

Managing Conflicts of Interest: The Limits of Disclosure and Informed Consent

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January 1, 2008

While many fiduciaries may believe that, when a conflict of interest arises, all that is required is disclosure, in reality much more is required. While this memorandum requires fuller development, there are three key points which fiduciaries should remember:

First, disclosure does not negate the continuing obligation to act in the best interests of the client.

Second, the fiduciary duty of loyalty cannot be waived.

Third, disclosure alone is not sufficient; informed consent of the client is also required. And, due to limitations clients face, often informed consent is unlikely to be obtained.

I enclose herewith two exhibits to aid in greater understanding of these concepts.

EXHIBIT A: Excerpt, NAPFA Comment Letter to SEC, Principal Trading and Informed Consent

EXHIBIT B: Excerpt, Exhibit F to Financial Planning Association's Fiduciary Task Force Final Report:
Lessons From Behavioral Science: The Effectiveness of Disclosures
Provided to Clients of Financial Intermediaries

Much greater work in this area is desired, both as to legal analysis and the undertaking of policy recommendations to those in legislative or regulatory positions, or who may be associated with industry associations. But these preliminary materials may provide a greater understanding of the limits of disclosure, the necessity for informed consent, and the realization that disclosure and informed consent, even where possible, do not negate the fiduciary duty to continue to act in the best interests of the client.

EXHIBIT A: EXCERPT FROM NATIONAL ASSOCIATION OF PERSONAL FINANCIAL ADVISORS, COMMENT LETTER TO SEC (2007)

Principal Trades Involving Investment Advisory Clients: The Need for Informed Consent. The U.S. Securities and Exchange Commission has long held that, *when 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.* See *Arleen W. Hughes*, 27 S.E.C. 629, 635 (1948) ("It is well settled that a fiduciary, as, for example, an agent, who sells his own property to his principal must disclose his cost to the principal so that the principal will know what profits the fiduciary will realize by effecting the transaction."), *aff'd sub nom.*, *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *William J. Stelmack Corporation*, 11 S.E.C. 601, 618 (1942) (agent must disclose not only that he "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 [including] the price paid by the agent for the property which he sells to the principal . . . and the price he receives for the property he buys from the principal."). See also *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) ("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 clients.").

In *Arleen W. Hughes*, the Commission found that a registered broker-dealer who was also a registered investment adviser violated the antifraud provisions of the securities laws by executing principal trades with her customers without disclosing fully the nature and extent of her adverse interest. Although the registrant had disclosed her principal status in her written agreement with her customers, the Commission determined that such disclosure was inadequate to alert the customers to the potential conflict of interest. The Commission held: "[I]f registrant chooses to assume a role in which she is motivated by conflicting interests . . . she may do so if, but only if, she obtains her client's consent after disclosure not only that she proposes to deal with them for her own account but also of all other facts which may be material to the formulation of an independent opinion by the client as to the advisability of entering into the transaction." *Hughes*, 27 S.E.C. at 637. Moreover, the Commission also opined that an investment adviser has "an affirmative obligation to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent. And this disclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent."

In *William J. Stelmack Corporation*, 11 S.E.C. 601, 618-19 (1942), the Commission held that disclosure of principal status on confirmation and customer order blank did not relieve broker-dealer of "the fiduciary's duty of loyalty and its various incidents." The fiduciary standards of conduct have not lessened since 1942; hence, the Temporary Rule's emphasis on disclosure of the mere fact that a principal trade may occur may inadvertently mislead broker-dealer firms that all is required to adhere to their fiduciary duties of loyalty, due care, and utmost good faith, when in fact far greater effort is required.

Likewise, the Commission in its “Information for Newly-Registered Investment Advisers” (2007) stated: “As a fiduciary, you are required to act in the best interests of your advisory clients, and to seek to obtain the best price and execution for their securities transactions. The term “best execution” means seeking the best price for a security in the marketplace as well as ensuring that, in executing client transactions, clients do not incur unnecessary brokerage costs and charges. You are not obligated to get the lowest possible commission cost, but rather, you should determine whether the transaction represents the best qualitative execution for your clients. In addition, whenever trading may create a conflicting interest between you and your clients, you have an obligation, before engaging in the activity, to obtain the informed consent from your clients after providing full and fair disclosure of all material facts. The Commission has described the requirement for advisers to seek best execution in various situations.”

EXHIBIT B: EXCERPT FROM FINANCIAL PLANNING ASSOCIATION'S FIDUCIARY TASK FORCE FINAL REPORT

MEMORANDUM

TO: Fiduciary Task Force

FROM: Ron A. Rhoades, Esq.

Date: January 29, 2007

RE: Lessons From Behavioral Science: The Effectiveness of Disclosures
Provided to Clients of Financial Intermediaries

A. Introduction. One of the key issues confronting the Fiduciary Task Force is whether consumers of financial planning advice achieve a sufficient understanding of the distinctions between the varied duties of fiduciaries and non-fiduciaries. Specifically, is a consumer of financial planning services likely to be able to provide “informed consent” when a financial planner who “holds out” as a trusted advisor (fiduciary) or who actually provides financial planning services, then seeks to “change hats” and assume non-fiduciary status, with consequential lesser protections afforded to the consumer. Stated differently, should the “fiduciary status” of a financial services intermediary be capable of “waiver” by the client through disclosure and informed consent?

In the setting of a financial services relationship between the financial planner and his or her client, two questions must be asked:

First, whether there exists adequate disclosure of the change of relationship from a fiduciary financial planning role to a non-fiduciary implementation role and the resulting change in legal standards applicable to the financial planner.

Second, whether there would likely exist an adequate understanding of that disclosure by the consumer of financial services and hence, whether informed consent would exist.

This memorandum seeks to provide policymakers with additional information discerned from recent research into behavioral science as applied to financial intermediaries and their important¹ relationships with their customers or clients, particularly as to the efficacy of disclosures and informed consent.

¹ “The rise of the financial intermediary was characterized by Professor Clark as representing an advanced stage of capitalism in the development of modern capitalistic civilization. In this stage, capital suppliers concentrate on whether they should relinquish their funds to a particular intermediary, and the intermediary to a greater or lesser extent would be competent to advice on investment choice. The intermediary’s brokerage services is essential to match suppliers and issuers of capital in the modern economy and securities intermediaries are in a position of relative trust and confidence *vis a vis* their capital supplying clients. The rise in financial intermediation has been empirically studied to bear a direct correlation with economic development, as financial intermediation is closely related to the growth of capital markets.” Iris Chiu, “Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation:

B. U.S. Securities Laws Are Generally Based Upon A Disclosure Regime. While securities laws often appear to impose limitations on actions by financial services intermediaries, such as “do not commit fraud,” in many instances the absence of fraud is found where there exists disclosure of material facts (including disclosures of conflicts of interests). Federal securities laws and regulations protect investors largely through requiring the disclosure of information – whether it be of material facts regarding an issuer of a security, or of compensation paid to a financial services intermediaries, or of conflicts of interest which exist as to financial services intermediaries. Indeed, it has been stated that in the United States, “federal securities law’s exclusive focus is on full disclosure.”²

C. General Inadequacies of Disclosures. Despite the reliance of securities regulators upon disclosures, many investors do not enjoy the intended protections of securities laws because the disclosures are: (1) inadequate (as to the quality or quantity of information provided); (2) incomprehensible to the individual consumer in terms of the language or terminology utilized; or (3) deficient in timing (*i.e.*, coming only after the consumer makes a decision). While efforts are made to undertake disclosures in “plain English,” this may have exacerbated a related problem – one in which individual investors receive a large volume of disclosure documents to the point of being overwhelmed. This is especially so when individuals invest in a mutual fund or variable annuity. As a result, disclosure is often ineffective or opaque, and this leads to abusive sales practices and investor harm.

D. “Access to Information” = “Disclosure”? Some disclosures are not necessarily proactively undertaken to consumers prior to investment decisions being made. Instead, “access” to the disclosure is provided. The view that access to disclosure is equivalent to disclosure under the securities laws has been strongly advanced recently. For example, the NASD in its 2005 “Report of the Mutual Fund Task Force: Mutual Fund Distribution,” the NASD undertook this proposal regarding mutual fund point-of-sale disclosure documents and, as well, prospectus delivery:

By giving investors a short disclosure document with access to further information through hyperlinks, the Profile Plus would allow investors to review as much or as little detail about a fund as desired and to easily compare all funds offered by a particular broker-dealer. To the extent that the Commission is concerned that investors will not actually go to the Profile Plus on the broker-dealer’s website, that is a matter of investor choice, exactly the same as choosing not to read hard copy disclosure or not to listen to oral disclosure. The web site mode of delivery is, in the Task Force’s view, critical to effective and timely disclosure of this information for the benefit of investors ...

The Task Force urges the Commission to apply an “access equals delivery” approach for the mutual fund prospectus. The Commission should take the position that an investor’s access

Some Observations from the EU’s Markets in the Financial Instruments Directive.” 2 Journal of International Commercial Law and Technology 38 (2007).

² 1 Thomas Lee Hazen, *The Law Of Securities Regulation*, § 8.1[1][B], at 740 (4th ed. 2002). As this memorandum demonstrates, “[d]isclosure is the primary tool of the present U.S. securities regulatory regime. Yet disclosure is unlikely to help investors suffering from overconfidence, loss aversion, and cognitive dissonance.” Stephen J. Choi & A.C. Pritchard, “Behavioral Economics and the SEC” (2003).

to the fund prospectus through the Internet would constitute delivery for purposes of the federal securities laws.³

[Emphasis added.] An example of an actual adoption of an “access equals delivery” of disclosure can be found in the controversial Merrill Lynch Rule, as it was finally adopted by the U.S. Securities and Exchange Commission in May 1105, which in pertinent part states:

(ii) Advertisements for, and contracts, agreements, applications and other forms governing, accounts for which the broker or dealer receives special compensation include a prominent statement that: “Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons’ compensation, may vary by product and over time.” The prominent statement also must identify an appropriate person at the firm with whom the customer can discuss the differences.⁴

[Emphasis added.] The move from actual disclosure of conflicts of interests, to embracing a more limited disclosure regime which requires the investment consumer to proactively seek out information (whether it be via the internet or by asking questions of an “appropriate person” at the brokerage firm), creates additional hurdles to the adequacy of disclosure and informed consent, as will be demonstrated later in this memorandum.

E. Consumer’s Responsibility? Under one view within the securities industry, consumers bear the burden of reading and understanding disclosure documents, and consumers should ask questions when they need more information. An example of this view is illustrated by the 1995 Tully Report.⁵ For example, the Report states:

As a general rule, RRs [i.e., 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 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. It also makes

³ NASD, “Report of the Mutual Fund Task Force: Mutual Fund Distribution” (2005).

⁴ 17 CFR §275.202(a)(11)-1(a)(1)(ii),

⁵ “Report Of The Committee On Compensation Practices,” April 10, 1995, from a Committee formed at the request of SEC Chairman Arthur Levitt, and chaired by Daniel P. Tully, Chairman and Chief Executive Officer, Merrill Lynch & Co., Inc. This Report is hereafter referred to as the “Tully Report.”

communication between a registered representative and an investor difficult and puts too much responsibility for decision-making on the shoulders of RRs – a responsibility that belongs with the investor.

Brokerage firms are not – and cannot be – teaching institutions for investors, but practices that narrow the knowledge gap between investors and RRs can only be viewed positively. Only one "best practice" was found in this area:

MAKE SPECIAL EFFORTS TO INFORM INVESTORS OF THEIR RIGHTS AND RESPONSIBILITIES. All brokerage firms distribute such materials to their clients, as required by law. Typically, however, these are done in print so small that only the most diligent would wade through them. One firm interviewed provides each new account holder with a clear and thorough document explaining risk, return, and the role of the registered representative. The document provides a summary of services provided by the firm, trade and settlement arrangements, and procedures for resolving complaints. Further, the document spells out the client's responsibilities with respect to communicating objectives, and so forth. Other firms spell out alternative compensation arrangements which are fee-based rather than transaction-driven

Investors have an important role to play in the alignment of interests described above. Intense competition has created a buyers' market for brokerage services, giving investors of the 1990s the power to demand AND RECEIVE high levels of professionalism and quality service.

Using their ability to direct business to organizations that serve them well, and to withhold it from those who serve them poorly, today's investors have more potential power over the behavior of brokers than any regulator or consumer watchdog. Investors' insistence on professionalism and quality service is the ultimate safeguard of their own best interests and, indirectly, the ultimate enforcer of high standards within the brokerage industry ...

[Clients must assume decision-making responsibility for their accounts. It is their responsibility to evaluate the advice of their brokers and to determine which actions will be taken. In many cases this means that clients must educate themselves in the basics of financial markets, the nature of risk, and other aspects of investing. Good decisions cannot be made in ignorance....⁶

[Emphasis added.] Interestingly, while the Tully Report expressly acknowledged the “knowledge gap” between registered representatives (RRs) and their customers, noted that certain disclosures are “impenetrable” to many individual investors, and set forth a long list of contents of a broker-dealer’s disclosure form an investor must “wade through” (the length of which disclosure form has only increased in recent years), the Tully Report still took the view that registered representatives should not shoulder the burden of investment responsibility, but rather that the individual consumer should bear this burden. The Tully Report asserts that individual investor consumers have the power to influence the behavior of registered representatives. Implicit in this statement is that individual consumers possess the ability to obtain knowledge (ostensibly through adequate disclosures under the securities laws), coupled with the ability to

⁶ Tully Report, pages 15-18.

understand and apply that knowledge to the decisions presented to the investor. The Tully Report places the burden on individual investors to become educated about the “basics” of the financial markets, the “nature of risk,” and “other aspects of investing,” but the Tully Report does not specify how this should occur or how long such an educational process would be expected to take.

The Tully Report is by no means alone in this view of individual investors possessing responsibility for their own investment decisions. Many other commentators or regulators promote the concept that individual investors possess responsibility to protect their own interests:

- “[I]t is for investors themselves to take advantage of higher standards of disclosure”⁷
- “The client [of a CFP certificant] is responsible for accepting or rejecting recommendations and for retaining and/or delegating implementation responsibilities.”⁸
- “By far the best way for investors to protect the money they put into the securities markets is to do research and ask questions.”⁹

F. Consumer “Understanding” of Disclosures, Generally. To accept the premise that investors are responsible for their own actions, it is necessary to conclude that investors are not only armed with adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them. Assuming, for the moment, that the disclosure is adequate (in writing, in “plain English” to the extent possible, specific as to the material facts to be disclosed, and communicated to the investor in advance of any decision by the investor), the sole question then becomes the adequacy of understanding of the disclosures which have been made.

In the context of financial planning decision-making and investment decisions, it cannot be denied that the financial world of individual consumers of financial services has become increasingly more complex in recent years. As stated in the well-written consumer brochure, “Cutting Through the Confusion”:

While some people are comfortable handling their own investments, many are not. They find the idea of creating a plan for allocating their assets bewildering, choosing a mutual fund intimidating, and designing an investment portfolio to be one more thing for which they have

⁷ Tharman Shanmugaratnam: “Regulating the capital markets: making market discipline work,” derived from speech by Tharman Shanmugaratnam, Deputy Managing Director of the Monetary Authority of Singapore at the StanChart-Reuters-Business Times Investment Awards ceremony, Singapore, 16 Feb 2001.

⁸ CFP Board of Standards, Inc., “Financial Planning Practice Standards” (Rev. 07/03), in the explanation of Standard 500-1, which explanation further notes: “If there are conflicts of interest, sources of compensation or material relationships with other professionals or advisers that have not been previously disclosed, such conflicts, sources or relationships shall be disclosed at this time.”

⁹ U.S. Securities and Exchange Commission, “The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation” (online brochure, 1/2007).

neither the time nor the expertise. This is nothing to be embarrassed about. Investing can be confusing.¹⁰

Evidence of lack of consumer understanding of even basic investment concepts abounds. For example, a 2002 Forbes Magazine survey finding that eighty-four percent of the surveyed investors believe that higher fund expenses result in higher performance by the fund.¹¹ As stated in the main body of this Final Report of the FPA[®] Fiduciary Task Force, even a vast majority of college students chose a higher-expense S&P 500 index fund over a lower-expense S&P 500 index fund, even when presented with detailed information.

The United States is not alone in the complexity of its financial markets. As stated over ten years ago in a report issued by the Financial Planning Association of Australia Limited:

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.¹²

[Emphasis in original.]

While the modern financial world has grown increasingly more complex over the last several decades, only recently has substantial thought been given to the ability of individual investors to achieve adequate understanding in order to make informed decisions. 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

¹⁰ “Cutting Through The Confusion,” a brochure published by the “Coalition on Investor Education,” which consists of the Consumer Federation of America, the North American Securities Administrators Association, the Investment Adviser Association, the Financial Planning Association, and the CFA Institute.

¹¹ Neil Weinberg, “Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs,” Forbes Magazine, Oct. 14, 2002, at 220.

¹² “Submission to the Financial System Inquiry” by the Financial Planning Association of Australia Limited, December 1996.

advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors.¹³

While the U.S. Securities and Exchange Commission has put greater emphasis on “plain English” writing, and this is a welcome development, plain English writing primarily addresses the problem of overly legalistic writing. Plain English writing does not provide a solution to achieving consumer understanding in an inherently more complex financial world. The investment, tax and financial worlds have become increasingly complex. The 20th Century saw an explosion of specialization, in response to an ever-more complex world. Specialists exist as a means to guide consumers through a complicated undertaking, such as the development of a financial plan. Specialists exist in recognition that the vast majority of consumers will possess neither the time nor the knowledge and experience to tackle a complex field and make good choices. Accordingly, the SEC’s emphasis on disclosure and its advice to individual investors to “do research and ask questions” may be misplaced.

G. The Robert Prentice Article: Behavioral Biases Which Inhibit Informed Consent By Individual Investors. In the last few decades scholars of behavioral economics have endeavored to show that actual human behavior is characterized by “bounds” that limit the extent to which people actually and effectively pursue utility maximization. In a law journal article entitled “Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future,”¹⁴ Professor Robert Prentice provides key insights into behavioral bias which illuminate the inadequacy of informed consent in the context of securities regulation. Various excerpts from this seminal article follow:

- “[C]ompanies, if left unregulated, will not disclose the socially optimal amount of financial information ... they will disclose suboptimally because disclosure implicates two types of costs. First are operational costs (out-of-pocket expenses, diversion of staff time, etc.). Second, and more critical, are inter-firm costs that can put a disclosing firm at a disadvantage relative to its competitors [f]ull voluntary disclosure ... rarely seems to occur in reality, and firms typically do not disclose more than regulation requires.”
- “[T]here are limits to reputation. Even economists concede that providers of both goods and services with high-quality reputations are constantly tempted to provide a low-quality service at a high-quality price and thus earn a large return ... Firms often can keep their defalcations and other errors quiet, especially because most disputes are handled through low-profile arbitration rather than more newsworthy litigation.”
- “Today investors have tons of information ... Thanks to SEC disclosure requirements, EDGAR, and the Internet, even the most unsophisticated and dunderheaded investors have access to much the same

¹³ 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).

¹⁴ 51 Duke L. J. 1397 (2002).

information available to the most sophisticated of professional and institutional investors¹⁵ ... what makes investors vulnerable often is not their lack of information, but a wide variety of limitations on human reasoning exposed by a substantial body of behavioral literature that ... indicates that many if not most investors, even with more information, will be unable to adequately protect themselves under his system. Psychological factors often prevent investors from adopting sufficiently wary attitudes. Importantly, even sophisticated (issuer-level) investors tend to be subject to these limitations.”

- Behavioral concepts affecting the ability of individuals to provide informed consent include:
 - *The Concept of Bounded Rationality.* “[H]uman rationality is bounded. It is now widely recognized ... that because they seldom have complete and perfectly accurate information and never have perfect capacity to process that information, people are intendedly rational, but only limitedly so. Because of bounded rationality, it is erroneous to assume that the parties usually will negotiate the most efficient possible contract.”¹⁶
 - *The Concept of Rational Ignorance.* “It is reasonable for decisionmakers ... who do not have unlimited time and unlimited resources, to choose not to gather all the relevant information for their decisionmaking. Decision-makers must choose among numerous demands on their time and attention and will often sensibly choose to ‘satisfice’ rather than to optimize their decisionmaking.”¹⁷
 - “Because an intermediary likely will present [the investor] with a relatively detailed form contract (investor regulation invalidates the SEC’s ‘plain English’ requirements, so the intermediary is free to inundate [the investor] with massive legal boilerplate), her ability to understand its obscure terms is bounded.”

¹⁵ The teachings of behavioral finance arguably counsel against too much disclosure, at least when it is not fairly organized and carefully presented. To this end, a Securities Industry Association document prepared after the adoption of Reg FD (for “Fair Disclosure,” which regulation makes it illegal for senior executives of publicly traded issuers to privately disclose material nonpublic information to any of a carefully defined class of persons, most notably investment analysts), claimed that “[t]he barrage of unorganized data is simply too much for investors, most of whom have neither the time nor the inclination to sort through the data and perform quality analysis of their own. Investor behavior was beginning to indicate information overload even prior to Reg. FD, as evidenced by behavioral finance studies that illustrate an inability to process ever growing informational inputs.” Securities Industry Association [now called the Securities Industry and Financial Markets Association, or SIFMA], “Costs And Benefits Of Regulation Fair Disclosure 17” (May 2001).

¹⁶ “The concept of bounded rationality reflects the recognition that people have limited cognitive capacities. As a result, people cannot attend to all available information or evaluate their choices fully, particularly with respect to complex decisions. Instead, they engage in satisficing—investing a level of effort that will produce a satisfactory, if not optimal, outcome. Bounded rationality is not, strictly speaking, a bias; it is a rational explanation for investor use of heuristics and other short cuts rather than more complete information.” Jill E. Fisch, “Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst,” 10 *Lewis & Clark L. Rev.* 57, 69-70 (2006).

¹⁷ The author of this memorandum notes that, while he is an attorney and is well-versed in the terminology utilized in many forms of commercial contracts as well as securities brokerage firm relationships and mutual fund disclosures, he does not read most of the consumer contracts which he signs, nor does he know anyone who does.

- “An investment of the time and mental energy needed to master the details of the contract may not be cost-justified, especially because the agent with whom [the investor] is dealing probably has no authority to alter the contract anyway. Therefore, rather than bargain extensively over the terms of the contract and how much she will pay for protection from fraud or unsuitable recommendations, [the investor] likely will sign the contract without meaningful negotiation and usually without reading more than a few parts of it. It is well known that investors typically do not read disclosure documents when investing in securities, and Professor Melvin Aron Eisenberg notes in the context of insurance contracts and other similar types of contracts that this is a sensible (if not optimally rational) strategy, concluding that ‘most form takers will find it irrational to engage in search and deliberation on any given form.’”
- *Overoptimism*. “Even if [the investor] reads the contract with the issuer and clearly sees and understands its limitation of liability provisions, [the investor] still may not bargain to change them. Humans are inherently overoptimistic in most settings; they think that good things are going to happen to them and that the bad things that happen to others will not happen to them ... Studies indicate that the overoptimism bias affects humans in the sphere of investments as well.”
- *Overconfidence*. “[The investor’s] optimism will be fueled by a Wall Street marketing juggernaut whose dominant message is simple: Wall Street can make you rich – and fast ... optimism will tend to lead her to believe that she will succeed where others will fail, that she will know the right path where others will be misled, that she will be impervious to fraud where others are victimized. [The investor’s] vulnerability to overoptimism will be reinforced by her overconfidence.”¹⁸
 - “Educated people and professionals are generally just as subject to phenomena such as overoptimism and overconfidence as are unsophisticated investors.”
- *Insensitivity to the Source of Information*. “Another reason [the investor’s] tendency will be to fail to realize that she is being defrauded and to fail to contract to protect herself from that fraud is the general human insensitivity to the source of information ... studies show that people have difficulty disregarding information, even when they learn that it is from an unreliable source.”
 - “[P]eople generally believe that they are good at detecting when they are being lied to, when the behavioral research shows that they are not.”
 - “[O]nce a broker successfully cultivates trust, willing reliance by the sophisticated investor -- imprudent though it may seem in hindsight -- is quite likely and, for that reason alone, worthy of some protection.”

¹⁸ In an oft-repeated quotation in the finance literature, DeBondt and Thaler state that “perhaps the most robust finding in the psychology of judgment is that people are overconfident.” Warner Debondt & Richard Thaler, *Financial Decisionmaking in Markets and Firms: A Behavioral Perspective*, in *Finance*, vol. 9 of *HANDBOOK OF OPERATIONS RESEARCH AND MANGEMENT SCIENCE*, chap. 13, at 385-86 (1995).

- *Oral Communications Trump Written Communications.* “[The individual investor] will enter into a contract with a securities professional after a period of negotiation. These negotiations likely will be oral, either in person or via telephone, and eventually [the investor] will find a professional whom she trusts ... Studies show that people whose success depends on the efforts of others tend naturally to form positive impressions of those on whom they depend. Once they decide to trust, they ‘overdraw’ on the information available; this simplifies life and allows customers to act as though they possessed real knowledge about a broker’s future conduct. Only after that trust and positive impression are established will the securities professional provide the written adhesion contract for [the investor] to sign ... Although [the investor] would be wise to read the contract in its extensive detail and to bargain for fraud protection, she probably will not do so. One simple reason is that in daily commercial intercourse, oral communications trump written communications.”¹⁹
- *Hesitation to Confront.* “Other reasons that [the investor] will hesitate to confront the intermediary over its form contract (and likely elicit the ‘What, you don’t trust us?’ response in an attempt to shame her into signing the contract immediately) include the availability bias ... and her realization that failure to show trust poisons relationships.”
- *Recency, Concreteness.* “[Investors] would tend to give undue weight to their good relationship with the manager at the time of contract formation, because that relationship is vivid, concrete, and instantiated, as compared with the possibility that the manager would exploit the bargain at some point in the future, which is abstract, general, and pallid.”
- *Representativeness Heuristic.* “[P]eople ... tend to judge probabilities by flouting numerous rules of statistics and to focus instead upon the degree of similarity that an item seems to bear to a category or parent population. Because of this influence, [the individual investor] would tend to overestimate the extent to which the present relationship with the [broker] is a reliable index of the future relationship.”

In summary, individual consumers possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure. 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.”²⁰

¹⁹ When the sellers of investment products present consumers with lengthy written contracts to sign, the individual investor, just like consumers of consumer products, tend to sign without reading them in any detail, especially after they have decided to trust the seller. Donald C. Langevoort, “Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers,” 84 Cal. L. Rev. 627, 682 (1996). “Most sales pitches in the securities field are made orally, yet most adhesion contracts disclaim oral representations in legal boilerplate. Why? For competitive reasons, sellers have an incentive to make oral representations to buyers of securities and then to present the buyers with written contracts that disclaim those same representations.” Robert Prentice, “Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis,” 2003 U.Ill.L.Rev. 337, 419 (2003).

²⁰ 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

H. What Are the Possible Responses to Inadequacy of Informed Consent? Given the behavioral biases and the huge knowledge gap, both of which pose substantial barriers to the ability of investment consumers to provide informed consent in matters relating to their investments and financial affairs, what is the correct response of policymakers? There are at least four possibilities²¹, only two of which appear mutually exclusive.

(1) Enhance The Disclosures. Disclosure regimens are historically strengthened following a financial crisis. For example, the adoption of the Sarbanes-Oxley Act greatly strengthened corporate disclosures following several high-profile failures of large public companies. While it is hopeful that a financial crisis not be necessary for disclosures to be enhanced, it is possible to enhance disclosures significantly. For example, rather than the somewhat vague disclosures provided as exhibits to the CFP Board's Code of Ethics, a much stronger form of disclosure could be advanced whenever a fiduciary advisor seeks to switch to non-fiduciary status:

Our (Fiduciary) Financial Planning Services. My firm, Smith & Jones, is a personal financial planning firm. In undertaking financial planning for our clients (and in providing investment advisory services) we are fiduciaries to our clients. As a fiduciary personal financial planner we possess the duties to act in your best interests, with due care, and in good faith. As a fiduciary I am required to reasonably avoid conflicts of interest, and even where they are not avoided I must properly manage the conflict of interest in order to keep your best interests paramount at all times. As a fiduciary and professional financial planner I am also required to ensure that the total fees and costs you bear in connection with the investments I recommend to you and your receipt of financial planning and investment advice are reasonable in light of all the circumstances. As a fiduciary I am also required to consider, in the formulation and implementation of your financial plan, your probable need to minimize income taxes over the long term.

Our (Non-Fiduciary) Brokerage and Insurance Services. My firm also functions, for some of its customers, as a broker-dealer firm and as an agent for insurance companies. As a broker-dealer firm or insurance agent, my firm is not a fiduciary to our clients. If you deal with me and my firm in this capacity, and not as the client of a financial planner, you will not possess the protections afforded in a fiduciary-client relationship. For example, neither my firm nor I are required to avoid conflicts of interest. Also, neither I nor my firm is required to act in your best interests. Instead, our duties are much more limited, such as the duty to ensure that the products or investments we sell to you are

Behavioralism Seriously: Some Evidence of Market Manipulation,” 112 Harv. L. Rev. 1420 (1999). Given potential use of behavioral biases by financial intermediaries, should there be attempts to educate individual consumers on how to counter these biases? “The ... direction – inviting a role that securities regulation has never taken that seriously – is to become an aggressive therapist, seeking to de-bias investors from all their dangerous propensities ... I doubt that the government could do this well, or that the intended audience would have the inclination to learn.” Donald Langevoort, “Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation,” Paper 64, Berkeley Program in Law & Economics, Working Paper Series (2002).

²¹ Professor Schwartz notes: “There are three possible ways to respond to this insufficiency [of the effectiveness of disclosures]. The first is to tolerate insufficient disclosure and its resulting information asymmetry. The second is to proscribe transactions for which the asymmetry exceeds certain bounds. The third is to require supplemental protections to minimize the asymmetry or mitigate its consequences.” Steven L. Schwarcz, “Rethinking The Disclosure Paradigm In A World Of Complexity,” Univ.Ill.L.R. Vol. 2004, p.1, 17 (2004). For purposes of this analysis the author separates out “supplemental protections” into two distinct potential responses.

suitable to you only from the perspective of whether they fit your overall risk profile. Additionally, as a registered representative of a broker-dealer firm (or as agent of an insurance company), neither me nor my firm are required to ensure that the products or investments sold to you are suitable as to their overall fees and costs nor as to their tax attributes. In my capacity as a registered representative of a broker-dealer firm and/or as agent of an insurance company I will not be acting as your financial planner, nor am I required to adhere to the Code of Ethics and Rules of Conduct of either the Certified Financial Planner Board of Standards, Inc. (whose license I possess to use the CFP® mark only in connection with my activities as a financial planning). Nor will I be required to adhere to the Code of Ethics and Rules of Conduct of the Financial Planning Association (of which I am a member). In summary, should you choose to implement the financial plan I may develop for you in my non-fiduciary capacity as a registered representative of a broker-dealer firm and/or insurance agent for an insurance company, you will have waived important protections.

You Possess A Choice. You possess the choice as to whether to implement any financial planning recommendations either with:

- (1) a fiduciary financial planner / investment adviser who acts in your best interests;
- (2) a non-fiduciary broker or insurance agent who is not required to act in your best interests.

You are under no obligation to utilize my firm to implement any financial planning recommendations I make to you.

Discussion Encouraged. I urge you to discuss any aspect of this Disclosure and of these rules with me or with a fiduciary financial planner of your choosing (and not associated with my firm) or your legal counsel prior to signing.

Acknowledgement That You Have Read This Disclosure. By signing below, you agree that you have read and understand this Disclosure and that it was provided to you prior to your decision to use the broker-dealer and/or insurance agency services provided by my firm and by me.

Acceptance. I have read and received a copy of this Disclosure and understand that by using you and your firm as a broker-dealer and/or an insurance agent I will not have the protections of a fiduciary relationship with you or your firm. I understand that you are not required to act in my best interests, that you will not be acting as my trusted advisor, and that you will possess various conflicts of interest which will not be fully disclosed to me. I will be responsible for protection of my own interests. I have been provided with a copy of this Disclosure, and I have been advised to review this Disclosure from time to time.

_____ Date: _____

Customer

Even armed with such a disclosure, it is suggested that other conditions should exist in order for the disclosure to be effective:

- The compensation model adopted by the broker-dealer firm or insurance agent must not appear to the customer to be one in which continual advice is to be provided. Only transactions should be permitted in which discrete compensation is paid. Hence, the receipt of ongoing 12b-1 fees, broker-dealer fee-based account fees, and other continual forms of compensation are inconsistent with the non-fiduciary model.

- The disclosure must be clear and unequivocal, and undertaken in a separate document, preferably with 12-point type, with various sections highlighted in **bold** and in red ink.
- Financial plan analysis and plan presentation must be kept separate and apart from implementation.
- The course of conduct of the broker-dealer firm and its employee must be consistent with its non-financial planner role. Even with clear disclosures and a course of dealing consistent with a firm acting as a “financial planner” during the financial planning analysis and preparation phase but a “broker” during implementation, the relationship between the customer and the broker-dealer could easily be misunderstood. If the conduct of a registered representative or other broker-dealer employee suggests, perhaps inadvertently, the continuation of the financial planner relationship while brokerage services are being provided, then the broker-dealer and its registered representative could still be found to be a financial planner and fiduciary under the law.

Of course, the likelihood of such a severe disclosure regime ever being adopted by regulators is remote. Even if adopted, it is still likely – due to the behavioral biases noted previously – that many individual consumers will not read or seek to adequately understand the disclosure which they are signing. The complexity of today’s financial world – with many different types of risks to which individual investors may be exposed, a bewildering array of product offerings, recent and ongoing developments in investment theory and portfolio management, and tax laws providing both opportunities and traps for the unwary – make the possibility of informed consent even more remote, even when consumers are provided with substantially better disclosures.

(2) Adopt Additional Protective Measures (Certifications). Another solution would be to provide the individual consumer of financial planning services with some measure of additional protection, other than disclosure. One supplemental protection that minimizes information asymmetry is the furnishing of some form of guarantee²² of the quality of the financial services intermediary. For example, membership in the FPA and/or certification as a “Certified Financial Planner™” are examples of a form of “guaranty” – a private-sector certification of the quality of the financial services provider. However, the ability of consumers to rely upon this “guarantee” is not substantial. The CFP® and related “certification marks are financial planning credentials awarded by Certified Financial Planner Board of Standards Inc. (CFP Board) to individuals who meet education, examination, experience and ethics requirements.”²³ Moreover, the CFP Board is very careful in its online search service for consumers to locate CFP® certificants to avoid any monetary or other guaranty of the quality of the certificant, noting that the search service is not a referral

²² Regulation of financial intermediaries can contribute to quality information and advice, but regulation is unlikely to remove variability of the quality of services provided by the financial intermediary nor should be perceived as an implicit contract or guarantee that consumers will be protected from loss. The need will remain for consumers to make their own inquiries and assessments as to the suitability of the advice for that particular consumer.

²³ Definition provided at www.cfp.net.

service. The Financial Planning Association’s search service makes this appropriate disclaimer: “This service provides access to PlannerSearch for search purposes only and participants should be aware that no representations about the suitability of this information and these services are made or endorsed.”²⁴ It should also be noted that neither the CFP Board of Standards, Inc. nor the Financial Planning Association engages in any form of peer review.

A different form of certification could emerge from the ISO 22222 International Standard. This International Standard has been drawn up with the objective of achieving and promoting a globally accepted benchmark for individuals who provide the professional service of personal financial planning. Certification of compliance with the standards is possible from an accredited organization (“an independent third-party certification body able to demonstrate its compliance with ISO/IEC 17024 and which has certification to this International Standard within its scope”), or through certification by other parties (such as by another organization, or through peer review), or through self-assessment.²⁵

Another means to secure enhanced protection would be through governmental regulation of financial planners, imposing standards for acceptance into a “profession” of financial planning, requirements for maintaining licensure (including continuing education and peer review), and a disciplinary process for suspension or revocation of licensure. The nature of such government regulation (federal or state, governmental agency and/or self-regulatory organization and/or professional regulatory organization) is beyond the scope of this memorandum, but may be explored further in future FPA® Fiduciary Task Force deliberations.

(3) Accept Inadequacy of Informed Consent. This paradigm reflects the current state of affairs in the United States for many individual investors. Disclosures, coupled by scattered attempts at consumer education by a variety of organizations, remain the primary means of addressing the “knowledge gap” between most financial intermediaries and individual consumers. While attempts to increase the efficacy of disclosure might be helpful to some investors, under this alternative regulators would tolerate the substantial information asymmetry which exists today between financial intermediaries and the vast majority of individual investors.

Under this laissez-faire view, the question might be posed as to why is it necessary to protect investors? Proponents of this approach may assert that investment entails risk and the investor should realize this and not expect any special protection over and above the general law of theft and fraud.²⁶ Hence, under this

²⁴ From www.fpanet.org web site.

²⁵ International Organization for Standardization, ISO 22222:2005(E), Section 8.3.

²⁶ The vast majority of economists have rejected this view for many years. As stated by Grower, “[T]his robust affirmation of laissez-faire principles has long since been rejected and it has been recognised that it is the investors’ own fault only if they were in a position to judge the extent of the risk. A variety of methods have been tried in an attempt to ensure that. The oldest is to provide for disclosure of information, with liability to criminal penalties and, perhaps, damages at the suit of the investor if the information was not truthfully disclosed. The weaknesses of that are that only sophisticated investors will be able to make an informed judgment on the information disclosed (others need

point of view policymakers would tolerate the unfortunate consequences resulting upon the set of individual investors who are unable to overcome the “knowledge gap” and who might be preyed upon by financial intermediaries who might fail to act in the individual consumer’s best interests. Policymakers may determine that reputational concerns alone would deter financial intermediaries from inappropriate conduct.²⁷ Policymakers may also be concerned with the cost of increased regulation in relation to its benefits.²⁸

(4) Ban Attempts to Secure Informed Consent. Under this paradigm a legislature (or regulatory organization), recognizing the inadequacy of informed consent, undertakes a judgment that the lack of informed consent is so harmful, either to individual investors (as to inability of individuals to secure the returns of the capital markets within a reasonable spectrum of risks due to poor or conflicted advice, or unwillingness to seek advice given concerns regarding ability to obtain trusted advice, or to the national interests - *i.e.*, placing additional burdens upon government due to inadequate retirement savings and/or improper investments of retirement “nest eggs”) as to merit further regulatory restrictions upon financial planners. Under this scenario the regulatory body prohibits the fiduciary advisor from seeking informed consent to the casting off of fiduciary status.

Why insist upon fiduciary status (or its continuation throughout the financial planning process)? Simply put, in the context of securities regulation, fiduciary status has long been seen as a means to encourage consumers to place their trust in financial services intermediaries. As stated by John H. Walsh, in discussing the evolution of federal securities legislation in the 1930’s:

professional advice) ... Hence disclosure has had to be supplemented by regulation ...” L. C. B. Gower, “Review of Investor Protection – A Discussion Document (London: Her Majesty’s Stationery Office, 1982).

²⁷ “It may be argued that intermediaries could be relied on to self-regulate as they would protect their own reputations. [Citing Stephen Choi, “Promoting Issuer Choice In Securities Regulation” (2001) 41 Virginia Journal of International Law 815.] Reputational capital is important to intermediaries and it may be argued that the intermediaries’ own drive towards reputational protection acts as a form of control on abusive behaviour against clients. However, research reveals that reputational pressures alone do not prevent wrong-doing.” Iris Chiu, “Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from the EU’s Markets in the Financial Instruments Directive.” 2 Journal of International Commercial Law and Technology 38, 39 (2007).

²⁸ If additional regulation of financial planners is merited, in the form of adoption of a non-waivable fiduciary duty to act in the client’s best interests in all phases of the financial planning relationship, there must be shown a causal relation between the adoption of a fiduciary standard and substantial benefits to the clients. “If retail investors are relying inappropriately in making investment decisions due to overconfidence, anchoring, bounded rationality, or other biases, should regulators respond, and, if so, how? A central objective of the federal securities laws was protection of the retail investor, and the SEC continues to view investor protection as its primary goal ... The primary difficulty with disclosure as a regulatory response is that there is limited evidence that disclosure is effective in overcoming investor biases. ... It is unclear ... that intermediaries offer meaningful investor protection. Rather, there is continued evidence that broker-dealers, mutual fund operators, and the like are ineffective gatekeepers. Understanding the agency costs and other issues associated with investing through an intermediary may be more complex than investing directly in equities ... once regulators move beyond disclosure into substantive efforts to constrain irrational behavior, regulation imposes substantial costs on the securities markets.” Jill E. Fisch, “Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst,” 10 Lewis & Clark L. Rev. 57, 74-83 (2006).

Despite current opinion, the important role moral purpose played in creating modern regulatory institutions should not be forgotten. To understand the regulatory regimes our predecessors created and bequeathed to the modern age, one must understand the fundamental impulses that inspired them. Now ignored, or even disavowed, moral purpose once served as such an impulse. This is an area where history has something to offer the law. The greater the modern age's subjective distance from the regulatory vision of an earlier era, the more law needs history to explain what our predecessors thought they were doing. Moral purpose played a fundamental role in creating the federal regulatory regime for the securities industry. Indeed, in many respects, even though federal regulation was a product of the 1930s, it reflected an orthodox Progressive sensibility. This was no accident ... In August 1932, [Franklin Delano Roosevelt] turned to a moral policy vision. His purpose, he decided, was to ensure the character of the people who composed the securities industry ... FDR's moral purpose was a deliberately chosen policy and, once chosen, that it played an important role in the creation of the federal regulatory regime ... FDR's proposals for implementing his vision—fiduciary duties and a simple code of ethics—also speak to modern times. Commentators have recognized that fiduciary duties provide a legal basis for a justifiable expectation of trustworthiness. FDR's code should be seen in the same light. As an effort to restore public trust in financial intermediaries—why else make it simple enough for the public to understand?—it represents a practical solution to a vexing problem. How does public policy produce trust? More specifically, how does public policy produce trust on a sufficient scale to influence an entire economy? The idea of a simple code, containing basic ethical principles, propagated across an entire industry, is a serious approach to the problem.²⁹

Under many of our federal securities laws, financial services intermediaries have been unable to seek informed consent to an act which would otherwise violate of a duty possessed by the intermediary to the customer or client. In other words, the federal securities laws often prohibit waiver by customers or clients of many of the duties imposed upon financial securities intermediaries.³⁰ These prohibitions against waiving rights under securities laws are consistent with a long line of cases which hold that one may not contract against his fraud.³¹

²⁹ John H. Walsh, J.D., Chief Counsel in the Office of Compliance Inspections and Examinations of the United States Securities and Exchange Commission, "A Simple Code of Ethics: a History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry," 29 Hofstra Law Review 1015 (2001).

³⁰ Securities Exchange Act of 1934, Section 29(a), and Investment Advisers Act of 1940, Section 215.

³¹ Robert Prentice, "Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis," 2003 U.Ill.L.Rev. 337, 353 (2003). "By prohibiting fraud and mandating disclosure, the securities laws protect investors and promote honesty, trust, and ethical behavior in commercial transactions. The securities laws set standards that serve to socialize, to educate, and to direct individuals toward more morally appropriate forms of behavior. The antiwaiver provisions and the mandatory nature of the securities laws send a strong signal that certain behavior will not be tolerated in any transaction involving a security." Elaine Welle, "Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement," 56 Wash. & Lee L. Rev. 519, 541 (1999).

Similarly, one paradigm for the regulation of financial planners, whether it be limited (such as granting of the right to utilize certain marks associated with financial planning, or restricting membership in an organization composed of financial planners) or more comprehensive (federal or state legislation requiring registration and requiring adherence to certain professional rules of conduct), is adoption of the stance that financial planners, once they hold out as financial planners (or use similar titles) or engage in a financial planning relationship, cannot alter their duty to continue to act in the best interests of their client. Given the intertwining of the processes of financial planning, during which the development of the plan (or its modification), implementation and monitoring may all occur at once (or during the same conversation between the financial planner and the client), this approach would avoid the necessity of constant disclosures of the status of the financial planner. In other words, the confusion which results from “switching hats” over and over would be avoided.

I. Conclusion: A Cost-Benefit Analysis Is Required. The choice of one or more remedies to the persistent problem of the ineffectiveness of disclosures is a policy choice, and one which should be undertaken following an examination of the various costs and benefits which result for consumers of financial planning services, individual financial planners, and the profession of financial planning.