

October 16, 2009

Honorable Christopher Dodd  
Chairman

Honorable Richard Shelby  
Ranking Member

Senate Committee on Banking  
Washington, DC 20510

Honorable Barney Frank  
Chairman

Honorable Spencer Baucus  
Ranking Member

House Financial Services Committee  
Washington, DC 20515

**Re: Section 103 of the Discussion Draft, Investor Protection Act of 2009**

Dear Chairman Dodd, Ranking Member Shelby, Chairman Frank and Ranking Member Bachus:

We write in our capacities as members of the academic, legal, compliance, and registered investment adviser communities, to express our strong support for preserving the current fiduciary standard of conduct found in the Investment Advisers Act of 1940. We express our deep concern over proposals advanced by some participants in the securities industry which would create a far lower standard for firms and individuals who provide investment advice.

In order to correct misunderstandings as the nature and effect of various proposals, and to facilitate a greater understanding of the fiduciary standard of conduct, we offer the following observations:

1. The Proposed Legislation Would Result in a Lowering of Standards of Conduct Upon Those Who Provide Investment Advice. The highest standard under the law<sup>i</sup> – the fiduciary standard of conduct – currently applies under the Investment Advisers Act of 1940<sup>ii</sup> and the common law<sup>iii</sup> of the various states to those who provide investment and financial advice. The proposed legislation<sup>iv</sup> would result in a lower standard of conduct for investment advisers, and hence less protection for all Americans who desire and who receive financial and investment advice, by adopting an arms-length standard of conduct for investment advisers in place of the fiduciary standard of conduct, as explained herein.
2. “Personalized Investment Advice” Includes Advice Provided to “Non-Retail” Clients. The Advisers Act is applied to all advisers’ clients, whether “retail”<sup>v</sup> or otherwise. The argument that that only “personalized investment advice” to “individual investors” was intended to be covered by the Advisers Act is mistaken. The term “personalized” used in connection with the phrase “investment advice” refers not to the nature of the client, but rather to the activities of the investment adviser.<sup>vi</sup> There exists no justification for narrowing the scope of the Advisers Act by excluding non-retail clients, such as endowment funds, government entities, pension funds, trustees, and many others, from the protections afforded by the fiduciary standard of conduct.
3. There Exists Only One Fiduciary Standard of Conduct for Investment Advisers; It is Uniformly Applied. When the fiduciary standard of conduct is applied to financial advisors and investment advisers, whether *such* standard is imposed by the Advisers Act or state common law, it has been applied *uniformly* by the courts to financial advisors and investment advisers. There are not “51 different standards,” as has been suggested by some advocates of a “new federal fiduciary standard” (which is not a fiduciary standard at all). Only one fiduciary standard of conduct exists under the law for investment advisers and financial advisors;<sup>vii</sup> there is no need to modify this one standard. Even if such uniform standards did not already exist, legislation which instead applies the currently existing one fiduciary standard of conduct to all providers of financial and investment advice would cure the very complaints of those who mistakenly give the impression that “51 different standards” exist. Furthermore, this uniform standard has been established and refined in years of interpretation by the courts and the regulators. A new “unified standard” will erase the rich history of the current law.

4. The Fiduciary Standard of Conduct Must Remain Flexible to Address Fraud. It has long been acknowledged under the law that fiduciary duties must adapt in order that fraudulent conduct, which is always changing, be successfully prohibited and punished.<sup>viii</sup> Any attempt to further “define” the fiduciary standard of conduct through legislation could effectively negate the ability of courts of equity to react to the ever-changing field of investment and financial planning advice and to new schemes cooked up by fraudsters.<sup>ix</sup>
5. The “New Federal Fiduciary Standard” as Proposed is Not A Fiduciary Standard of Conduct; How Fiduciaries Deal with Conflicts of Interest. Advocates of a “new federal fiduciary standard” have implied that “disclosure” of a conflict of interest, followed by the “consent” of the client to proceed with the transaction, is all that is required of the fiduciary. This view takes into account only the disclosure-based regime of either the Securities Act of 1933 or the Securities Exchange Act of 1934 which contemplate an arms-length relationship<sup>x</sup> between the issuer or broker and customer. In contrast, the Advisers Act requires much more of those in fiduciary relationships with their clients. In the presence of a conflict of interest, fiduciary law protects the client by obligating the fiduciary to: (1) *affirmatively disclose all material facts* to the client; (2) ensure *client understanding* of the transaction, the conflict of interest which exists, and their ramifications; (3) obtain an *intelligent, independent and informed consent* from the client; and (4) ensure that the proposed transaction, even with client consent, remains a *substantively fair arrangement* for the client.<sup>xi</sup>
6. Consumer Choice Remains; Investors Will Retain Access to a Broad Array of Products. The issue of “consumer choice” is a red herring.<sup>xii</sup> The same investment product choices will remain for Americans. The issues are the standard of conduct for those who offer investment and financial advice, and the representations and inferences<sup>xiii</sup> made by providers with regard to their duties toward the client. The fiduciary standard of conduct possesses real teeth, as it imposes affirmative obligations of loyalty, utmost good faith and due care on the advisor, which duties continue throughout the life of the relationship. It is not, and should not become, a check-the-box standard that only periodically applies, as individual investors rarely possess the knowledge necessary to negotiate for the standard of conduct which the advisor should provide.<sup>xiv</sup>
7. Commission-Based Compensation Is Not Prohibited Under the Advisers Act; Third-Party Compensation Arrangements Create Difficulties, But These Should Be Resolved Through Best Practices, Not Legislation. Commission-based compensation is not specifically prohibited under the current Advisers Act; there is no need to specify in legislation that commission-based compensation is permitted, and inclusion of such a paragraph could inadvertently be construed as permitted self-dealing, a lowering of the fiduciary standard. Commission-based compensation leads to conflicts of interest which must be affirmatively disclosed and properly managed, as discussed above. The even more difficult problem a fiduciary faces is when *variable compensation* is present. In this regard, the securities industry could adopt the approach of agreed-to-in-advance *level compensation* as a “best practice.” Those who seek to provide investment advice should adapt to the higher standard of conduct imposed upon investment and financial advisors; the law should not be revised to accommodate the sales practices of Wall Street’s broker-dealer firms operating under the guise of unbiased advice.<sup>xv</sup>
8. The *Bona Fide* Fiduciary Standard of Conduct is Essential for Americans, and America Itself. Strong practical and public policy reasons exist for the imposition of the true fiduciary standard of conduct upon investment advisers and financial advisors.<sup>xvi</sup> The increased complexities of today’s modern capital markets and the difficult decisions today’s Americans face in preparing for their own financial futures provide an even greater rationale for the fiduciary standard of conduct established in the Advisers Act.<sup>xvii</sup>

9. The Proposed Legislation Which Would Lower Standards of Conduct for Investment Advisers and Financial Advisors, Following a Global Economic Crisis Caused In Large Part by Broker-Dealer Firms, Would Undermine the Investors' Trust in Our Capital Markets. Restoring individual investor's trust in our capital markets system is essential. It would be ironic indeed if the economic crisis is used by lobbyists, who represent the very same firms whose risk-taking led in substantial part to the current recession. It would be tragic if they succeed in convincing Congress to lower the standards of conduct for providers of investment advice to our fellow Americans, instead of tightening the standards.
10. If a New Standard of Conduct is to be Adopted, Don't Call it a "Fiduciary Standard." Fiduciary standards are applicable to many who are in positions of trust and confidence. The lowering of a "fiduciary standard" as to one fiduciary actor could result in a slippery slope, in which the fiduciary standards of conducts are subsequently lowered for attorneys, trustees, ERISA plan sponsors and advisors, and many other forms of fiduciaries. Congress should not proceed down this path of enacting "particular exceptions" which would "denigrate" the one fiduciary standard of conduct.<sup>xviii</sup>
11. Harmonization" Should Not Lower Standards of Conduct. It has been recognized that brokers have recently changed their business practices to act and look more like advisers, and to refer to themselves using terminology which denotes an advisor-client fiduciary relationship based upon trust and confidence. In contrast, the business practices of investment advisers have not generally changed in the nearly seven decades since the Advisers Act of 1940 was adopted. The proposed "harmonization" seeks to make investment advisers look more like brokers,<sup>xix</sup> and transforms the current fiduciary relationship between investment advisers and their clients into a contractual arms-length relationship. This proposed standard matches the far lower past suitability standard, but is advanced under the guise of a new "federal fiduciary standard." This attempt at "harmonization" has no foundation in investor protection.<sup>xx</sup>

**Conclusion.** As Congress works to restore the vitality of the U.S. economy, renew investor confidence, and address failures of and weaknesses in, the current regulatory framework, the undersigned express our strong support of the proposal in the Obama Administration's white paper on financial regulatory reform to require that "broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers."

Federal investor protection laws since 1933 have been largely developed by Congress to strengthen, supplement and enhance co-existing state laws for the protection of investors and not to deny investors the common law protections they already possess. The Investor Protection Act of 2009, as proposed in the "Discussion Draft" dated Oct. 1, 2009, would – to the extent it would take away the common law protections applicable to fiduciaries – place investors in a lower caste or subclass; such investors would be denied the protections afforded by common law to all other beneficiaries of fiduciary duties. If this should become Congressional policy, it would contradict and undermine the Congressional policy which led to federal securities regulation in the first place.

We urge Congress to revise the draft of the Investor Protection Act of 2009 to: (1) unambiguously provide for the fiduciary standard of conduct, as developed over centuries of common law and applied with remarkable consistency by civil, probate and other courts across this great nation to those brokers who choose to offer investment advice, whether to individuals or entities; and (2) ensure that the fiduciary duty which already exists under the Advisers Act is not undermined or weakened in any way. Such an approach will enhance investor protection, reduce investor confusion, and promote regulatory fairness and efficiency by establishing the same fiduciary duty for all investment professionals who provide investment and financial advice.

Our fellow Americans deserve no less.

Sincerely,

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University of Pennsylvania

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Texas Tech University

Jill E. Fisch,  
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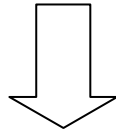
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**Exhibit A: The Distinction: Arms-Length (Broker) vs. Fiduciary (Adviser) Relationships**

**ARMS-LENGTH SALES RELATIONSHIPS**

**PRODUCT MANUFACTURERS,  
SECURITIES ISSUERS,  
SECURITIES DEALERS**

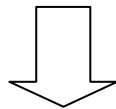
Providers of mutual funds, ETFs, annuities, life insurance products, stocks, bonds, hedge funds, and other financial products



**REPRESENTATIVE OF MANUFACTURERS  
/ ISSUERS (BROKERAGE FIRM /  
REGISTERED REPRESENTATIVE / LIFE  
INSURANCE BROKERS AND AGENTS)**

Providers / distributors of mutual funds, ETFs, annuities, life insurance products, stocks, bonds, hedge funds, and other financial products

Securities brokers and dealers receive commissions and other forms of compensation (payment for shelf space, soft dollar compensation) paid by product manufacturers



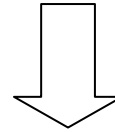
**CUSTOMER**

Entitled to rely on the “good faith” of the broker, dealer, or seller, enhanced by the requirement that any product sold be “suitable” to the customer’s needs (which relates mainly to product-specific risks, not to the fees, costs, or tax consequences of the product)

**FIDUCIARY ADVISORY RELATIONSHIPS**

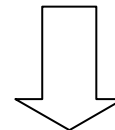
**CLIENT**

Seeks out a trusted advisor for guidance. Requires expert advice to navigate the complexities of the modern financial world.



**REPRESENTATIVE of CLIENT  
(PURCHASER): INVESTMENT ADVISER /  
FINANCIAL ADVISOR**

Bound to represent the best interests of the client at all times. Possessing broad fiduciary duties of due care, loyalty, and utmost good faith toward the client.



**PRODUCT MANUFACTURERS / ISSUERS /  
SECURITIES DEALERS**

Investment product / securities providers.

Increased competition to develop products and more choices, due to presence of knowledgeable advisors acting as representatives of the purchaser.

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<sup>i</sup> The fiduciary standard of conduct is consistently described by the courts as the “highest standard of duty imposed by law.” See, generally *Black's Law Dictionary* 523 (7th ed. 1999) (“A duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another.”); also see *F.D.I.C. v. Stahl*, 854 F.Supp. 1565, 1571 (S.D. Fla., 1994) (“Fiduciary duty, the highest standard of duty implied by law, is the duty to act for someone else's benefit, while subordinating one's personal interest to that of the other person); and see *Perez v. Pappas*, 98 Wash.2d 835, 659 P.2d 475, 479 (1983) (“Under Washington law, it is well established that ‘the attorney-client relationship is a fiduciary one as a matter of law and thus the attorney owes the highest duty to the client.’”), cited by *Bertelsen v. Harris*, 537 F.3d 1047 (9th Cir., 2008).

<sup>ii</sup> As stated by the U.S. Supreme Court: “As we have previously recognized, §206 [of the Advisers Act] establishes ‘federal fiduciary standards’ to govern the conduct of investment advisers, *Santa Fe Industries, Inc. v. Green*, supra, 430 U.S., at 471, n. 11, 97 S.Ct., at 1300; *Burks v. Lasker*, 441 U.S. 471, 481-482, n. 10, 99 S.Ct. 1831, 1839, 60 L.Ed.2d 404; *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192, 84 S.Ct. 275, 282-283, 11 L.Ed.2d 237. Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations. See H.R.Rep.No.2639, 76th Cong., 3d Sess., 28 (1940); S.Rep.No.1775, 76<sup>th</sup> Cong., 3d Sess., 21 (1940); SEC, Report on Investment Trusts and Investment Companies (Investment Counsel and Investment Advisory Services), H.R.Doc. No.477, 76th Cong., 2d Sess., 27-30 (1939).” *Transamerica Mortgage Advisors, Inc v. Lewis*, 444 U.S. 11, 17-18, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979).

The Advisers Act's fiduciary duties are based upon, and codified, state common law which applied fiduciary duties upon relationships based on trust and confidence as a means of preventing constructive fraud. As stated by the U.S. Supreme Court: “Congress codified the common law ‘remedially’ as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries ... Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation ‘enacted for the purpose of avoiding frauds,’ not technically and restrictively, but flexibly to effectuate its remedial purposes.” *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

The Congress has continuously incorporated the common law of fiduciary duty into numerous federal statutes by simply using the words “fiduciary duty” - see, e.g., §36(b), Investment Company Act, and ERISA. The Supreme Court has repeatedly held that “where Congress uses terms that have settled meaning under common law ... Congress means to incorporate the established meanings of these terms.” *NLRB v. Amax Coal Co.*, 53 U.S. 322, 101 S.Ct. 2789, 69 L.Ed.2d 672 (U.S.1981) (adopting *Meinhard's* fiduciary standard).

The existence of a “federal fiduciary standard” under the Investment Advisers Act of 1940 does not mean that deference is not provided to the scope of fiduciary duties as they exist under state common law. See *U.S. v. Brennan*, 938 F.Supp. 1111 (E.D.N.Y., 1996) (“Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law. See, e.g., *Varity v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996); *F.D.I.C. v. Wright*, 87 B.R. 1011 (D.S.D. 1988) (bankruptcy).”) *Id.* at 1119.

<sup>iii</sup> The recognition of the existence of a fiduciary relationship under the common law is said to consist of two main branches. 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. When a personal financial advisor accepts actual discretion over a client's account, under this branch of fiduciary relationships fiduciary status for the advisor will result (due to the application of agency law). Various court decisions note that common law fiduciary duties arise from the principal-agent relationship, and that these duties will usually be interpreted quite broadly. In essence, since the scope of the agency includes the exercise of discretionary authority to undertake sales and

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purchases in the account, the agent (registered representative) owes a fiduciary duty to the principal (the customer) in the actions undertaken which exercise that discretion.

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. It is under this branch that most financial advisors will find fiduciary status applied by the common law.

The development of this second branch of fiduciary relationships accelerated during the 20<sup>th</sup> 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).

Many state courts, applying state common law to relationships based upon trust and confidence, have held that the relationship is or may constitute a fiduciary relationship between the financial advisor and/or investment adviser and the client. *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007) ("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."). See also *U.S. v. Williams*, 441 F.3d 716, 724 (9th Cir. 2006); *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 4430 (NY 6/2/2005) (NY, 2005); *Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 2005); *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385, 414 (S.D.N.Y., 2005) (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."); *Mathias v. Rosser*, 2002 OH 2531 (OHCA, 2002) ("[T]he evidence established that Rosser was a licensed stockbroker and held himself out as a financial advisor, and that plaintiff was an unsophisticated investor who sought investment advice from Rosser precisely because of his alleged expertise as a broker and investment advisor. Further, Rosser testified that plaintiff had relied upon his experience, knowledge, and expertise in seeking his advice. Therefore, we conclude that plaintiff presented sufficient evidence to establish that she and Rosser were in a fiduciary relationship."); *Cunningham vs. PLI Life Insurance Company*, 42 F.Supp.2d 872 (1990); *MidAmerica Federal Savings and Loan Ass'n v. Shearson / American Express Inc.*, 886 F.2d 1249 (10th Cir. 1989) (The court found a fiduciary relationship under Oklahoma law between a broker and his client in circumstances where the broker held himself out as having superior knowledge and expertise and the client reasonably placed his confidence in the broker.); *Koehler v. Pulvers*, 614 F. Supp. 829 (USDC, Cal, 1985).

Neither federal nor state securities laws generally preempt common law claims based upon breach of fiduciary duty. This is because the securities statutes were modeled after the common law actions of fraud and deceit. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-215, 96 S.Ct. 1375, 1381-1391, 47 L.Ed.2d 668 (1976) (review of legislative history); see also Securities Regulation, 69 Am.Jur.2d Sec. 1 *et seq.*

It is noted that all agents, including brokers and investment advisers, are, by definition, fiduciaries under common law, with the scope of those fiduciary duties (care, loyalty, good faith and disclosure) dependent on the powers and responsibilities assumed.

<sup>iv</sup> The text of Section 103 of the proposed Investor Protection Act of 2009, as set forth in the "Discussion Draft" as released by Subcommittee Chair Kanjorski on October 1, 2009 (available at [http://www.house.gov/apps/list/press/financialsvcs\\_dem/investor\\_protection\\_act\\_draft.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/investor_protection_act_draft.pdf)), provides:

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SEC. 103. ESTABLISHMENT OF A FIDUCIARY DUTY FOR BROKERS, DEALERS, AND INVESTMENT ADVISERS, AND HARMONIZATION OF REGULATION.

(a) IN GENERAL.—

(1) SECURITIES EXCHANGE ACT OF 1934.—Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78) is amended—

(A) by redesignating the second subsection (i) as subsection (j); and

(B) by adding at the end the following new subsections:

(k) STANDARDS OF CONDUCT.—

(1) IN GENERAL.—Notwithstanding any other provision of this Act or the Investment Advisers Act of 1940, the Commission shall promulgate rules to provide that, with respect to a broker or dealer that is providing investment advice to a retail customer (and such other customers as the Commission may by rule provide), the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940. The receipt of compensation based on commission shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer.

(2) RETAIL CUSTOMER DEFINED.—For purposes of this subsection, the term ‘retail customer’ means an individual, or the legal representative of such individual, who—

(A) receives personalized investment advice from a broker or dealer; and

(B) uses such advice primarily for personal, family, or household purposes.

(l) OTHER MATTERS.—The Commission shall—

(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers; and

(2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors.”

(2) INVESTMENT ADVISERS ACT OF 1940.—Section 211 of the Investment Advisers Act of 1940, as amended by section 102(d), is further amended by adding at the end the following new subsection:

(f) STANDARDS OF CONDUCT.—

(1) IN GENERAL.—Notwithstanding any other provision of this Act or the Securities Exchange Act of 1934, the Commission shall promulgate rules to provide that the standards of conduct for all brokers, dealers, and investment advisers, in providing investment advice to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.

(2) RETAIL CUSTOMER DEFINED.—For purposes of this subsection, the term ‘retail customer’ means an individual, or the legal representative of such individual, who—

(A) receives personalized investment advice from a broker, dealer, or investment adviser; and

(B) uses such advice primarily for personal, family, or household purposes.

(g) OTHER MATTERS.—The Commission shall—

(1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their 3 relationships with brokers, dealers, and investment advisers; and

(2) examine and, where appropriate, promulgate rules prohibiting sales practices, conflicts of interest, and compensation schemes for financial intermediaries (including brokers, dealers, and investment advisers) that it deems contrary to the public interest and the interests of investors.

(b) HARMONIZATION OF ENFORCEMENT AND REMEDY REGULATIONS.—Section 15 of the Securities Exchange Act of 1934, as amended by subsection (a), is further amended by adding at the end the following new subsection:

(m) HARMONIZATION OF ENFORCEMENT AND REMEDY REGULATIONS.—The Commission shall issue regulations to ensure, to the extent practicable, that the enforcement options and remedies available for violations of the standard of conduct applicable to a broker or dealer providing investment advice to a retail customer are commensurate with those enforcement options and remedies available for violations of the standard of conduct applicable to investment advisers under the Investment Advisers Act of 1940.

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<sup>v</sup> SIFMA desires Congress to exclude all non-retail clients from the application of the Advisers Act, which would represent a significant narrowing of the current application of the Advisers Act. Mr. Taft, representing SIFMA, stated: “The federal fiduciary standard that SIFMA supports should apply to individual investors only based on our view that institutional clients are better able to – and in practice do in fact – appreciate and appropriately define the terms of their relationships with investment advisory service providers.” U.S. House Of Representatives Committee On Financial Services Hearing On: *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight Of Private Pools Of Capital, And Creating A National Insurance Office*, October 6, 2009, written testimony of John Taft, Head Of U.S. Wealth Management, RBC Wealth Management, Chairman, Private Client Group Steering Committee, Securities Industry And Financial Markets Association.

<sup>vi</sup> Rule § 275.203A-3(a)(2)(ii) defines “Impersonal investment advice” to mean “investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.” The term “accounts” refers to accounts of both retail and non-retail clients.

The Investment Advisers Act of 1940 applies to all clients of investment advisers, whether they are “retail clients” or “institutional clients.” The Advisers Act was intended to apply to “personalized investment advice” and to “fiduciary, person-to-person relationships ... and that are characteristic of investment adviser-client relationships.” *Lowe v. SEC*, 472 U. S. 181, 210 (1985). Investment counsel was characterized in the testimony leading up to the enactment of the Advisers Act “as a personal service profession, and depends for its success upon a close personal and confidential relationship between the investment counsel firm and its client. It requires frequent and personal contact of a professional nature between us and our clients ... We must establish with each client a relationship of trust and confidence designed to last over a period of time because economic forces work themselves out slowly.” *Id.* at 196-7. “The [Advisers] Act was designed to apply to those persons engaged in the investment-advisory profession -- those who provide personalized advice attuned to a client's concerns, whether by written or verbal communication.” *Id.* at 207-8. It is submitted that the term “personalized” refers not to the nature of the client, but rather to the nature of the advice being provided.

Moreover, given the existence of many forms of non-retail clients (i.e., hedge funds, pension funds, mutual funds, small endowment funds, trustees of charitable and private trusts, public entities such as villages, nonqualified retirement fund trustees, etc.) who could easily be taken advantage as a result of the vast disparity of knowledge between an investment adviser and client, and given the lack of the substantial resources to engage third party experts to monitor the actions of those providing investment advice, there appears insufficient rationale to now deny to non-retail clients of investment advisers the protections afforded by fiduciary law which they presently enjoy.

<sup>vii</sup> Despite assertions to the contrary, the fiduciary standard of conduct is nearly uniformly applied by the courts, whether the standard is imposed by the Investment Advisers Act of 1940 or state common law. The advocates for a “new federal fiduciary standard” unpersuasively argue that there exist “51” different fiduciary standards. They confuse the distinction between the various bodies of law which impose fiduciary status (i.e., *when* fiduciary duties are imposed) and the fiduciary principles which are applied when fiduciary status is found (i.e., *what* fiduciary duties exist). “The laws applicable to the situations in which fiduciary power is delegated should not be confused with the principles of fiduciary law. The *same* fiduciary principles apply to fiduciary power, and are superimposed on the *different* bodies of law governing the contexts in which that power appears.” Tamar Frankel, *Fiduciary Law*, 71 Calif. L. Rev. 795 (1983).

At the U.S. House Of Representatives Committee On Financial Services Hearing On: *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight Of Private Pools Of Capital, And Creating A National Insurance Office*, October 6, 2009, written and oral testimony in support of a “new federal fiduciary standard” was provided on behalf of SIFMA, the broker-dealer trade association, by John Taft, Head Of U.S. Wealth Management, RBC Wealth Management, Chairman, Private Client Group Steering Committee, Securities Industry And Financial Markets Association. In the written testimony, at page 8, in footnote 18, Mr. Taft cites several cases which, he concludes, support the proposition that: “fiduciary law has developed haphazardly and often inconsistently among the 50 states. Consequently, investor protection can actually grow or diminish as an

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individual investor moves from state to state.” *However*, all of these cases only address *when* fiduciary status is applied upon providers of financial advice. Under the second branch of fiduciary relationships – those which are implied by law on the basis of particular facts and circumstances evidencing a relationship based on trust and confidence. The cases provide *no support* for the proposition that the broad fiduciary duties of due care, loyalty and utmost good faith are unevenly applied. Again, Mr. Taft has mixed up the *context* to which fiduciary duties are applied, and fails to note that the fiduciary principles, once applied by the courts, are very uniformly applied. There does not exist “51” different fiduciary standards of conduct, as Mr. Taft suggests – there is only one fiduciary standard of conduct, and it is well-developed under the law and evenly applied by the courts of all fifty states and the federal courts.

Moreover, the question before Congress is whether to reverse the direction taken by the U.S. Securities and Exchange Commission (SEC) in recent years, in which it has permitted stockbrokers to engage in the delivery of financial and investment advice in an amount which clearly exceeds that permitted under the “solely incidental” language found in the broker-dealer exemption from the Advisers Act. A clear statement by Congress to apply fiduciary standards of conduct to all those who provide investment and financial advice is suggested as a means of rectifying the SEC’s interpretation of the “solely incidental” language in such a broad manner that it challenges both the expressed intent of Congress in its enactment of the Advisers Act as well as the validity of the phrase, “words have meaning.” Legislation which reverses the SEC’s course, by clearly applying fiduciary standards to all providers of financial and investment advice, would create the very uniform application of fiduciary standards which SIFMA complains about does not exist. Moreover, it will avoid continued judicial challenges to the efficacy of the SEC’s exercise of its rule-making authority.

In conclusion, as stated by one of our current SEC Commissioners: “There is only one fiduciary standard ....” SEC Commissioner Luis A. Aguilar, Speech, “SEC’s Oversight of the Adviser Industry Bolsters Investor Protection” (May 7, 2009).

It should be noted that this one fiduciary standard is then given further elaboration in the United States through the frequently-referred to triad of broad fiduciary duties – due care, loyalty, and utmost good faith. *See, e.g., Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001) (“The presumption [afforded by the business judgment rule] can be rebutted by showing that the board violated “any one of its triad of fiduciary duties: due care, loyalty, or good faith.”); *also see Malone v. Brincat*, 722 A.2d 5 (DE, 1998) (“The director’s fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty. That tripartite fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided.”) *See also Von Noy v. State Farm Mutual Automobile Insurance Company*, 2001 WA 80 (WA, 2001) (Justice Philip Talmadge, concurring opinion) (“A fiduciary relationship is a relationship of trust, which necessarily involves vulnerability for the party reposing trust in another. 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. One can call this the fiduciary principle.”)

Very recent cases applying fiduciary law in other contexts confirm the uniformity of the application of the fiduciary standard of conduct. *See Robinson v. Global Resources, Inc.*, A09A1682 (Ga. App. 9/3/2009) (Ga. App., 2009) (“Defendants were in a confidential fiduciary relationship with 1st Affinity (or ABI) and owed Plaintiff the highest duties of due care, loyalty, honesty, good faith, and fair dealing.”) *Dubroff v. Wren Holdings, LLC*, C.A. No. 3940-VCN (Del. Ch. 5/22/2009) (Del. Ch., 2009) (“The Delaware Supreme Court has held that [w]henver directors communicate publicly or directly with shareholders about the corporation’s affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty.”).

<sup>viii</sup> Fiduciary duties must evolve over time to meet the ever-changing business practices of advisors and fraudulent conduct successfully circumscribed. *See Stonemets v. Head*, 248 Mo. 243, 154 SW 108 (1913), in which Judge Lamb of the Missouri Supreme Court stated:

Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly

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circumvented at once by new schemes beyond the definition. Messieurs, the fraud-feasors, would like nothing half so well as for courts to say they would go thus far, and no further in its pursuit.

See also Justice Douglas in *Pepper v. Litton*, 308 U.S. 295, 311 (1939), wherein he stated:

He who is in such a fiduciary position cannot serve himself first and his cestuis second ... He cannot use his power for his personal advantage and to the detriment of [the cestuis], no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis, Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation ... Otherwise, the fiduciary duties ... would go for naught: exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart.

<sup>ix</sup> The broad judicial descriptions of the fiduciary duty of loyalty, *e.g.*, by Justice Cardozo in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928), and by the U.S. Supreme Court in *Michoud v. Girod*, 45 U.S. 503, 4 How. 503, 11 L.Ed. 1076 (1846), were deliberately designed to discourage marginal conduct by making it difficult for fiduciaries to determine the point at which self-serving conduct will be prohibited and thus encouraging conduct well within the borders--the common law of fiduciary duties was developed to perform a prophylactic function; as one court more recently stated, the judicial platitudes on fiduciary duty are "a judicial attempt to emphasize that the heart of a fiduciary's duty is an attitude...and a fiduciary who follows it will fulfill its obligations without the need to worry about detailed rules." *Chiles v. Robertson*, 784 P.2d 1099, 308 Or. 592 (Or., 1989).

Because fraud is by its very nature boundless, the one fiduciary standard of conduct applicable to investment advisers should not be subjected to attempts to define or restrict it legislatively, by means of any particular definition. See Speech, "Diversiform Dishonesty" by Edward H. Cashion, Counsel to the Corporation Finance Division, U.S. Securities and Exchange Commission, on November 17, 1945 to the National Association of Securities Commissioners, where in reference to Section 36 of the Investment Company Act of 1940, Mr. Cashion stated:

Like fraud, abuse of trust is not a fact but a conclusion to be drawn from facts. *The terms 'gross abuse of trust' or 'gross misconduct' should not be limited by any hard and fast definition.* Both constitute fraud in its general sense ... the interpretation of gross misconduct and gross abuse of trust as used in Section 36 will depend not only upon relevant common law principles but also upon the declaration of policy as set forth in the Act ... I believe that any substantial deviation from that codification of the fiduciary obligations imposed upon directors and officers of investment companies, ipso facto, constitutes gross misconduct and gross abuse of trust. [*Emphasis added.*]

The Investment Advisers Act of 1940 "recognizes that, with respect to a certain class of investment advisers, a type of personalized relationship may exist with their clients ... The essential purpose of [the Advisers Act] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful." *Lowe v. SEC*, 472 U.S. 181, 200, 201 (1985). "The Act was designed to apply to those persons engaged in the investment-advisory profession -- those who provide personalized advice attuned to a client's concerns, whether by written or verbal communication." *Id.* at 208. "The dangers of fraud, deception, or overreaching that motivated the enactment of the statute are present in personalized communications ...." *Id.* at 210.

<sup>x</sup> The distinction between arms-length relationships and fiduciary relationships is illustrated in Exhibit A.

<sup>xi</sup> "Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his customers." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

"When a stock broker or financial advisor is providing financial or investment advice, he or she ... is required to disclose facts that are material to the client's decision-making." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006). A material fact is "anything which might affect the (client's) decision whether or how to act." *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 227 Va. 441 (Va., 1984).

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As stated by Justice Cardozo: “If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity of reservation, in all its stark significance ....” *Wendt v. Fischer*, 243 N.Y. 439, 154 N.E. 303 (1926).

An example of the type of disclosure, when a conflict of interest is present, is revealed in a recent decision arising under the Advisers Act: “[W]hen a firm has a fiduciary relationship with a customer, it may not execute principal trades with that customer absent full disclosure of its principal capacity, as well as all other information that bears on the desirability of the transaction from the customer’s perspective.’... Other authorities are in agreement. For example, the general rule is that an agent charged by his principal with buying or selling an asset may not effect the transaction on his own account without full disclosure which ‘must include not only the fact that the agent is acting on his own account, but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction, from the viewpoint of the principal.’” *Geman v. S.E.C.*, 334 F.3d 1183, 1189 (10th Cir., 2003), quoting *Arst v. Stifel, Nicolaus & Co.*, 86 F.3d 973, 979 (10th Cir.1996) (applying Kansas law) (quoting RESTATEMENT (SECOND) OF AGENCY § 390 cmt. a (1958)).

“[T]he duty of full disclosure was imposed as a matter of general common law long before the passage of the Securities Exchange Act.” *In the Matter of Arleen W. Hughes*, SEC Release No. 4048 (February 18, 1948).

Disclosure must be timely provided. “[D]isclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent.” *In the Matter of Arleen W. Hughes*, SEC Release No. 4048 (February 17, 1948), *affirmed* 174 F.2d 969 (D.C. Cir. 1949).

The duty to disclose is an affirmative one, and the failure to disclose by an investment adviser is a violation of the Advisers Act. The fiduciary is required to ensure that the disclosure is received by the client; the “access equals delivery” approach undertaken with regard to disclosures required by the SEC under the ’33 and ’34 Acts would not qualify as an appropriate disclosure by a fiduciary financial advisor to her or his client. As stated in an early case applying the Advisers Act:

It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge material facts to the ones whose interests she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure. The statutes and rules discussed above make it unlawful to omit to state material facts irrespective of alleged (or proven) willingness or readiness to supply that which has been omitted.

*Hughes v. SEC*, 174 F.2d 969 (D.C. Cir., 1949).

The purpose of the fiduciary duty of disclosure is arming the client with sufficient information to undertake an informed decision, when the client is called upon to do so. In the context of conflicts of interest which may exist between the fiduciary and the client, the purpose of full and affirmative disclosure of material facts by a fiduciary financial planner is also to obtain the client’s informed consent to proceeding with a recommendation or transaction. Indeed, under traditional notions of fiduciary law, conflicts of interest must be avoided absent the informed consent of the client. However, “informed consent” does not exist if full disclosure of all facts is not undertaken, if the consent is induced, or if the transaction does not remain fair and reasonable to the client. As one court stated:

One of the most stringent precepts in the law is that a fiduciary shall not engage in self-dealing and when he is so charged, his actions will be scrutinized most carefully. When a fiduciary engages in self-dealing, there is inevitably a conflict of interest: as fiduciary he is bound to secure the greatest advantage for the beneficiaries; yet to do so might work to his personal disadvantage. Because of the conflict inherent in such transaction, it is voidable by the beneficiaries unless they have consented. Even then, it is voidable if the fiduciary fails to disclose material facts which he knew or should have known, if he used the influence of his position to induce the consent or if the transaction was not in all respects fair and reasonable.

*Birnbaum v. Birnbaum*, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986).

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The informed consent of the client to proceed with a transaction recommended by a fiduciary advisor in the presence of a conflict of interest would rarely be given by an informed client if the conflict of interest were not managed to keep the best interests of the client paramount at all times; clients rarely undertake gratuitous transfers to their financial advisors. Hence, courts appear to often find that there was not full disclosure, or that it was not affirmatively undertaken, or that the terms of the transaction were not fair, where the voluntary nature of the consent, or the understanding by the client of the material facts, is suspect. Such cases often arise in the context of the attorney-client relationship. See, e.g. *Schenk v. Hill, Lent & Troescher*, 530 N.Y.S.2d 486, 487 (N.Y. Sup. Ct. 1988) (a lawyer hired to sue another lawyer for malpractice was himself a potential defendant in the same action, and obtained client consent to waive the conflict of interest. In disqualifying the lawyer, the court said: “[T]he consent obtained in this case does not reflect a full understanding of the legal rights being waived ... [T]he unsophisticated client, relying upon the confidential relationship with his lawyer, may not be regarded as able to understand the ramifications of the conflict, however much explained to him.”); *Wade v. Clemmons*, 377 N.Y.S.2d 415, 419 (N.Y. Sup. Ct. 1975) (striking down contingent fee because client would have refused to agree to settlement offer yielding fee if properly advised).

The fiduciary duty to avoid conflicts of interest, and the necessity to obtain the informed consent of the client as to conflicts of interest not avoided, were well known in the early history of the Advisers Act. In an address entitled “The SEC and the Broker-Dealer” by Louis Loss, Chief Counsel, Trading and Exchange Division, U.S. Securities and Exchange Commission on March 16, 1948, before the Stock Brokers’ Associates of Chicago, the fiduciary duties arising under the Advisers Act, as applied in the *Arleen Hughes* release, were elaborated upon:

The doctrine of that case, in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to *make a scrupulously full disclosure of every element of its adverse interest in the transaction.*

In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. *He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses.* This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law ‘acts not on the possibility, that, in some cases the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.’ Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine ‘has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, ‘Lead us not into temptation, but deliver us from evil,’ and that caused the announcement of the infallible truth, that ‘a man cannot serve two masters.’

*This time-honored dogma applies equally to any person who is in a fiduciary relation toward another, whether he be a trustee, an executor or administrator of an estate, a lawyer acting on behalf of a client, an employee acting on behalf of an employer, an officer or director acting on behalf of a corporation, an investment adviser or any sort of business adviser for that matter, or a broker. The law has always looked with such suspicion upon a fiduciary's dealing for his own account with his client or beneficiary that it permits the client or beneficiary at any time to set aside the transaction without proving any actual abuse or damage. What the recent Hughes case does is to say that such conduct, in addition ‘to laying the basis for a private lawsuit, amounts to a violation of the fraud provisions under the securities laws: This proposition, as a matter of fact, is found in a number of earlier Commission opinions. The significance of the recent Hughes opinion in this respect is that it elaborates the doctrine and spells, out in detail exactly what*

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*disclosure is required when a dealer who has put himself in a fiduciary position chooses to sell his own securities to a client or buys the client's securities in his own name ...*

*The nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases use of the term 'principal' itself may suffice. In others, a more detailed explanation will be required. In all cases, however, the burden is on the firm which acts as fiduciary to make certain that the client understands that the firm is selling its own securities ...*

*Id.* [Emphasis added.]

<sup>xii</sup> Should brokers not be providing investment advice, but instead limit their activities to the sale of an investment product in which only information about the investment product is provided (such as its characteristics, risks, fees, costs), brokers would be able to continue to engage in product sales. However, once brokers provide investment advice, they should be subject to the restrictions on *conduct* imposed by the fiduciary standard of conduct. This does not restrict what investment products may be sold. Since investment advisers possess a fiduciary duty of care, and in connection therewith are required to consider the total fees and costs clients bear in association with any securities recommended, it is likely that the rise of investment advisers will serve to lower the fees and costs of many investment products, as increased competition is created due to increased demand from the knowledgeable representatives of their clients.

<sup>xiii</sup> Brokers have, in recent years, begun to utilize titles which imply relationships based upon trust and confidence, to which fiduciary duties should apply, such as "financial advisor," "financial consultant," "wealth manager," etc. Under state common law, the utilization of such titles remains a significant factor in determining whether a fiduciary relationship exists. See, e.g., *Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 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.) To alleviate consumer confusion, only those bound by the fiduciary standard of conduct should be permitted to utilize these or similar titles, as consumers often infer that an advisory (fiduciary) relationship as opposed to a sales (arms-length) relationship exists by those who utilize such titles.

<sup>xiv</sup> 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. "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).

One commentator noted the danger of the "check-the-box" approach: "In its written testimony to the House Financial Services Committee, SIFMA argued that investors should have the 'choice to define or modify relationships with their financial services provider based upon the investor's preference' ... as a means of preserving investor choice. Under one interpretation of SIFMA's proposal, Wall Street firms could have their customers sign away the fiduciary standards of conduct by simply signing a lengthy, incomprehensible, multi-page, small print agreement when they enter into a relationship with a broker. This is contrary to fiduciary law, which clearly provides that blanket waivers of fiduciary standards are not permitted. Fiduciary standards of conduct are imposed by law on relationships based on trust and confidence, in recognition of the fact that consumers lack the ability to bargain for the correct standard of conduct." Rhoades, SIFMA's Proposed "New Federal Fiduciary Standard": Consumer Protection ... or "A Wolf in Sheep's Clothing"? (Advisor Perspectives, July 21, 2009), available at [http://www.advisorperspectives.com/newsletters09/pdfs/SIFMAs\\_Proposed\\_New\\_Federal\\_Fiduciary\\_Standard.pdf](http://www.advisorperspectives.com/newsletters09/pdfs/SIFMAs_Proposed_New_Federal_Fiduciary_Standard.pdf).

<sup>xv</sup> Marketing investment advisory services or financial planning services as a means to effect the sale of securities may well violate the anti-fraud provisions of Section 206 of the Advisers Act. See *Elmer D. Robinson*, SEC No-Action Letter (Jan. 6, 1986); *Nathan & Lewis*, SEC No-Action Letter (Apr. 4, 1988). [However, a broker-dealer that employs terms such as "financial planner" merely as a device to induce the sale of securities might violate the antifraud provisions of the Securities Act of 1933 and the Exchange Act. Cf. *In re Haight & Co., Inc.*, Securities Exchange Act Release No. 9082 (Feb. 19, 1971) (Broker-dealer defrauded its customers in the offer and sale of securities by

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holding itself out as a financial planner that would give comprehensive and expert planning advice and choose the best investments for its clients from all available securities, when in fact it was not an expert in planning and made its decisions based on the receipt of commissions and upon its inventory of securities.))”

Professor Tuch noted that: “The standard of conduct required of the fiduciary is not diminished by reason of its organizational structure.” Tuch, Andrew, “The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife with Conflicts of Interest” (January 2008).

<sup>xvi</sup> A review of the reasons behind the imposition of fiduciary status is essential to gaining an understanding of subsequent issues which arise in the application of fiduciary duties. The rationale for imposition of fiduciary duties involves a combination of the disparity in knowledge between fiduciaries and their entrustors (clients), the high costs of monitoring fiduciary conduct, and the promotion of public policy.

A. *The Increased Knowledge Gap Between Financial Advisors and Consumers in Today’s Complex Financial World.* Without question there exists a substantial knowledge gap between fiduciary investment advisers and the vast majority of their clients in today’s modern, complex financial world. Indeed, the world is far more complex for individual investors today than it was just a generation ago. There exists a broader variety of investment products, including many types of 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.

“With the increasing complexity of the financial system, the wide range of choices available and the role of compulsory savings, advice is playing an ever important role for consumers ... Deregulation has created a large number of investment alternatives and means of accessing them ... that the first priority for most people is to seek advice on the financial strategy that best suits their circumstances. The selection of investment products is secondary, yet still this requires access not only to information on the numerous investments available in the market but also analysis and application of that information to individual circumstances ... Strategy plays a key role in effective financial decision making and most consumers will not be in a position to develop their own strategy ... **The average person will no more become an instant financial planner simply because of direct access to products and information than they will a doctor, lawyer or accountant.** Despite extensive information being available on drugs (via the internet and by other means) people still seek the advice of a doctor to determine an appropriate response to a medical problem and, where necessary, to prescribe the most suitable drug.” “Submission to the Financial System Inquiry by the Financial Planning Association of Australia Limited,” December 1996. [Emphasis in original.]

B. *The 1995 Tully Report Recognized the Knowledge Gap.* Even the broker-dealer industry, after careful study, acknowledged the wide disparity of knowledge between brokers and their customers in the Tully Report:

As a general rule, RRs [registered representatives] and their clients are separated by a wide gap of knowledge – knowledge of the technical and financial management aspects of investing. The pace of product innovation in the securities industry has only widened this gap. It is a rare client who truly understands the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many. This

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knowledge gap represents a potential source of client abuse, since uninformed investors have no basis for evaluating the merits of the advice they are given.

Report of the Committee on Compensation Practices (April 10, 1995), also called the “Tully Report,” at p. 15.

Yet, the Tully Report, under the influence of the Committee Chairman, Daniel P. Tully (at the time Chairman and Chief Executive Officer, Merrill Lynch & Co., Inc.), did not call for the imposition of fiduciary duties upon registered representatives (and did not even mention the word “fiduciary.”). Instead, the Report stated that the knowledge gap “makes communication between a registered representative and an investor difficult and puts too much responsibility for decision-making on the shoulders of RRs [registered representatives] - a responsibility that belongs with the investor.” Tully Report at p. 15.

Emotional biases limit consumers’ ability to close the knowledge gap. Recent insights from behavioral science call into substantial doubt some cherished pro-regulatory strategies, including the view that if regulators force delivery of better disclosures and transparency to investors that such can be utilized effectively. Calls have been heard that the SEC’s emphasis on disclosure is only part of the equation for the protection for consumers. “Two things are needed for the federal securities laws, or any disclosure-based regulatory regime, to be effective. The first is straightforward: information has to be disclosed. The second is equally straightforward, but often overlooked. That is, the users of the information – for example, investors, securities analysts, brokers, and money managers – need to use the disclosed information effectively. The federal securities laws primarily focus on the former – mandating disclosure.” Paredes, Troy A., “Blinded by the Light: Information Overload and its Consequences for Securities Regulation” (2003), available at SSRN: <http://ssrn.com/abstract=413180> or DOI: 10.2139/ssrn.413180. For years it has been known that that investors do not read disclosure documents. See, generally, Homer Kripke, *The SEC and Corporate Disclosure: Regulation In Search Of A Purpose* (1979); Homer Kripke, *The Myth of the Informed Layman*, 28 *Bus.Law.* 631 (1973). See also Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 *Stan. L. Rev.* 7, 19 (1994) (“[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures ....”); Kenneth B. Firtel, *Note*, “Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933,” 72 *S. Cal. L. Rev.* 851, 870 (1999) (“[T]he average investor does not read the prospectus ....”). For an overview of various individual investor bias such as bounded irrationality, rational ignorance, overoptimism, overconfidence, the false consensus effect, insensitivity to the source of information, the fact that oral communications trump written communications, and other heuristics and bias, see Robert Prentice, “Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future,” 51 *Duke L. J.* 1397 (2002).

The SEC’s emphasis on disclosure, drawn from the focus of the 1933 and 1934 Securities Acts on enhanced disclosures, results from the myth that investors carefully peruse the details of disclosure documents that regulation delivers. However, under the scrutinizing lens of stark reality, this picture gives way to an image a vast majority of investors who are unable, due to behavioral biases and lack of knowledge of our complicated financial markets, to undertake sound investment decision-making. As stated by Professor (now SEC Commissioner) Troy A. Paredes:

The federal securities laws generally assume that investors and other capital market participants are perfectly rational, from which it follows that more disclosure is always better than less. However, investors are not perfectly rational. Herbert Simon was among the first to point out that people are boundedly rational, and numerous studies have since supported Simon’s claim. Simon recognized that people have limited cognitive abilities to process information. As a result, people tend to economize on cognitive effort when making decisions by adopting heuristics that simplify complicated tasks. In Simon’s terms, when faced with complicated tasks, people tend to “satisfice” rather than “optimize,” and might fail to search and process certain information.<sup>xvi</sup>

Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 83 *Wash.Univ.L.Q.* 907, 931-2 (2003).

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Note as well that “instead of leading investors away from their behavioral biases, financial professionals may prey upon investors’ behavioral quirks ... Having placed their trust in their brokers, investors may give them substantial leeway, opening the door to opportunistic behavior by brokers, who may steer investors toward poor or inappropriate investments.” Stephen J. Choi and A.C. Pritchard, “Behavioral Economics and the SEC” (2003), at p.18.

Indeed, “when faced with complex, difficult and affect-laden choices (and hence a strong anticipation of regret should those choices be wrong), many investors seek to shift responsibility for the investments to others. This is an opportunity – the core of the full-service brokerage business – to use trust-based selling techniques, offering advice that customers sometimes too readily accept. Once trust is induced, the ability to sell vastly more complicated, multi-attribute investment products goes up. Complex products that have become widespread in the retail sector, like equity index annuities, can only be sold by intensive, time-consuming sales effort. As a result the sales fees (and embedded incentives) are very large, creating the temptation to oversell. In the mutual fund area, the broker channel – once again, driven by generous incentives - sells funds aggressively. Recent empirical research suggests that buyers purchase funds in this channel at much higher cost but performance on average is no better, and often worse, than readily available no-load funds.” Donald C. Langevoort, “The SEC, Retail Investors, and the Institutionalization of the Securities Markets” (Jan. 2009), prior version available at SSRN: <http://ssrn.com/abstract=1262322>.

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.” Robert Prentice, “Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis,” 2003 U.Ill.L.Rev. 337, 343-4 (2003), *citing* Jon D. Hanson & Douglas A. Kysar, “Taking Behavioralism Seriously: The Problem of Market Manipulation,” 74 N.Y.U.L.REV. 630 (1999) and *citing* Jon D. Hanson & Douglas A. Kysar, “Taking Behavioralism Seriously: Some Evidence of Market Manipulation,” 112 Harv.L.Rev. 1420 (1999). It should be noted that much training of brokers and advisers involves how to establish a relationship of trust and confidence with the client, following which it is well known that customers / clients, respectively, will generally accede to the recommendations mde by the broker or adviser.

- C. *Financial Literacy Efforts, While Important, are Known to be Ineffective.* Financial literacy is important, for the more educated the individual American the better he or she will undertake financial decisions, with or without the aid of an advisor. However, as recently stated by Professor Lauren E. Willis:

The gulf between the literacy levels of most Americans and that required to assess the plethora of credit, insurance, and investment products sold today—and new products as they are invented tomorrow—cannot realistically be bridged. Educators would need to impart a sophisticated understanding of finance because rules of thumb are not useful for decisions about complex products in a volatile market. Further, high financial literacy can be necessary for good financial decisionmaking, but is not sufficient; heuristics, biases, and emotional coping mechanisms that interfere with welfare-enhancing personal finance behaviors are unlikely to be eradicated through education, particularly in a dynamic market. To the contrary, the advantage in resources with which to reach consumers that financial services firms enjoy puts firms in a better position to capitalize on decisionmaking biases than educators who seek to train consumers out of them.

Willis, Lauren E., “Against Financial Literacy Education,” Iowa Law Review, Vol. 94, 2008, at p.3; U of Penn Law School, Public Law Research Paper No. 08-10; Loyola-LA Legal Studies Paper No. 2008-13. Available at SSRN: <http://ssrn.com/abstract=1105384>. *See also* Lusardi, Annamaria and Mitchell, Olivia S., “Financial Literacy and Planning: Implications for Retirement Wellbeing” (2005). Michigan Retirement Research Center Research Paper No. WP 2005-108, available at SSRN: <http://ssrn.com/abstract=881847> noting that “consumers making retirement saving decisions require substantial financial literacy, in addition to the ability and tools needed to plan and carry out retirement saving plans” and confirming “survey findings about financial literacy from Bernheim (1995, 1998), Hogarth and Hilgerth (2002), and Moore (2003), who report that most respondents do not understand financial economics concepts, particularly those relating to bonds, stocks, mutual funds, and

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the working of compound interest; they also report that people often fail to understand loans and interest rates.”

- D. *Due to the Knowledge Gap, the Advisor Has The Ability to Abuse Trust and Power.* The expert services of the fiduciary personal financial advisor are socially desirable. As in medicine or law, it can take many years to acquire the requisite degree of knowledge, skill, and experience to be a competent and effective personal financial advisor. Yet it is this very expertise renders clients of personal financial advisors vulnerable to abuse of trust and lack of care. Moreover, the advisory services undertaken by investment advisers are often subject to only general prescriptions, as investment advisers must be free to react to a changing market environment. If the fiduciary does not utilize his or her greater knowledge to promote the client’s best interests, the fiduciary could usurp the delegated power, authority, or trust in advice for the fiduciary’s own benefit.
- E. *Reduction of Transaction Costs, when Monitoring Costs are High.* In service provider relationships which arise to the level of fiduciary relations, it is highly costly for the client to monitor, verify and ensure that the fiduciary will abide by the fiduciary’s promise and deal with the entrusted power only for the benefit of the client. Indeed, if a client could easily protect himself or herself from an abuse of the fiduciary advisor’s power, authority, or delegation of trust, then there would be no need for imposition of fiduciary duties. Hence, fiduciary status is imposed as a means of aiding consumers in navigating the complex financial world.

The authors of the Federal Securities Acts contemplated fiduciary advisors, given the inability of individual consumers to interpret complex financial data and concepts. As stated by Professor Steven L. Schwarcz: “Analysis of the tension between investor understanding and complexity remains scant. During the debate over the original enactment of the federal securities laws, Congress did not focus on the ability of investors to understand disclosure of complex transactions. Although scholars assumed that ordinary investors would not have that ability, they anticipated that sophisticated market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors.” Steven L. Schwarcz, “Rethinking The Disclosure Paradigm In A World Of Complexity,” Univ.Ill.L.R. Vol. 2004, p.1, 7 (2004), citing “Disclosure To Investors: A Reappraisal Of Federal Administrative Policies Under The ‘33 And ‘34 Acts” (The Wheat Report), 52 (1969); accord William O. Douglas, “Protecting the Investor,” 23 Yale Rev. 521, 524 (1934).

- F. *Difficulty in Tying Performance Results to One’s Obedience to His or Her Fiduciary Duties.* The results of the services provided by a fiduciary advisor are not always related to the honesty of the fiduciary or the quality of the services. For example, an investment adviser may be both honest and diligent, but the value of the client’s portfolio may fall as the result of market events. Indeed, rare is the instance in which an investment adviser provides substantial positive returns for each period over long periods of time – and in such instances the honesty of the investment adviser should be suspect (as was the situation with Madoff).
- G. *Difficulty in Identifying and Understanding Conflicts of Interest.* Most individual consumers of financial services in America today are unable to identify and understand the many conflicts of interest which can exist in financial services. For example, a customer of a broker-dealer firm might be aware of the existence of a commission for the sale of a mutual fund, but possess no understanding that there are many mutual funds available which are available without commissions (i.e., sales loads). Moreover, brokerage firms have evolved into successful disguisers of conflicts of interest arising from third-party payments, including payments through such mechanisms as contingent deferred sales charges, 12b-1 fees, payment for order flow, payment for shelf space, and soft dollar compensation.

Transparency is important, but even when compensation is fully disclosed, few individual investors realize the impact high fees and costs can possess on their long-term investment returns; often individual investors believe that a more expensive product will possess higher returns. In a recent study, Professors “Madrian, Choi and Laibson recruited two groups of students in the summer of 2005 -- MBA students about to begin their first semester at Wharton, and undergraduates (freshmen through seniors) at Harvard. All participants were asked to make hypothetical investments of \$10,000, choosing from among four S&P 500 index funds. They could put all their money into one fund or divide it among two or more. ‘We chose the index funds because they are all

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tracking the same index, and there is no variation in the objective of the funds,' Madrian says ... 'Participants received the prospectuses that fund companies provide real investors ... the students 'overwhelmingly fail to minimize index fund fees,' the researchers write. 'When we make fund fees salient and transparent, subjects' portfolios shift towards lower-fee index funds, but over 80% still do not invest everything in the lowest-fee fund' ... [Said Professor Madrian,] 'What our study suggests is that people do not know how to use information well.... My guess is it has to do with the general level of financial literacy, but also because the prospectus is so long.'" Knowledge@Wharton, "Today's Research Question: Why Do Investors Choose High-fee Mutual Funds Despite the Lower Returns?" citing Choi, James J., Laibson, David I. and Madrian, Brigitte C., "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds" (March 6, 2008). Yale ICF Working Paper No. 08-14. Available at SSRN: <http://ssrn.com/abstract=1125023>.

- H. *Shifting of Monitoring and Verification Costs to Government.* It is common that fiduciary duties, once they are imposed, result in oversight (monitoring and verification) and enforcement by agencies of government. As stated in a recent Government Accounting Office report:

In general, regulators help protect consumers/investors who may not have the information or expertise necessary to protect themselves from fraud and other deceptive practices ... that the marketplace may not necessarily provide. Through monitoring activities, examinations, and inspections, regulators oversee the conduct of institutions in an effort to ensure that they do not engage in fraudulent activity and do provide consumers/investors with the information they need to make appropriate decisions of financial institutions in the marketplace. However, in some areas providing information through disclosure and assuring compliance with laws are still not adequate to allow consumers/investors to influence firm behavior.

GAO-05-61, "Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure," Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, October 2004.

Fiduciary relationships are relationships in which the fiduciary provides to the client a service that public policy encourages. When such services are provided, the law recognizes that the client does not possess the ability, except at great cost, to monitor the exercise of the fiduciary's powers. Usually the client cannot afford the expense of engaging separate counsel or experts to monitor the conflicts of interest the person in the superior position will possess, as such costs might outweigh the benefits the client receives from the relationship with the fiduciary. Enforcement of the protections thereby afforded to the client by the presence of fiduciary duties is shifted to the courts and/or to regulatory bodies. Accordingly, a significant portion of the cost of enforcement of fiduciary duties is shifted from individual clients to the taxpayers, although licensing and related fees, as well as fines, may shift monitoring costs back to all of the fiduciaries which are regulated.

- I. *The Lack of Desire to Expend Time, Resources on Monitoring.* The inability of clients to protect themselves while receiving guidance from a fiduciary does not arise solely due to a significant knowledge gap or due to the inability to expend funds for monitoring of the fiduciary. Even highly knowledgeable and sophisticated clients (including many financial institutions) rely upon fiduciaries. While they may possess the financial resources to engage in stringent monitoring, and may even possess the requisite knowledge and skill to undertake monitoring themselves, the expenditure of time and money to undertake monitoring would deprive the investors of time to engage in other activities. Indeed, since sophisticated and wealthy investors have the ability to protect themselves, one might argue they might as well manage their investments themselves and save the fees. Yet, reliance upon fiduciaries is undertaken by wealthy and highly knowledgeable investors and without expenditures of time and money for monitoring of the fiduciary. In this manner, "fiduciary duties are linked to a social structure that values specialization of talents and functions." Tamar Frankel, Ch. 12, *United States Mutual Fund Investors, Their Managers and Distributors*, in *CONFLICTS OF INTEREST: CORPORATE GOVERNANCE AND FINANCIAL MARKETS* (Kluwer Law International, The Netherlands, 2007), edited by Luc Thévenoz and Rashid Barhar.

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- J. *For Fiduciaries, the Cost of Proving Trustworthiness is Quite High.* How does one prove one to be “honest” and “loyal”? The cost to a fiduciary in proving that the advisor is trustworthy could be extremely high – so high as to exceed the compensation gained from the relationships with the advisors’ clients. This is why it is important to fiduciary advisors to be able to distinguish themselves from non-fiduciaries. A recent example of the problems faced by investment advisers was the “fee-based brokerage accounts” adopted by the SEC in 2005, which would have permitted brokers to provide the same functional investment advisory services as investment advisers but without application of fiduciary standards of conduct. This would have negated to a large degree economic incentives for persons to become investment advisers and be subject to the higher standard of conduct. The SEC’s fee-based accounts rule was overturned in *Financial Planning Ass’n v. S.E.C.*, 482 F.3d 481 (D.C. Cir., 2007).
- K. *Monitoring and Reputational Threats are Largely Ineffective.* The ability of “the market” to monitor and enforce a fiduciary’s obligations, such as through the compulsion to preserve a firm’s reputation, is often ineffective in fiduciary relationships. This is because revelations about abuses of trust by fiduciaries can be well hidden (such as through mandatory arbitration clauses and secrecy agreements regarding settlements), or because marketing efforts by fiduciary firms are so strong that they overwhelm the reported instances of breaches of fiduciary duties.
- L. *Public Policy Encourages Specialization, Which Necessitates Fiduciary Duties.* As Professor Tamar Frankel, long the leading scholar in the area of fiduciary law as applied to securities regulation, once noted: “[A] prosperous economy develops specialization. Specialization requires interdependence. And interdependence cannot exist without a measure of trusting. In an entirely non-trusting relationship interaction would be too expensive and too risky to maintain. Studies have shown a correlation between the level of trusting relationships on which members of a society operate and the level of that society’s trade and economic prosperity.” Tamar Frankel, *Trusting And Non-Trusting: Comparing Benefits, Cost And Risk*, Working Paper 99-12, Boston University School of Law. Fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment management or law, in recognition of the value such services provide to our society. For example, the provision of investment consulting services under fiduciary duties of loyalty and due care encourages participation by investors in our capital markets system. Hence, in order to promote public policy goals, the law requires the imposition of fiduciary status upon the party in the dominant position. Through the imposition of such fiduciary status the client is thereby afforded various protections. These protections serve to reduce the risks to the client which relate to the service, and encourage the client to utilize the service. Fiduciary status thereby furthers the public interest.

<sup>xvii</sup> 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 of 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 relating to financial planning and investment decisions 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.

Survey after survey (including the Rand Report cited by SIFMA) has concluded that consumers place a very high degree of trust and confidence in their investment adviser, stockbroker, or financial planner. These consumers deal with their advisors on unequal terms. As evidence of the lack of knowledge possessed by consumers, the Rand Report noted that 30% of investors believed that they did not pay their financial consultant any fees! This

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calls into substantial question the conclusion derived from the Rand Report's survey that most customers of brokers are happy with their financial consultant.

<sup>xviii</sup> We urge Congress not to proceed down the path which will result in an erosion of the fiduciary standard of conduct – a path so long warned about by Justice Benjamin Cardozo:

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 marketplace. 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' (*Wendt v. Fisher*, 243 N.Y. 439, 444). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. ***It will not consciously be lowered by any judgment of this court. [Emphasis added.]***

*Meinhard v. Salmon*, 249 N.Y. 458, 463-4, 164 N.E. 545 (1928).

<sup>xix</sup> "First, there must be recognition that brokers have changed their business practices to become more like advisers—who have generally been successfully regulated under the Investment Advisers Act of 1940 for nearly seven decades. 'Harmonization' that seeks to make advisers more like brokers has no foundation in investor protection." Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, before the Committee on Financial Services, United States House of Representatives, on "Industry Perspectives on The Obama Administration's Financial Regulatory Reform Proposals" (July 17, 2009).

<sup>xx</sup> The framing of the debate by the broker-dealer industry as one of "harmonization" serves to mislead Congress as to the reality of the issue before it and the present circumstances. "To the extent that securities firms that were predominantly broker-dealers are now entering into on-going relationships with clients by emphasizing the offer of investment advice in exchange for a fee based on assets under management, the brokerage industry is moving closer to the investment adviser industry. There is a significant conflict of interest that results when the same entity serves both as an agent selling a security and as one providing investment advice. As a result of this movement by broker-dealers, there has been a great deal of discourse about 'harmonizing' the regulations of broker-dealer versus investment advisers. I think the better way to frame the issue is to ask how broker-dealers who provide investment advice should be regulated. There is a reason that investment adviser services are regulated differently than broker-dealer services." Speech, SEC Commissioner Luis A. Aguilar, "SEC's Oversight of the Adviser Industry Bolsters Investor Protection" (May 7, 2009).

Moreover, as explained by Professor Tamar Frankel, "*harmonizing*" has been used in reference to only the fiduciary duty of care; the real problem of broker dealers ("b/ds") involves the duty of loyalty when brokers provide investment advice. "In light of the confusing state of the law and the different treatment of b/ds, advisers, and financial planners, proposals have used the word "harmonizing" as the objective for rationalizing the current law. However, the word harmonizing has been used to apply to fiduciaries' duty of care rather than to the prohibition of fiduciaries' conflict of interest. [Citation to Lemke/Stone article.] I believe that the emphasis on the duty of care diverts attention from the real problem posed by b/ds and their activities that might lead to fraud. The two duties are fundamentally different. The duty of loyalty aims at preventing the abuse of entrusted property or power. The duty of care is aimed to ensuring expert services and avoiding negligence in the performance of the services." Frankel, Tamar, "Fiduciary Duties of Brokers-Advisers-Financial Planners and Money Managers" (August 10, 2009). Boston Univ. School of Law Working Paper No. 09-36.

Available at SSRN: <http://ssrn.com/abstract=1446750>.

As more succinctly set forth by the North American Securities Administrators Association: "We recognize that so-called 'harmonization' of standards is simply code for adoption of a lower standard and is therefore unacceptable." Speech, Denise Voigt Crawford, Texas Securities Commissioner and current NASAA President, before the NASAA Annual Conference (Sept. 15, 2009).