client in advance. Hence – to avoid self-dealing – the fiduciary duty of loyalty is imposed by law in order to compel the fiduciary to act in the best interests of the client, and not out of the fiduciary's self-interest. In the securities law context, fiduciaries are prohibited (within the bounds of their own reasonable compensation, and with certain exceptions) to misappropriate the economic value which can be obtained for the client from their management or advisory services for their own benefit.

Why Are Fiduciary Duties Imposed by Law? The imposition of fiduciary obligation facilitates the efficient allocation of resources by protecting the beneficiary of the fiduciary relationship from overreaching by the provider of services. Typically, that provider is a professional who specializes in the provision of that service. The specialization of function forces individuals to rely on others to produce goods and services on fair terms. That reliance has necessarily

afforded the opportunity for specialists to act in a self-interested fashion at the expense of the client by using their superior knowledge or skills. Accordingly, the fiduciary standard is applied to minimize the transaction costs of regulating specialized exchanges.

To promote the efficiency gains of specialization, society imposes special regulations on occupational groups having the greatest latitude to drive hard bargains, such as those in confidential relationships with clients. The activities of the fiduciary are, therefore, policed by imposing certain duties upon the specialist-fiduciary; these duties are imposed to avoid the inefficiencies resulting from specialist overreaching. Accordingly, the fiduciary's duty of loyalty requires the fiduciary to follow the course of conduct the beneficiary would have chosen if the beneficiary had either the same expertise as the fiduciary or had consulted another fiduciary.

In essence, fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment advisor services or legal services, in recognition of the value such services provide to our society. Such recognition does not come solely from statutory law, such as by the application of fiduciary duties upon registered investment advisers by the Investment Advisers Act of 1940 and by portions of the Uniform Securities Act (adopted in various forms by the states). Another body of law serves to apply fiduciary status upon certain financial intermediaries.

State common law applies fiduciary status to many of those who provide financial and/or investment advice in relationships of trust and confidence, regardless of how they are regulated. A variety of facts might give rise to a finding fiduciary status for a financial intermediary. Actually providing financial advisory services to an unsophisticated client is a key factor. However, nearly as important in some of the decisions is the use of titles, such as "financial planner," "financial advisor," "investment planner," "investment counselors," and "estate planner," which denote the existence of a relationship based upon trust and confidence. Also, in determining whether a fiduciary

relationship exists, state courts consider a variety of other factors, including whether there is dependence and inequality based on weakness of age or mental strength, lack of business intelligence, inferior knowledge of facts involved, or other factors giving one side an advantage over the other.

V. Legislative Reform Efforts: Enhance Protections for the American Consumer

It is commonly argued by those seeking to influence securities legislation or regulation that the financial world has changed. *Yes, it has.* With the continuing evolution of Modern Portfolio Theory and its offshoots, the explosion in the number and type of mutual funds and other products, the presence of exotic products designed to either assume or alleviate risks, and the “hidden fees and costs” of many investment products, it is a far more complex world for consumers than that which existed in 1940. The “knowledge gap” between consumers and financial advisors has never been greater.

Hence, fiduciary principles – which are imposed when there is a placement of trust and a substantial disparity in knowledge – are even more relevant now. The fiduciary principles of the Advisers Act, and those arising from state common law, are indeed more relevant today than ever in this ever-more-complex financial world.

Participation in the capital markets fails when consumers deal with financial intermediaries who cannot be trusted. As stated by Professor Tamar Frankel, long the leading scholar in the area of fiduciary law:

I doubt whether investors will commit their valuable attention and time to judge the difference between honest and dishonest ... financial intermediaries. I doubt whether investors will rely on advisors to make the distinction, once investors lose their trust in the market intermediaries. From the investor's point of view, it is more efficient to withdraw their savings from the market.

[Tamar Frankel, “Regulation and Investors’ Trust In The Securities Markets,” 68 Brook. L. Rev. 439, 448 (2002).] Hence, the fiduciary

principle is the paramount answer to the question, “How do we restore trust by Americans in our financial institutions.”

At the same, time, some regulatory consolidation may be undertaken to promote efficiency and in order to provide for greater coordination, particularly in times of crisis. However, other agencies should be kept apart and separate, to ensure each agency’s resources are applied effectively and that those resources are not diminished by competing needs. To avoid diminishment of the high standards of conduct required of fiduciaries, regulatory organizations which regulate them should remain separate and distinct from regulatory organizations which regulate actors in arms-length relationships with their customers. Additionally, regulatory overlap should continue when the presence of such overlap, whether the resulting competition is between federal regulatory agencies or between diverse federal and state agencies, substantially hinders fraudulent activities or regulatory capture.

During the upcoming efforts to effect regulatory reform, legislators are encouraged to carefully consider not only maintaining, but also enhancing, the protections afforded to consumers. Various structures should be explored to keep pace with our modern, more complex financial world.

In undertaking regulatory reform, legislators should first seek to further understand the various business models for the delivery of financial products and services. Legislators should be aware of the compelling need to make these business models distinct and separate in the eyes of the consumer, and the imperative to apply to each business model the appropriate standards of conduct.

Where trust and confidence is placed by the consumer in the financial advisor, the fiduciary standard of conduct should be applied at all times. The creation of one or more new professional regulatory organizations for the regulation of all personal financial advisors will serve to bridge one major gap which has arisen in our nation’s evolving financial system.