The Federal Assault On The Citadel of Fiduciary Protection: How Will State Securities Administrators Respond?

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The proposals and opinions set forth in this outline are those of the author alone and are not necessarily the views of any organization or committee or task force to which the author belongs.

A. **The Importance of Fiduciaries To Consumers.** The application of fiduciary duties is more important than ever in order to protect individual investors from high-cost and inappropriate investment products.

1. ***Fiduciary Law Plays An Important Role In Protecting Consumers.*** In this era of increased complexity in the securities markets and investment theory, and increased specialization in our modern society, fiduciary law has been expanded to fill the void. Consumer understanding of increasingly complex investment concepts, even with greater disclosure, is unlikely. In fact, even the authors of the original federal securities acts contemplated a substantial role for fiduciary advisors.

   a. An Increasingly Complex Financial World. Key to understanding the need for increased application of fiduciary duties is reviewing the increased challenges presented to investment consumers since the enactment of federal securities laws some six to seven decades ago. The increased need to apply fiduciary duties to financial advisors is a natural result of the increased complexity of the capital markets, the increased number of investment products available to consumers, the increasing complexity of tax law as it applies to financial planning and investment decisions, and the substantially increased burden placed upon individuals in recent years to plan for their own financial futures (given the demise of private pension plans and their replacement with defined contribution plan accounts over which consumers are given discretion to choose certain investment alternatives). In addition Modern Portfolio Theory has arrived and its many offshoots, including capital assets pricing

models, the efficient markets hypothesis, and much more. All of the foregoing dictates that more than mere knowledge about a stock or bond is required in order to undertake sound financial planning and investment decisions.

b. Consumer Education, While Important, Is Not the Answer. "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." *Submission to the Financial System Inquiry by the Financial Planning Association of Australia Limited*, December 1996.

2. ***Non-Application of Fiduciary Status Costs Consumers Billions Annually.*** Billions and billions of dollars are lost each year to individual investors through non-application of fiduciary standards of conduct to investment advisory activities. This amount far exceeds the amount lost due to theft and outright fraud and deceit, which losses have to date been the primary focus of state enforcement efforts.

3. ***Why Are Fiduciaries Needed?*** In this era of increased complexity in the securities markets and investment theory, and increased specialization in our modern society, fiduciary law has been expanded to fill the void. This is because investment consumer understanding of increasingly complex investment concepts, even with greater disclosure, is unlikely. In fact, even the authors of the original federal securities acts contemplated a substantial role for fiduciary advisors.

a. Specialization Leads To Interdependence, and Greater Need for "Trusting." 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.

b. Fiduciary Status Is Imposed To Reduce Transaction/Monitoring Costs. Fiduciary relationships are those 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. In this regard, the client may be incapable of understanding the (often multiple) conflicts of interest which the person with greater knowledge and expertise will possess, and may not understand the potential ramifications of such conflicts of interest. Moreover, 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. Especially through the latter, a significant portion of the cost of enforcement of fiduciary duties is shifted from the individual clients to the taxpayers.

c. Disclosure Has Been the Focus of Securities Laws; But Disclosure, While Important, Is Often Ineffective. Despite the perspective that individual investors need a guiding hand, over the decades federal securities laws and regulations have evolved to 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." Thomas Lee Hazen, The Law Of Securities Regulation, Vol. 1, § 8.1[1][B], at 740 (4th ed. 2002). However, recent insights from behavioral science call into 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. In the final analysis, the SEC's emphasis on disclosure 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 of investors who are (90% or more of the time) unable (due to behavioral biases and lack of knowledge of our complicated financial markets) to undertake sound investment decision-making, and who therefore turn to others into whom they place their trust and confidence. 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. 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). Hence, emphasis on disclosure alone is misplaced. Instead, renewed emphasis on the need for, and essential role of, fiduciary advisers is required.

4. ***The Authors of the Federal Securities Acts Contemplated Fiduciaries As Advisors.*** 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).

5. ***The World Has Changed Since 1940. But Why <u>Not</u> Apply the Investment Advisers Act of 1940?*** A common argument of large wirehouse firms, which will surface again as the RAND Corporation's report is presented to the SEC in December 2007 and discussion occurs in the financial services industry as to the proper method of regulation of financial intermediaries, is that the financial world is vastly different from that which existed in 1940, and hence federal statutes should be updated to reflect the changes. However, a closer scrutiny of these arguments reveals their flaws.

    a. <u>The World Has Changed.</u> Admittedly the financial and tax world facing investment consumers is far more complicated today than it was in 1940. Instead of receipt of a monthly pension supplemented by bank savings accounts, today's investor increasingly has the responsibility to accumulate and then manage during retirement a "nest egg." At the same time, the types and number of investment products have proliferated, and discerning the expected returns, risks and tax attributes of these vehicles has also grown more difficult.

Additionally, federal income tax law has become increasingly complex, providing opportunities for the attentive but also traps for the unwary or misinformed.

(1) *Successfully navigating the financial world of today requires an even higher degree of knowledge, skill and experience than that which existed in 1940. As a result, there is even a greater disparity of knowledge between providers of advisory services and individual consumers. This denotes, as set forth below, a greater need for fiduciary protections, not a lesser need.*

(2) *Are "non-discretionary brokerage accounts" similar to "investment advisory accounts"? No. Under brokerage accounts only advice relating to the investment product which is solely incidental to the sale or transaction is permitted. Despite this, large wirehouses assert that the lines have blurred in the functions of brokers (product sellers, i.e., representatives of the product manufacturers) and investment advisers (providers of professional advice, and representatives of the consumer or product purchaser). While registered representatives possess a duty of suitability, such refers to the internal documentation of the client's circumstances and the risks of the product as suitable for those circumstances; nothing in a suitability analysis requires the registered representative to provide more comprehensive advice to his or her customer.*

(3) *In reality, the functions of registered representatives and investment adviser (representatives) are, and remain, completely different and distinct. Any blurring which has occurred is only because the SEC has permitted registered representatives to provide advice that is not "solely incidental" to a transaction without being subject to the IAA of 1940, as was intended by Congress.*

(4) *Simply put, in today's more complex world, consumers want and need more comprehensive advice – advice which registered representatives cannot provide without becoming subject to the IAA of 1940. But they desire to provide it anyway – only under lesser standard of care – not a fiduciary standard of care.*

(5) "The legal system provides for only two levels of trust and their differentiation is necessary for them to be useful tools for parties setting up relationships ... In essence, legal systems provide only two levels of loyalty between contracting parties, arm's-length and fiduciary relationships. The difference in the degree of trust that the two levels of loyalty entitle the parties is dramatic. Fiduciary relations impose a pure duty of loyalty, according to which the fiduciary must place the interests of his employer before his own. Arm's-length relations, by contrast, allow exploitation within the parameters of good faith." [Nicholas L. Georgakopoulos, "Meinhard v. Salmon and the Economics of Honor," Draft (1998).]

b. What Did Broker-Dealers Do In 1940? Historically, investment advice by registered representatives was limited to product-specific recommendations. "The predominant

concern of the securities industry is the sale of securities, and in pursuit of this activity members of the industry make use of many of the standard techniques of merchandising … Public investors are attracted to securities markets through the extensive use of sales promotion activities, which include advertising in almost all media of communication as well as market letters, research reports, lectures, and even investor contests. In style and emphasis these range from the 'institutional' approach to the highly flamboyant, and the former is not necessarily the exclusive domain of the more conservative firms. Whatever style is used, one of two themes predominates: the trust and confidence which the customer should place in the firm because of its superior research facilities and experience, or the potential profits to be reaped by investors from the purchase of its merchandise." *Report of Special Study of Securities Markets of the Securities and Exchange Commission* (1963), at p. 323. "Most of the published material distributed by broker-dealers is in one of two general categories: brief 'market letters' and longer 'research reports.'" *Id.* at p. 345.

c. What Was The Intent of the Investment Advisers Act of 1940? By contrast to the activities of broker-dealer firms, "investment consultants" in 1940 had a much different function, and the enacters of the Investment Advisers Act of 1940 had two major purposes in mind – (1) protect individual investors; and (2) protect honest investment counselors' reputations from being tarnished by wrong-doers.

(1) *Protection of Individual Investors.* From the landmark case of *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180 (1963), extensive excerpts are appropriate:

(a) "The Public Utility Holding Company Act of 1935 'authorized and directed' the Securities and Exchange Commission 'to make a study of the functions and activities of investment trusts and investment companies . . . .' Pursuant to this mandate, the Commission made an exhaustive study and report which included consideration of investment counsel and investment advisory services. This aspect of the study and report culminated in the Investment Advisers Act of 1940."

(b) "The report reflects the attitude -- shared by investment advisers and the Commission -- that investment advisers could not "completely perform their basic function -- furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments -- unless all conflicts of interest between the investment counsel and the client were removed." The report stressed that affiliations by investment advisers with investment bankers, or corporations might be 'an impediment to a disinterested, objective, or critical attitude toward an investment by clients . . . .'"

(c) "This concern was not limited to deliberate or conscious impediments to objectivity. Both the advisers and the Commission were well aware that whenever advice to a client might result in financial benefit to the adviser -- other than the fee for his advice – 'that advice to a client might in some way be tinged with that pecuniary

interest [whether consciously or] subconsciously motivated ….' The report quoted one leading investment adviser who said that he 'would put the emphasis . . . on subconscious' motivation in such situations. It quoted a member of the Commission staff who suggested that a significant part of the problem was not the existence of a 'deliberate intent' to obtain a financial advantage, but rather the existence 'subconsciously [of] a prejudice' in favor of one's own financial interests. The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations, which contained the following canon: '[An investment adviser] should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect.'"

(d) "Other canons appended to the report announced the following guiding principles: that compensation for investment advice 'should consist exclusively of direct charges to clients for services rendered'; that the adviser should devote his time 'exclusively to the performance" of his advisory function'; that he should not 'share in profits' of his clients; and that he should not 'directly or indirectly engage in any activity which may jeopardize [his] ability to render unbiased investment advice.' These canons were adopted 'to the end that the quality of services to be rendered by investment counselors may measure up to the high standards which the public has a right to expect and to demand.'"

(e) "Although certain changes were made in the bill following the hearings, there is nothing to indicate an intent to alter the fundamental purposes of the legislation. The broad proscription against 'any ... practice … which operates … as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end. And the Committee Reports indicate a desire to preserve 'the personalized character of the services of investment advisers,' and to eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.' The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested. It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit,' intended to require proof of intent to injure and actual injury to clients."

(f) "This conclusion moreover, is not in derogation of the common law of fraud, as the District Court and the majority of the Court of Appeals suggested. To the contrary, it finds support in the process by which the courts have adapted the common law of fraud to the commercial transactions of our society. It is true that at common law intent and injury have been deemed essential elements in a damage suit between parties to an arm's-length transaction. But this is not such an action … 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. There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue. The 1909 New York case of *Ridgely v. Keene*, 134 App. Div. 647, 119 N. Y. Supp. 451, illustrates this continuing development. An investment adviser who, like respondents, published an investment advisory service, agreed, for compensation, to influence his clients to buy shares in a certain security. He did not disclose the agreement to his client but sought 'to excuse his conduct by asserting that . . . he honestly believed, that his subscribers would profit by his advice …." The court, holding that 'his belief in the soundness of his advice is wholly immaterial,' declared the act in question 'a palpable fraud.'"

(2) <u>*Establish A Fiduciary Profession.*</u> As John Walsh observed regarding the historical underpinnings of the Investment Advisers Act of 1940, "All of the themes of this history are reflected in the legislative history of the IAA. First, the Act was explicitly motivated by the desire to protect and enhance advisers' professional ethics. Second, this objective was to be reached by prohibiting conduct inconsistent with the ideal. Third, even associational self-regulation made an appearance in the idea that all advisers suffered from the stigma placed on the unethical fringe elements, and in the idea that federal regulation was needed to support the industry's voluntary effort to establish a code of ethics." [John H. Walsh, "A Simple Code Of Ethics: A History Of The Moral Purpose Inspiring Federal Regulation Of The Securities Industry," 29 Hofstra L.Rev. 1015, 1068 (2001).]

(a) *The Important Economist View of Professional Status and the Need for Its Preservation through Functional Regulation.* Why would a person desire to become a fiduciary? The benefit of the assumption of fiduciary status is the increased marketability of the fiduciary. By endowing fiduciaries with a reputation for honesty backed by strict adherence to fiduciary standards of conduct and rigid enforcement, the fiduciary is the recipient of a greater ability to promote and market his or her

services. Should the regulatory body permit others to undertake substantially the same services as those provided by the fiduciary without imposition of fiduciary status, the increased marketability of the fiduciary is thwarted. Professor Macey in his 2002 article observed: "Each financial planner has incentive to develop and maintain a reputation for honesty and competence in order to increase the demand for his services. All financial planners suffer when the reputation of the profession suffers because consumers are unable to distinguish between high-quality services of ethical or competent financial planners and low-quality services of unethical or incompetent financial planners. This, in turn, reduces the market's demand and willingness to pay for financial planners. The practical implications of this basic problem, described by economists as "information asymmetry" because of the fact that consumers have less information than producers (and therefore the distribution of information between the sellers of services and the buyers of services is asymmetric) are important for the future of any industry or profession. The general problem was first described in a famous article by George Akerloff, in which he showed what would happen to an industry if consumers were unable to distinguish between high quality producers and low quality producers [citing George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q. J. ECON.488 (1970)]. The consequences of this problem are far more severe than may appear at first blush. The structure of the problem can be described with reference to the financial planning profession as follows: suppose, for the sake of clarity and simplicity, there are only three types of financial planners, excellent quality planners, whose work is worth $900 per hour, medium quality financial planners, whose work is worth $300 per hour, and low quality financial planners, whose work is worth minus $300 per hour because of the costs that such planners impose on their clients through incompetence and fraud. Imagine further that consumers are unable to differentiate among these various types of financial planners until after they have received their services. They don't know whether the advice they are getting is of high, medium or low quality until they have purchased the advice. Where this is true, economists have shown that the products all will sell for the same price, because consumers who pay more than the standard market price still will be unable to increase the probability that they are receiving high quality advice." [“Regulation of Financial Planners,” White Paper Prepared for the Financial Planning Association by Jonathan R. Macey, April 2002, available at http://www.fpanet.org, under “Government Relations” / “White Papers.”]

(b) *Observations From A Recent Visit to Congressional Staff: Déjà Vu!* Recently this writer had the opportunity, as part of a group representing one of the organizations of financial advisers, to visit with Congressional staff regarding issues involving the application of fiduciary duties to financial intermediaries. As the discussion ensued,

requests by the group were made of Congressional staff to protect the investment advisory profession and to protect consumers through expansion of fiduciary duties, or at least the enforcement of fiduciary duties on all those who provide investment advisory services. As the conversation went on, I reflected that it sounded like a return to the late 1930's, when "[i]ndustry spokespersons emphasized their professionalism. The 'function of the profession of investment counsel,' they said, 'was to render to clients on a personal basis competent, unbiased and continuous advice regarding the sound management of their investments.' In terms of their professionalism they compared themselves to physicians and lawyers. However, industry spokespersons indicated that their efforts to maintain professional standards had encountered a serious problem. The industry, they said, covered 'the entire range from the fellow without competence and without conscience at one end of the scale, to the capable, well-trained, utterly unbiased man or firm, trying to render a purely professional service, at the other end.'" In response to a question from a Congressional staffer as to the likelihood that the many organizations whose members consists of financial planners would band together to create a uniform set of standards, or whether federal intervention was required, I felt like I was transported back nearly seven decades. The entire conversation seemed like déjà vu.

d. <u>Financial Planning Association vs. SEC.</u>

(1) In Financial Planning Ass'n v. S.E.C., 482 F.3d 481 (D.C. Cir., 2007), the U.S. Court of Appeals cited to the legislative history of the IAA, stating:

(a) "According to the Committee Reports, '[t]he essential purpose of [the IAA] ... [was] 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.' H.R.Rep. No. 76-2639, at 28 (1940) … :

(b) "In §202(a)(11) of the IAA, Congress broadly defined 'investment adviser' as 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities' ....

(c) "Carving out six exemptions from this broad definition, Congress determined that an 'investment adviser' did not include … (C) any broker or dealer [1] whose

performance of such services is solely incidental to the conduct of his business as a broker or dealer and [2] who receives no special compensation therefor …."

(2) While the focus of much of the Court's decision was on "special compensation," the Court of Appeals did discuss the legislative history behind the "solely incidental" test:

(a) "The Committee Reports recognized that the statutory exemption for broker-dealers reflected this distinction; the Reports explained that the term 'investment adviser' was 'so defined as specifically to exclude ... brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions).' S.Rep. No. 76-1775, at 22 [HA 164]; H.R.Rep. No. 76-2639, at 28 [HA 168]".

(3) The Court then went on to discuss Congress' intent behind the "broad definition" of "investment adviser:

(a) "Just as the text and structure of paragraph of 202(a)(11) make it evident that Congress intended to define 'investment adviser' broadly and create only a precise exemption for broker-dealers, so does a consideration of the problems Congress sought to address in enacting the IAA. A comprehensive study conducted by the SEC pursuant to the Public Utility Holding Company Act of 1935 indicated that "many investment counsel have 'strayed a great distance from that professed function' of furnishing disinterested, personalized, continuous supervision of investments." Securities and Exchange Commission, Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, at 25 (1939) (quoting testimony of brokerage executive James N. White, of Scudder, Stevens & Clark). Floor debate on the IAA called attention to the fact that while this study was being conducted investment trusts and investment companies had perpetrated "some of the most flagrant abuses and grossest violations of fiduciary duty to investors." 86 Cong. Rec. 2844 (daily ed. Mar. 14, 1940) (statement of Sen. Wagner). Congress reiterated throughout its proceedings an intention to protect investors and bona fide investment advisers.

(b) "The overall statutory scheme of the IAA addresses the problems identified to Congress in two principal ways: First, by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined, see Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11, 17, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979), and second, by requiring full disclosure of all conflicts of interest. As the Supreme Court noted, Congress's "broad proscription against `any ... practice ... which

operates ... as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end." SEC vs. Capital Gains Research Bureau, 375 U.S. at 191, 84 S.Ct. 275.

(c) "[T]he Committee Reports indicate a desire to … eliminate conflicts of interest between the investment adviser and the clients as safeguards both to `unsophisticated investors' and to `bona fide investment counsel.' The [IAA] thus reflects a . . . congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.

(4) Lastly, in footnote 7, the U.S. Court of Appeals also recalled an early interpretation of the IAA:

(a) "Very shortly after enactment of the IAA, the SEC advised that any charges directly related to the giving of investment advice would be special compensation. On October 28, 1940, the SEC General Counsel issued an opinion stating: "Clause (C) of section 202(a)(11) amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause (C) which refers to "special compensation" amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities."

6. ***Application of Fiduciary Status Does NOT Lead (Per Se) To Greater Claims Against Financial Intermediaries.*** Common broker-dealer arguments against the application of fiduciary duties state that the liability associated with such accounts is too great and that the costs to investors of investment advisory accounts is too high. However, E&O insurance industry observations have noted that the application of fiduciary duties upon financial intermediaries does not lead to expanded liability (as to either quantity of claims or size of awards); in fact, investment advisers have fewer claims, in lesser dollar amounts, than broker-dealer firms. This is because operating with a "fiduciary mantra" or "fiduciary attitude" avoids many of the concerns which otherwise arise. The attitude of non-fiduciaries, in contrast, is one which lends itself to claims; as related to this author by numerous registered representatives and insurance agents when operating under the NASD and/or state insurance regulations, "it is o.k. to do anything that is not specifically prohibited").

a. *See* comment letter of Bayard Bigelow, III, MBA, CPA, President and CEO, The Cambridge Alliance, January 4, 2005, regarding Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers [Release Nos. 34-42099; IA-1845]: "Until 1996, our program underwrote both Broker Dealers and Registered lnvestment Advisers. Beginning in 1993 we began to examine the differences in claims arising from Broker Dealers and those from Registered lnvestment Advisers. Our predisposition was, because of their heightened legal duty, that Registered lnvestment Advisers would present claims with both greater frequency and severity than Broker Dealers. To our surprise, just the opposite was the case -claims against Broker Dealers dominated and were, on average, twice as frequent and twice as severe as those made against Registered lnvestment Advisers. Upon further examination, the differences became even more apparent -while Registered lnvestment Advisers had the heightened duty of a fiduciary, the evidence unequivocally suggested that they also, at the risk of regulatory censure or sanctions, did a demonstrably more effective job in meeting the needs of the investing public."

7. ***Fiduciary Accounts Do <u>NOT</u> Lead to Higher Costs for Investors, But Rather Lessens the Costs of Intermediation.*** Furthermore, the maintenance of investment adviser accounts is not more expensive for investors. In fact, the opposite is true. Fiduciary advisers, who possess a duty to ensure that the total fees and costs paid by their clients are reasonable and that clients' portfolios are designed and managed tax-efficiently, must not engage in the recommendation of higher-expense and/or tax-inefficient investment products. The result is that fiduciary advisers act as purchaser's representatives, leading to increased pressures on product providers and custodians to lower costs. In essence, disintermediation occurs, and more of the returns the capital markets have to offer make their way down to individual investors. What about serving the small investor? Arguments have been advanced that maintaining investment advisory accounts and collecting fees on such accounts is far more expensive than, for example, selling Class A or Class C mutual fund shares to investors, and being able to provide occasional or ongoing advice to such investors. As indicated later in this outline, payment of 12b-1 fees, for ongoing advice, clearly implicates registration requirements under the IAA. However, the ability of the securities industry to adapt should not be underestimated. Proposals could be advanced for direct deduction of investment advisory fees from investment products held in investment advisory accounts (or automatic deduction from accounts), with clear notification to the consumer of the fees paid in each instance. Furthermore, there are investment adviser business models which serve smaller investors which currently are in operation, and which business models have proven to be sufficiently profitable to attract a large number of advisors. Lastly, smaller investors deserve the protection of the fiduciary standard of conduct just as much as wealthy investors do.

   a. Placed under scrutiny, perhaps the argument of the wirehouse firms is more truthfully set forth as this: "Our investment adviser business model does not permit us to extract from

small individual investors a great deal of profits." The argument really goes to the lack of profitability of the business model (at least at the high degree of profits sought by wirehouses). If large wirehouse firms or other broker-dealers cannot serve the small investor, then other businesses will emerge that will serve smaller investors. In fact, such business models already exist, and under a fiduciary standard.

8. ***Disintermediation Can Assist In Solving America's Long-Term Economic Problems.*** The dramatic effects of disintermediation through the application of fiduciary standards of conduct may, collectively, play an essential role in solving the long-term economic problems facing the United States, particularly as to the underfunding of public benefits programs. If increased returns for investors results (through lower fees and costs, as a result of fiduciaries' duties to ensure their reasonableness), this may take substantial pressure off of the federal government in the funding of benefits for retirees.

9. ***The IAA Definition of "Investment Adviser" Is Quite Broad.*** The definition of "investment adviser" in the IAA is quite broad, and the broker-dealer exception is quite narrow, as evidenced by the March 30, 2007 decision of the D.C. Court of Appeals in *Financial Planning Association vs. SEC*. Several times the D.C. Court indicated that the definition of "investment adviser" was intended by Congress to be "broadly applied" while the broker-dealer exception was limited to the receipt of commissions for which only incidental advice was provided. While the IAA clearly applies fiduciary duties upon investment advisers, the SEC may nevertheless seek to restrict the application of the IAA, and hence fiduciary status, by further rule-making.

B. **Recent Divergence In Federal/State Application of Fiduciary Standards: State Securities Administrators and State Courts Apply Fiduciary Status, While The SEC Retreats From Its Application**. The SEC and state securities regulators have diverged in their approach to the application of fiduciary duties to advisory activities.

1. ***SEC Attacks On Fiduciary Protections for Investors.*** The SEC in recent years has sought to lessen the application of fiduciary duties, including the ill-fated adoption of the rule permitting fee-based brokerage accounts, the recently adopted temporary rule providing relief to investment advisers with regard to principal trading, and SEC expressions of their views on financial planning activities as not subject to regulation under the IAA as fiduciary activities.

2. ***Is SEC Authority To Apply Fiduciary Duties Limited?*** Note that the SEC's ability to apply fiduciary standards may, to a degree, be limited by the scope of the Investment Advisers Act of 1940 (IAA). The scope of the fiduciary duty arising under the IAA is determined by reference to SEC rules and federal court and administrative decisions, rather than state common law analogies. *See* Robert E. Plaze, "The Regulation of Investment Advisers By the U.S. Securities and Exchange Commission," p.38, fn. 90, citing *Laird v. Integrated Resources, Inc.*, 897 F.2d 826 (5th Cir. 1990) ("[B]ecause state law is not considered, uniformity is promoted.").

3. ***States Impose Fiduciary Status More Broadly.*** State regulators have increasing applied their state investment adviser registration acts or otherwise imposed fiduciary status to regulate investment advisory and financial planning activities.

   a. Fee-Based Brokerage Accounts***.*** The states properly sought to extend the application of fiduciary duties to advisory activities as a means of protecting individual investors. This was most evident in the NASAA's opposition to the fee-based brokerage accounts rule promulgated by the SEC. *See* Rex Staples, Esq., "Corrected Brief of Amicus Curie of North American State Securities Administrators," April 12, 2006, in support of the Financial Planning Association's suit against the SEC relating to fee-based brokerage accounts, arguing in part that the SEC's improper interpretation of the IAA leading to the adoption of Rule 202(a)(11)-1 "has seriously compromised investor protection" [*Id.* at p.3] and stating that "the pillar of undivided loyalty, which characterizes an investment advisory relationship, goes well beyond the standard of conduct to which a broker-dealer must adhere." *Id*. at p.18. The NASAA also fought against the pre-emption aspects of the rule, stating: "The states have played an important role in protecting investors, and without this additional layer of protection to compensate for the erosion of investor protection at the federal level, more and more investors are left with nowhere to turn." *Id.* at p.24.

   b. State Anti-Fraud Statutes & Securities Regulation: Approaching 100 Years. All states had antifraud statutes before the adoption of the federal securities laws. [Roberta Romano, *The Advantage of Competitive Federalism for Securities Regulation* (The AEI Press, Washington, DC, 2002), p.43.] In fact, securities regulation began as a matter of state law more than twenty years before Congress enacted federal securities regulation in 1933. [Jonathon Macey & Geoffrey Miller, "The Origins Of Blue-Sky Laws," 70 Tex L. Rev. 347, 348 (1991).] In 1911, Kansas enacted the first securities statute, which required registration of both brokers and securities. By the time Congress adopted the 1933 Act, forty-nine states had enacted blue-sky laws under their assumed responsibility to protect their citizens from wide ranging fraud and abuse. [Marilyn B. Cane & Peter, "Back to the Future: The States' Struggle to Re-Emerge as Defenders of Investors' Rights."] Moreover, the savings clause in the '33 and '34 Acts preserved states' authority over securities and persons in the securities industry, creating a dual regulatory scheme that persisted for over 60 years. ["Nothing in this chapter shall effect the jurisdiction of the securities commission (or any agency or office performing like functions) of any state or territory of the United States, or the District of Columbia, over any securities or any person."]

   c. No Preemption of State Anti-Fraud Authority To Regulate Advisory Activities Under NSMIA. Despite preemption of state authority on securities regulation in some areas by NSMIA, state regulatory authority with respect to regulation against fraudulent sales or advisory activities was retained. This was made clear by an early 2007 decision, *Capital Research and Management Company v. Brown*, Decision No. B189249 (Cal. App. 1/26/2007) (Cal. App.,

2007), wherein the court stated: "NSMIA's savings clause is sufficiently broad to permit the Attorney General of California to pursue injunctive relief and penalties against a covered security's investment advisor and wholesale broker-dealer who allegedly made inaccurate or inadequate representations to purchasers … The plain language of the savings clause and its legislative history persuade us that Congress intended to preserve the states' anti-fraud authority to control the conduct of brokers and dealers, notwithstanding that the exercise of such controls might prospectively influence the disclosures made by a covered security. … The Joint Conference Report of both houses offers a similar insight into the purpose of the savings clause. 'The [statute preserves] the authority of the states to protect investors through application of state antifraud laws. This preservation of authority is intended to permit state securities regulators to continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses, such as churning accounts or misleading customers.'" The Court went on to note the following: "Our conclusion is supported by the clear statement of Congressional intent expressed at the time the savings clause was enacted. By way of example, a Senate Report explained that the statute preserved the states' authority to "continue their role in regulating broker-dealer conduct whether or not the offering is subject to state review. The [Senate] Committee believes that allowing the states to oversee broker-dealer conduct in connection with preempted offerings will ensure continued investor protection. As long as states continue to police fraud in these offerings, compliance at the federal level will adequately protect investors. In preserving this authority, however, the Committee expects the states only to police conduct — not to use this authority as justification to continue reviewing exempted registration statements or prospectuses. The Committee clearly does not intend for the `policing' authority to provide states with a means to undo the state registration preemptions." (Sen. Rep. No. 104-293, 2d Sess. (1996) [1996 WL 367191 at *15], emphasis added.) The Attorney General's enforcement action, which challenges broker-dealer conduct, cannot reasonably be construed as an effort to regulate a non-party issuer."

d. State Securities Administrators Take A More Expansive State View of "Investment Adviser" Statutory Definition. For example, Joseph Borg, Director of the Alabama Securities Commission, stated that he had found a new approach to preventing abusive sales practices: "If the agents are advising people to sell mutual funds or get out of 401(k)s, they are acting as investment advisers. And in my state, being an unregistered investment adviser is a felony." In 'dozens' of equity-indexed annuity (EIA) sales the state has investigated in the past few years, he says, insurers have "paid the money back, plus 6% interest." (Kelly Greene, "Backlash Hits Annuities Tied To Stock Market," *Wall Street Journal*, 8/8/07). Other states have taken the same approach in challenging EIA sales.

e. Three Schools of Thought: Brokers As Fiduciaries. As pointed out in a recent article by Jeffrey Spill, Deputy Director, New Hampshire Bureau of Securities Regulation, under the

common law "three schools of thought emerge [as to when brokers might become fiduciaries]. The minority view is that a broker is not a fiduciary unless the customer entrusts him with "discretion" to select the investments. This view sees the broker relationship as an arm's-length contractual relationship wherein no fiduciary obligation exists. The majority of courts, however, fall into one of two groups. The first group follows the "shingle theory" of brokerage which states that when a broker hangs his shingle he impliedly represents that he will deal with the public fairly, and that even in a non-discretionary account, he is always under a fiduciary obligation as to each individual brokerage transaction. These duties include: recommending a stock only after becoming familiar with its nature, price and fundamental prognosis; carrying out the customer's order in a manner that is best execution for the customer; informing the customer of the risks of an investment; transaction of business only after receiving authorization; refraining from self-dealing or disclosure of personal interest; and not to misrepresent material facts. The second group takes the position that the scope of a stock broker's fiduciary obligation in a particular case is an issue of fact that turns on the manner in which investment decisions have been reached and transactions executed for the account." Spill, "The Merrill Rule: Old Habits Die Hard," The Blue Sky Bugle (ABA Committee on State Regulation of Securities), Volume 2007, No. 1 (Winter 2007).

(1) Quasi-Fiduciary Duties of Broker-Dealers. Are broker-dealer firms and their registered representatives (RRs) fiduciaries? Yes, as to the scope of their agency. In this regard the broker-dealer firm accepts responsibility as an "agent" of the customer for the proper execution of the brokerage transaction. In connection with the scope of that agency, the broker-dealer and its RRs owe "limited fiduciary duties" or "quasi-fiduciary duties" to the customer. However, no broad fiduciary duties to exist with respect to most RRs and their broker-dealer firms, under the law of agency, at least with respect to non-discretionary accounts.

(2) Discretionary Accounts. Fiduciary duties expand when the broker-dealer firm (through its RR) assumes discretion over an account. At the hearing on September 19, 2007, the SEC announced that it will continue to view discretionary brokerage accounts are subject to the IAA and its fiduciary duties. Additionally, from various court decisions addressing discretionary accounts, it is clear that common law fiduciary duties arise from the principal-agent relationship, and that these duties will be interpreted quite broadly. In essence, since the scope of the agency is expanded to include the exercise of discretionary authority to undertake sales and purchases in the account, the agent (RR) owes a fiduciary duty to the principal (the customer) in the actions undertaken which exercise that discretion. Some state courts go further and apply the very broad triad of fiduciary duties – loyalty, due care, and utmost good faith – when the broker-dealer possesses discretion over a customer's account. *See Leib v. Merrill Lynch, Pierce, Fenner*

& Smith, Inc. 461 F Supp 951, 953 [ED Mich. 1978] ["[u]nlike the broker who handles a non-discretionary account, the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense."]. "When a stock broker or financial advisor is providing financial or investment advice, he or she is required to exercise the utmost good faith, loyalty, and honesty toward the client. The broker or advisor implicitly represents to the client that he or she has an adequate basis for the opinions or advice being provided." *Johnson v. John Hancock Fund*s, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006) citing *Hanly v. S.E.C*., 415 F.2d 589, 596-97 (2d Cir. 1969); *Univ. Hill Found. v. Goldman*, 422 F. Supp. 879, 893 (S.D.N.Y. 1976).

(3) "De Facto Control" Leading To Finding A Discretionary Account To Exist. Furthermore, even though an account may be "non-discretionary" on paper, some state courts find that the RR may exercise de facto control over non-discretionary accounts. In essence, such a finding transforms the scope of the agency from a limited one to a broad one, and fiduciary duties then apply to that broadened scope of the agency. For example, if a broker has provided broad advice relative to investment strategies and decisions, and if the customer has frequently relied on that advice, there is a strong indication that the account is discretionary. There are many factors, however, that apply, and in each instance it is a "facts and circumstances" analysis.

f. ***State Courts Increasing Apply Broad Fiduciary Duties To Financial Advisory Relationships.*** There is an ever-expanding body of case law finding the existence of a fiduciary relationship between a financial advisor (as that term is utilized in its widest sense) and his or her customer or client, applying the common law rule that 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. While most issues involving the application of common law fiduciary duties to the activities of financial intermediaries serving individual investors are not made public due to the confines of mandatory arbitration, some cases do emerge. Recent case law includes (but is not limited to) the following cases:

(1) Graben (2007). A dual registrant crossed the line in "holding out" as a financial advisor, and in stating that ongoing advice would be provided, and other representations, and in so doing the dual registrant, who sold a variable annuity, and was found to have formed a relationship of trust and confidence with the customers to which fiduciary status attached. "Obviously, when a person such as Hutton is acting as a financial advisor, that

role extends well beyond a simple arms'-length business transaction. An unsophisticated investor is necessarily entrusting his funds to one who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his investor/entrustor. The relationship goes well beyond a traditional arms'-length business transaction that provides 'mutual benefit' for both parties." *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007).

(2) Williams (2006). In a case arising from Oregon, a self-employed insurance seller and licensed financial planner took advantage of his position as a financial advisor to gain the trust of an 87-year-old man, Stubbs, convincing the elderly man to grant him a power of attorney, with which the financial planner stole about $400,000. The court held that the licensed financial planner was employed as a fiduciary, specifically noting that the elderly man relied upon the fiduciary as a financial advisor and estate planner. *U.S. v. Williams*, 441 F.3d 716, 724 (9th Cir. 2006).

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

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

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

(6) Mathias (2002). “In the fall of 1985, plaintiff, having recently divorced and relocated to Columbus, Ohio, sought investment advice from Thomas J. Rosser. At the time, Rosser was a licensed salesman for Great Lakes Securities Company and held himself out as a financial advisor … [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." *Mathias v. Rosser*, 2002 OH 2531 (OHCA, 2002). The court further noted, that under Ohio law, a fiduciary relationship is "a relationship in which one party to the relationship places a special confidence and trust in the integrity and fidelity of the other party to the relationship, and there is a resulting position of superiority or influence, acquired by virtue of the special trust."

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

(8) MidAmerica (1989). In 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. The court in its ruling looked at the strength on one side and the weakness on the other which resulted in trust and dependence reposed in the stronger.

(9) Koehler (1985). A U.S. District Court in 1985 held that a fiduciary relationship existed in part because of a defendant's status as financial planner to a client. In *Koehler v. Pulvers,* 614 F. Supp. 829 (USDC, Cal, 1985) the defendant, CSCC, was primarily in the business of real estate syndication, but also in business under the name Creative Financial Planning. As stated in the decision, "The developer defendants obtained investment capital from the public by posing as financial planners ... The financial planners typically had a background in either insurance or real estate sales … As an alleged financial planning company, CSCC, dba Creative Financial Planners, contacted potential investors by conducting Creative Financial Planning seminars open to the public. Utilizing a slick presentation… CSCC attempted to lure investment capital out of savings accounts, home equity, insurance policies, and other conservative investment vehicles and into the speculative real estate ventures it controlled … At the seminars, CSCC offered to draft a 'Coordinated Financial Plan' for attendees at little or no charge. Individuals who accepted this offer received recommendations to purchase limited partnership or trust deed interests in CSCC controlled partnerships and project ...." The court also noted, "Most of the plaintiffs are and were unsophisticated investors. Few had a preexisting relationship with the developer defendants at the time they

purchased their securities ... [the investors] relied upon the misrepresentations discussed in detail below. This reliance was reasonable in part because of the developer defendants' purported disinterested financial planner status."

C. **Titles That Imply Fiduciary Status May Trigger IA Registration, Or May Be Viewed As Misleading.** Titles such as "financial planner," "wealth manager," "estate planner," or "financial consultant" imply fiduciary status, and may trigger registration as an investment adviser representative or the application of fiduciary status by the courts.

1. ***Holding Out.*** Holding out by using titles such as those set forth above is a significant factor in determining whether a fiduciary relationship exists under state common law.

2. ***Deceptive Trade Practices or Misleading?*** Query whether the use of designations results in an unfair or deceptive trade practices, or a misleading representation in connection with the sale of a security. Should the states utilize their authority under their securities anti-fraud statutes to promulgate rules to the effect that the use of the adjectives "financial," "investment," "estate," "wealth" or similar words in conjunction with the nouns "adviser," "consultant," "planner," "manager" or similar words require the user of that term to be a fiduciary to his or her clients at all times?

3. ***Model Disclosures***? Alternatively, should the states, pursuant to their anti-fraud authority, require each insurance agent, registered representative, and/or investment adviser to clearly state whether he or she is acting as a fiduciary or non-fiduciary? To be effective such a disclosure must explain the differences between fiduciary and non-fiduciary financial intermediaries, must explain the differing standards of conduct, must indicate the "incidental advice" provided by a non-fiduciary advisors is not financial planning or similar advisory services but rather is associated with the promotion and sale of an investment or insurance product. The disclosure should be set forth in a separate form with appropriate large, bold print, and should use red typeface where appropriate.

D. **Restrictions On The Use of Certain Designations: Welcome Developments.** Balancing investor protection and freedom of speech is not always an easy task.

1. ***Massachusetts*** has adopted regulatory amendments making it a dishonest or unethical practice in the securities business for a broker-dealer or investment adviser representative to use a professional designation implying special expertise in advising or servicing senior citizens, unless accredited by an organization recognized by Massachusetts by rule or order. According to the Division, this rule is based on concerns about the use of designations that falsely convey a certain expertise in matters dealing with seniors and their special needs. The Division specifically cited the example of using the designation "Certified Elder Planning Specialists" ("CEPS") as misleading and a method to disguise that the associate was an insurance agent.

2. ***Washington State*** is soliciting comments on how it can address the issue of misleading professional designations through regulation, as well as comments on the use of the term "financial planner."

3. ***Nebraska.*** Jack Herstein, deputy director of the Securities Bureau of the Nebraska Department of Banking and Finance, recently noted that the Securities Bureau has approved eight (8) professional designations for use by registered investment advisers in Nebraska. Herstein also explained that once the professional designation review process is completed, a person could be fined or suspended for using professional designations that haven't been approved by the Nebraska Securities Bureau.

E. **Fee-Based Brokerage Accounts: Resurrection?** If fee-based brokerage accounts return, in a different form, should state securities regulators regulate fee-based brokerage accounts as investment advisory accounts anyway?

1. ***The IAA Definition of "Investment Adviser" Is Quite Broad.*** The definition of "investment adviser" in the IAA is quite broad, and the broker-dealer exception is quite narrow, as evidenced by the March 30, 2007 decision of the D.C. Court of Appeals in *Financial Planning Association vs. SEC*. Several times the D.C. Court indicated that the definition of "investment adviser" was intended by Congress to be "broadly applied" while the broker-dealer exception was limited to the receipt of commissions for which only incidental advice was provided. While the IAA clearly applies fiduciary duties upon investment advisers, the SEC may nevertheless seek to restrict the application of the IAA, and hence fiduciary status, by further rule-making.

2. ***Merrill Lynch and Morgan Stanley***, according to press reports, are "mulling a new platform that would enable clients to maintain paying a fixed fee based on their level of trading activity. The new account, according to people familiar with the plan, will be brokerage in nature but clients would pay a fixed commission based on trading frequency rather than a fee based on their assets … Both firms' move is seen as a clever attempt to skirt a March ruling by the U.S. Court of Appeals for the D.C. Circuit …. Merrill's and Morgan Stanley's upcoming brokerage platforms could allow them to have similar pricing structures to the fee-based brokerage model that the court declared illegal." "Merrill Lynch, Morgan Stanley Mull New Brokerage Account," *Financial Advisor* magazine, August 30, 2007.

3. ***"Commissions Only."*** The U.S. Court of Appeals decision in Financial Planning Association vs. SEC, No. 04-1242 (D.C. Cir., March 30, 2007), possesses potentially far-reaching implications. Three times in that decision the Court emphasized that the term "investment adviser" was "broadly defined" by Congress. Additionally, in discussing the exclusion for brokers (insofar as their advice is solely incidental to brokerage transactions for which they receive no special compensation), the U.S. Court of Appeals stated: "The relevant language in the committee reports suggests that Congress deliberately drafted the exemption in subsection (C) to apply as written. Those reports stated that 'investment adviser' is so defined as specifically to exclude ...

brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive *only brokerage commissions*) ….” [*Emphasis added*.]

4. ***Should the States Challenge Any Reemergence of Fee-Based Accounts?***

   a. Court Challenge? Given the clear language of the *FPA vs. SEC* decision (“By seeking to exempt broker-dealers beyond those who receive only brokerage commissions for investment advice, the SEC has promulgated a final rule that is in direct conflict with both the statutory text and the Committee Reports”), court challenge to the Merrill Lynch / Morgan Stanley fee-based brokerage accounts, if they are launched, may occur.

   b. Another Approach? Registration and Enforcement At The State Level? The precise nature and structure of such accounts, if they are launched, are unknown at the time of the writing of this outline. Will they be only for active traders? Or will they include “modular” financial planning services? If the accounts provide “investment advisory services” beyond product descriptions provided by broker-dealers which are incidental to the sales transaction, the states could choose to enforce registration of registered representatives offering such accounts as investment adviser representatives, and apply their anti-fraud authority to enforce advertising restrictions on the firms offering such accounts, ensure complete disclosure of material facts to clients, etc.

F. **“Blanket Consent” To Principal Trading By IAs: An Assault On Fiduciary Relationships**. A likely SEC proposed rule, to be announced Sept. 19th according to published reports, would grant investment advisers who have affiliated BD firms relief from principal trading rules. Such relief would permit some form of “blanket consent” - which poses substantial dangers to investors and to honest fiduciaries.

1. ***A Distortion of the IAA and Congressional Intent?*** “The high standards of business morality exacted by our laws regulating the securities industry do not permit an investment adviser to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in these recommendations to his clients.” *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180, 201 (1963).

2. ***Blanket Consent A “Loyalty Waiver” Not Permitted By §215, IAA?*** In essence, blanket consent appears to nullify, by a device which may be denoted as “procedural” in nature but which, in reality, constitutes the “exception” to the no-profit rule” swallowing the rule itself. “In its ‘declaration of policy' the original bill stated that: ‘Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission . . . *it is hereby declared that the national public interest and the interest of investors are adversely affected* ... *when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients* ... It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is presently practicable to eliminate the

abuses enumerated in this section ..." *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180, (1963). [*Emphasis added.]* Section 215(a) of the IAA states that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation or order thereunder shall be void." As such, blanket consent may constitute an impermissible "loyalty waiver" prohibited under §215(a).

3. ***State Laws Also Apply to Principal Trading Activities of Investment Advisers***. The basis for state intervention in fiduciary issues involving principal trades was illustrated by a 2004 U.S. Court of Appeals decision, wherein the court stated: "As the Commission has said here, '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' … 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. SEC*, 334 F.3d 1183, 1189 (2004), citing *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)).

   a. The Restatement 3d of Agency (2007) sets forth in §8.06(1) the boundaries of a principal's consent: "(1) Conduct by an agent that would otherwise constitute a breach of duty … does not constitute a breach of duty if the principal consents to the conduct, provided that (a) in obtaining the principal's consent, the agent (i) acts in good faith, (ii) discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal; and (b) the principal's consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship." As comment b to that section states: "Common-law agency does not accord effect to all manifestations of assent by a principal that purports to eliminate or otherwise affect the fiduciary duties owed by an agent. This is so for two distinct reasons: (1) the law, and not the parties, determines whether a particular relationship is an agency …; and (2) the law imposes restrictions on the efficacy of a principal's manifestation of asset in the interest of safeguarding the principal's intention in creating a relationship of common-law agency … the law imposes mandatory limits on the circumstances under which an agent may be empowered to take disloyal action. These limits serve protective and cautionary purposes. Thus, an agreement that contains general or broad language purporting to release an agent in advance from the agent's general fiduciary obligation to the principal is not likely to be enforceable. This is

because a broadly sweeping release of an agent's fiduciary duty may not reflect an adequately informed judgment on the part of the principal; if effective, the release would exploit the agent's position in ways not foreseeable by the principal at the time the principal agreed to the release. In contrast, when a principal consents to specific transactions or to specified types of conduct by the agent, the principal has a focused opportunity to assess risks that are more readily identifiable … In assessing whether an agent has obtained valid consent from the principal to the agent's acquisition of a material benefit, courts often state that it is necessary for the agent to make 'full and fair' disclosure to the principal."

b. Many other state cases illuminate the general principles involved, and lead to the conclusion that blanket consent fails not only the requirements of state anti-fraud statutes but also runs afoul of the fiduciary duties imposed upon investment advisers by state common law. Just a few cases are set forth herein:

   (1) Informed consent is only present where the investor (client) is competent, has full knowledge of the relevant facts, knows his or her legal rights, and his or her consent is not induced by any other improper conduct of the trustee. *See Lambos v. Lambos*, 9 Ill.App.3d 530, 535, 292 N.E.2d 587 (1973).
   (2) "[A]uthorization to engage in self-dealing must be clear and explicit. Full and complete disclosure is essential …." *Equ. Invest. v. Opportunity Equity*, 427 F.Supp.2d 491 (S.D.N.Y., 2006).
   (3) "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).

c. ***"Blanket" Consent Is Not "Informed" Consent.*** Highly specific consents by a client of an investment adviser, following full disclosure of all material facts, are permitted under the IAA. In this regard, §206(3) is designed to preserve basic fiduciary duties which clients possess a right to expect from their trusted advisers. The purpose of the rule is to ensure that the adviser serves the interests of his client with undivided loyalty. Loyalty is said to be "the distinctive and unifying element of fiduciary relationships." Deborah A. DeMott, "Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences," Duke Law School Faculty Scholarship Series (2006).

(1) One wonders why the SEC would change course on this important issue (and, apparently, with some form of emergency and/or temporary rule proposal, to be adopted with limited or no opportunity for public comment), especially after six decades of refusing to approve blanket consents. As stated in Robert Plaze's outline summarizing the IAA's requirements: "Notification and consent must be obtained separately for each transaction, i.e., a blanket consent for transactions is not permitted … [citing] Opinion of Director of Trading and Exchange Division, Investment Advisers Act Release No. 40 (Jan. 5, 1945). The SEC has instituted enforcement actions against investment advisers for violating section 206(3) when they entered into principal transactions with their clients using only prior blanket disclosures and consents. *See In the Matter of Stephens, Inc.,* Investment Advisers Act Release No. 1666 (Sept. 16, 1997); *In the Matter of Clariden Asset Management (New York) Inc*., Investment Advisers Act Release No. 1504 (July 10, 1995)."

(2) The duty of loyalty, which includes the no-profit rule, exists because fiduciaries, by virtue of their position, possess subtle opportunities for cheating or stealing that are hard to monitor. Likewise, blanket consents to principal trading fail to meet the requirements of section 206(3) [and 206(1-2)], for they present the dangers of systematic unforeseeability of the risks to the client (and profits of the broker), and present the potential for exploitation with little practical ability to monitor the conduct of the investment adviser (and the adviser's true intent in recommending the trade).

   (a) As to the potential for exploitation, *see* Melvin Aron Eisenberg, "The Limits of Cognition and the Limits of Contracts," 47 STAN. L. REV. 211 (1995).

   (b) The duty of loyalty is often said to be one of the three major fiduciary duties, the others being "utmost good faith" and "due care." Writing in 1908, the American philosopher Josiah Royce characterized loyalty as the ethical principle that unifies and animates all other virtues. Royce defined loyalty as "[t]he willing and practical and thoroughgoing devotion of a person to a cause." Loyalty in his account necessarily requires submission of other desires to the object of loyalty, which then guides an actor's conduct. Josiah Royce, *The Philosophy Of Loyalty* (Vanderbilt Univ. Press 1995) (1908).

(3) Additionally, blanket consents easily transform into "standard form contracts" or "standard provisions," taking advantage of consumer behavioral biases. Faced with preprinted terms whose effect the investment consumer knows he or she will find difficult or impossible to fully understand, and faced with economic costs of search and processing to verify if the terms of a blanket consent are in his or her best interests, the client of an investment adviser will typically decide to remain ignorant of the risks and accept the blanket consent. In large part this is due to the relationship of trust and confidence already established between the fiduciary and his or her client. *See* Robert Prentice, "Whither Securities Regulation? Some Behavioral Observations Regarding

Proposals For Its Future," 51 Duke L. J. 1397 (2002); *also see* Shmuel I. Becher, "Behavioral Economics And Consumer Standard Form Contracts: Imperative Lessons From Behavioral Science," Yale Law School Student Scholarship Series (2005).

4. ***The Potential for Harm***. Principal trading restrictions upon investment advisers is not just about ensuring best execution. It is also about the practice of dumping unwanted securities upon unsuspecting advisory clients, or recommending purchases of a security which support another activity of the large and diverse wirehouse firm, such as product manufacturing activities or investment underwriting.

5. ***Don't Permit The Highest Standard Under The Law To Be Eroded.*** So why permit the duty of loyalty to be eroded to such a degree by permitting blanket consent to principal trades? We should all be reminded of the famous words of Judge Cardozo, in Meinhard v Salmon, 164 N.E. at 548 (N.Y.1928), when he described in modern terms the standard to which fiduciaries will be held:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct fiduciaries been kept at a level higher than that trodden by the crowd.

The fiduciary standard of conduct is the highest standard of conduct under the law. Diminishing the fiduciary duty of loyalty through an exception for blanket and therefore uninformed consent would, in essence, negate nearly all of the protections of the IAA and negate the relationship of trust and confidence between the professional investment adviser and the client. This would be harmful not only to consumers, but also to the investment advisory profession, to public confidence in our capital markets system, and to the fiduciary standard itself.

6. ***What Should Be The Response Of State Regulators?*** One possible response would be to challenge any SEC rule in federal court. In essence, by permitting principal trading without informed consent, the "exception" has swallowed the "no-profit rule" and substantially undermined the important protections intended by Congress in adopting the Advisers Act. Another response, less confrontational yet still in accord with the duties of state securities administrators to protect individual investors, would be to

issue a warning to all broker-dealers, registered investment advisers, and their representatives conducting business in the state, perhaps along these lines:

"The U.S. Securities and Exchange Commission's (proposed) adoption of 'blanket consent' procedures for principal trading by investment advisers who are dually registered as broker-dealers or who possess affiliated broker-dealer firms creates problems in adherence to fiduciary duties which arise under state statutory law and state common law. This correspondence cautions firms and their representatives to adopt procedures which comply with state law."

"Under state common law, investment advisers are generally fiduciaries to their clients and must act in the client's best interest at all times. Under the duty of loyalty a fiduciary is generally prohibited from seeking or obtaining profit in connection with transactions effected for a client. The exception to the 'no-profit' rule arising under state common law occurs when the client is afforded full and complete disclosure of all material facts relating to the proposed transaction, and the client provides informed consent to the transaction. A consumer's ability to either grant or withhold permission to a transaction involving a principal trade, following full disclosure of all material facts, is an important safeguard. Moreover, state common law is not changed by the SEC's rule-making, and may be enforced either by private causes of action brought by individual investors and/or through the regulatory authority granted to state securities administrators. As a result, firms should adopt procedures to ensure that each and every client is afforded the opportunity to either grant or withhold informed consent to each transaction involving a principal transaction. Where full disclosure of all material facts cannot be undertaken in advance of the transaction, due to dynamic market conditions (such as changes in pricing which may occur), estimates of pricing and profits (together with all other material facts) should be provided in advance of the transaction followed by confirmation of pricing and full disclosures of any profits of the broker-dealer firm immediately following the transaction."

"In addition, under NSMIA states retain broad authority to regulate activities which may give rise to fraud and deceit. Nondisclosure of material facts in advance of principal trading activities, or dumping of unwanted securities by a broker-dealer upon customers, or failure to achieve best execution, are all examples of activities which may be deemed fraudulent. The states will continue to vigorously enforce its laws and regulations in this regard, and may undertake either targeted or other inspections to ensure compliance. Accordingly, all firms engaging in principal trades with investment advisory clients should adopt policies and procedures to comply with state law, should adopt record-keeping systems to record their compliance as to each transaction with a client, and should be prepared for targeted inspections."

G. **Can A Dual Registrant Wear Two Hats At The Same Time? Or Switch Hats?** "Bait-and-switch" tactics and consumer confusion, and an erosion of the reputation of fiduciaries, would result.

1. ***Prior State Action Against This Practice.*** At least one state has been very critical of the practice of "casting off the fiduciary hat" during the implementation phase of a financial plan. The New Hampshire Bureau of Securities Regulation filed an action against American Express Financial Advisors, Inc., alleging marketing practices amounting to a "bait and switch" technique, noting that "advisors were immersed in a sales culture dominated by an emphasis on proprietary sales." Despite this action, the Ameriprise web site still indicates that the preparation of a financial plan, followed by sales under a brokerage account (not an investment advisory account), may still be occurring.

   a. "Central to the Respondent's marketing efforts in New Hampshire was the sale of investment advice given through the completion of a financial plan entitled American Express Financial Advisory Service (hereinafter referred to as the "investment plans"). In the year 2000, the investment plans were 65% of the Respondent's total advisory services and fees. During the relevant time period the Respondent sold approximately 5,000 of these investment plans to New Hampshire investors for a fee. Fees charged for an investment plan varied greatly depending on the circumstances of the customer and his needs. The minimum fee charged for an investment plan was $300, but it could be as high as several thousand dollars. Ongoing investment advisory service was available for a fee with each plan, or the investor had the option of paying a one-time fee for the initial plan with no ongoing investment service. The investment plans could automatically renew annually for an annual fee, or the plan would cancel at the option of the investor. Each investor had the option of receiving a variety of financial advice services, which could include income tax planning, protection planning, retirement planning, and estate planning. The service options could be comprehensive or issue specific. The advisory service provided was non-discretionary. The investment plans were marketed through the use of a lengthy disclosure document which described the goal of the investment plans and the process by which an advisor would compile the client's financial information and generate the investment plan. The Respondent marketed the investment plans as "*designed to assist individuals and/or business owners in identifying, analyzing, and reaching their financial objectives*" [Disclosure document, April 1, 2002-March 31, 2003 at pg 5]. In reality the American Express Investment Advisory Service was primarily a vehicle to promote and sell American Express and specially selected securities products, many with mediocre performance." [*Emphasis in original.*] Staff Petition For Relief *In The Matter Of American Express Financial Advisors, Inc*. (State Of New Hampshire, Department Of State, Bureau Of Securities Regulation) (2004).

2. ***Informed Consent By Consumers To Casting Off The Fiduciary Hat Is Unlikely.*** Individual investors do not possess the training and education sufficient to provide "informed consent" to a switch from fiduciary status to non-fiduciary status. Moreover, individual investors possess substantial behavioral biases which negate the likelihood of informed consent occurring. *See* Appendix F of the FPA® Fiduciary Task Force Final Report (at pp. 104-119), "Lessons From Behavioral Science: The Effectiveness of Disclosures Provided to Clients of Financial Intermediaries."

   a. For An Investment Adviser To Recommend Dropping The Fiduciary Status, Termination of the Relationship Must First Occur, and Completely, At A Minimum, Or A Breach of Fiduciary

Duty Results. Additionally, the duty of a fiduciary to provide objective advice may, in essence, negate any possibility of a suggestion by a fiduciary adviser to his or her client to a switch to non-fiduciary status. As stated in a comment letter to the Certified Financial Planner Board of Standards, Inc., from Ron A. Rhoades, dated July 27, 2006: "Again, it must be asked whether any person, acting as a surrogate decision-maker or advisor to a client as to whether to waive the fiduciary duties of one who desired to provide financial planning advice, could ever advise a client to forego the fiduciary duty. There is no advantage in the waiver of the legal requirement to act in the client's best interests and as a fiduciary. This is because the same services could be obtained, for the same fees, from another advisor who chooses to be bound by the fiduciary duty. If a choice were to exist, there simply is no situation in which a knowledgeable person would advise a client to forego the fiduciary protections which could otherwise be afforded to the client."

3. ***States Should Enforce Their Common Law: Fiduciary Status Attaches To Relationships.*** It must be recognized that fiduciary duties are applied to relationships, not accounts, under state common law. Relationships based upon trust and confidence, such as those of investment advisers or financial planners, are entered into by contract - but the law imposes certain terms upon the contract. In such relationships fiduciary duty status is not chosen by the parties; rather, fiduciary duties are imposed upon the investment advisor or financial planner by law and as a function of the relationship. Fiduciary law does not regulate the parties' behavior as to whether a relationship should be established. However, once the fiduciary and client enter into a relationship, the bargain concerning the duties owed by the fiduciary is governed not by contract but by law. This is because fiduciary status is imposed by law upon relationships in situations where the contracting parties possess vastly different knowledge and expertise. Fiduciary status is imposed, in part, because the client is not capable of negotiating, contractually, the protections which the client should be afforded. Accordingly, the states, applying their own law, may be in a good position to stop "dual hats" and "switching of hats."

   a. In response to the inability of the vast majority of individual investors to provide consent to a switch from fiduciary to non-fiduciary status, "a legislature (or regulatory organization), recognizing the inadequacy of informed consent [and for the other reasons stated above], [may] undertake 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." FPA® Fiduciary Task Force Final Report, June 1, 2007, at p.118.

b. SEC Limitations. While the SEC may have previously attempted to negate a switch from RIA to BD status, the SEC is hampered by the fact that its authority is limited to that provided by the IAA of 1940 and federal common law; it cannot incorporate fiduciary law as it has evolved over the past several decades under state common law. In contrast, the states possess the ability to apply state common law – which uniformly states (as to one branch of the application of fiduciary duties) that fiduciary status is imposed upon a relationship based upon trust and confidence (and not just to one or more "accounts" of a customer).

4. ***Additional Materials: The Dual Hat Argument.*** "[B]roker-dealers have argued that, regardless of the capacity in which they may be acting when providing financial planning services, in the implementation phase of a financial plan, they execute specific investment ideas stemming from the financial plan in the customer's brokerage account and are acting as broker-dealers (not investment advisers or fiduciaries), unless the customer expressly elects to execute the plan through a discretionary or other type of advisory account." Outline prepared by Steven W. Stone, Morgan, Lewis & Bockius LLP, "Investment Adviser Issues for Broker-Dealers," presented at SIFMA Compliance & Legal Division Annual Seminar 2007, Phoenix, AZ, March 25-28, 2007, at p.17. The outline cites *Safer v. Nelson Financial Group, Inc.,* No. 04-31092 (5th Cir. Oct. 14, 2005), and *In the Matter of IFG Network Securities, Inc*., Initial Decision Release No. 273 (Feb. 10, 2005) (stating that "[t]here is no case precedent that holds that an associated person of an investment adviser cannot change hats, to use [defendant's] metaphor, and act in the capacity of an associated person of a broker-dealer without the higher obligations of an adviser," and rejecting contentions by the SEC's Division of Enforcement that the IAA antifraud provision applied to the defendant's execution of transactions to implement customer financial plans where the agreements with customers stated that the defendant would be acting as broker when doing so). However, as observed by the FPA® Fiduciary Task Force Final Report, June 1, 2007, at pp.39-40, that the *IFG Network Securities* "decision was overturned on appeal by the SEC's Division of Enforcement to the Commission, and a Commission opinion was rendered on July 11, 2006. *See In The Matter Of IFG Network Securities, Inc*., 1934 Rel. No. 54127, IA Rel. No. 2533, Admin. Proc. File No. 3-11179. The Commission opinion does not address, however, the issue of conversion from an advisory relationship to a non-advisory relationship. Given the fact that the administrative law judge's decision was subsequently overturned, and the lack of discussion of the adequacy of informed consent both in the initial decision and in the Commission's opinion, the FPA® Fiduciary Task Force does not believe that this decision establishes any precedent in this area." The FPA® Fiduciary Task Force Final Report also suggested that the *Safer* decision was not dispositive of the issues, noting that "there is no significant discussion in the case as to the fiduciary duties which arise under the Investment Advisers Act of 1940 or the common law, the adequacy of disclosure and informed consent, and when and whether such fiduciary duties can be terminated. Given such, and the unique facts of

the case (as to the facts which were pled by the plaintiff), this decision should not be relied upon as authoritatively addressing the issue of adequacy of informed consent." Final Report at p. 40.

H. **<u>Are 12b-1 Fees "Special Compensation"?</u>** The issue has recently been raised as to whether the receipt of 12b-1 fees by broker-dealer firms and their registered representatives, which by the SEC's own admission are asset-based fees and relationship compensation, run afoul of the IAA when received by registered representatives and outside investment advisory relationships with their customers and utilized, perhaps in large part, to finance the provision of ongoing advice. In essence, 12b-1 fees appear to be, at least in part, "special compensation" paid to registered representatives for advice which is not "solely incidental." The written statements of many brokerage industry representatives acknowledge that 12b-1 fees are utilized in large part to compensate registered representatives (RRs) for the fostering of an ongoing relationship between the RR and the investor, including the provision of advice over time with respect to a customer's personal circumstances, and including financial planning, estate planning, and investment advice (not specific to any transaction). [Barbara Roper of the Consumer Federation of America first raised the issue at the all-day forum hosted by the SEC on the issue of 12b-1 fees on June 19, 2007, when she observed that all of the discussion during that day regarding 12b-1 fees being utilized to fund ongoing advice to investment consumers by registered representatives sounded like "special compensation" which was not "solely incidental" to a brokerage transaction.]

1. ***SEC Repeal of 12b-1 Fees?*** The SEC is currently considering whether to rescind or amend Rule 12b-1, on the basis that 12b-1 fees no longer serve the purpose for which they were originally intended and/or on the basis that disclosures of 12b-1 fees are viewed by many as confusing and inadequate.

2. ***Should The States Exercise Their Regulatory Authority?*** If the SEC should, however, continue to permit 12b-1 fees to be utilized to pay registered representatives for ongoing investment advisory services, should state securities regulators take the position that 12b-1 fees constitute payment for ongoing advisory services under state (statutory or common) law and enforce fiduciary duties against registered representatives (who should be registered with the states as investment adviser representatives? Initially, the states could require registration and the provision of the comprehensive disclosures (Form ADV, Part II) required of investment advisers to their clients. The states could then explore whether the actions of the registered representative otherwise met with their duties, including fiduciary duties owed to their clients, as investment advisor representatives. (Note that Class C shares, often imposing a 1% annual 12b-1 fee and often not convertible into Class A shares, are rarely in the best interests of the long-term investor.)

3. ***Additional Background Materials On This Issue – Excerpts From Recently Submitted Comment Letter***. (To SEC, From Ron A. Rhoades, dated June 18, 2007):

a. It is clear from various comments recently submitted by broker-dealer firm registered representatives, as well as published comments by broker-dealer industry representatives and the ICI, that 12b-1 fees are being utilized as "special compensation" for advice which is ongoing, covering a broad range of areas, and which clearly cannot be considered incidental to the mutual fund sales transaction. It cannot be denied that the original purpose of 12b-1 fees has completely changed. As a result, 12b-1 fees impermissibly compensate broker-dealer firms and their registered representatives and constitute "special compensation" for a wide range of ongoing advisory services which are not connected to a securities transaction.

b. Various participants in the securities industry itself recognizes this improper use of 12b-1 fees is occurring. "The advent of **12b-1 fees created an incentive for financial advisors to provide ongoing advice** and service to their clients. There was an alignment of the customer's interests with the registered rep's. The financial advisor has an incentive to keep the customer's interests and needs satisfied by providing **ongoing advice** and service. Advice does not end with the purchase transaction. Clients need someone to answer questions during times of market turmoil. They need help in re-evaluating their risk tolerance and asset allocations. Guidance is necessary when life events cause a new financial need or a change in course. By growing their base of **assets under management** and the resulting 12b-1 **fee income stream**, financial advisors have been able to create the infrastructure needed to provide the **ongoing advice** and service to their clients." Comment letter of Nicholas H. Phelps, April 30, 2004, regarding File No. S7-09-04. **[Emphasis added.]**

c. Even regulatory bodies acknowledge the use of 12b-1 fees are not transactional sales charges, but rather ongoing "assets under management" fees. In its comment letter to the SEC of April 19, 2007, the NASD stated: "[W]e respectfully recommend that the Agencies amend proposed Regulation R to treat only Rule 12b-1 service fees -and not asset-based sales charges - as 'relationship compensation' … The proposal defines the term 'relationship compensation' to mean any compensation a bank receives that consists of (1) an administration fee; (2) an annual fee (payable on a monthly, quarterly or other basis); (3) **a fee based on a percentage of assets under management**; (4) a flat or capped per order processing fee, paid by or on behalf of a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or (5) any combination of these fees … the rule provides that a fee based on a percentage of assets under management (an "AUM fee") includes, without limitation – A fee paid by an investment company pursuant to a plan under 17 CFR 270.12b-1. **Although Rule 12b-1 fees are related to mutual funds, we believe they should be viewed as relationship compensation because they are paid on an assets under management basis, rather than on a transactional basis** …." (NASD comments relating to SEC File No. S7-22-06, p. 32.) **[Emphasis added.]** This commentator submits that the NASD should not be permitted to state that 12b-1 fees are "relationship compensation" (and hence clearly "special compensation") for purposes of Regulation R (relating to banking exemptions from application of the securities acts), but take a different position with regard to the broker-dealer exemption from the application of the IAA and its fiduciary standards.

d. Additionally, as stated by the ICI, the use of 12b-1 fees to compensate registered representatives for ongoing advice (which, if ongoing, cannot be considered incidental

advice to a transaction) is widespread. "Virtually all 12b-1 fees are used to compensate financial advisers for service provided to fund shareholders at the time of a purchase of fund shares or for administrative and **advice services provided to the shareholder after the initial purchase**." Investment Company Institute's 2004 Fact Book, p.52. **[Emphasis added.]**

e. Furthermore, as stated by Chet Helck, President, Raymond James Financial, Inc, in testimony before the U.S. Senate Committee On Banking, Housing, And Urban Affairs (Review Of Current Investigations And Regulatory Actions Regarding The Mutual Fund Industry: Fund Costs And Distribution Practices) on March 31, 2004: "[B]ecause [12b-1 fees] are paid over an extended period of time, they promote a **continuing relationship**, encouraging the financial **advisors** to offer **continued service** over a period of time." **[Emphasis added.]**

f. Furthermore, if the broker-dealer and mutual fund industry were to take the position (despite all evidence to the contrary) that 12b-1 fees are not paid for the provision of ongoing advisory services by registered representatives, it must be asked whether the payment of 12b-1 fees over an extended time period (such as 10 years, or potentially much longer) would violate the general principles of NASD regulations which prohibit unreasonable compensation and excessive sales charges. This is especially true since most Class C shares (which often possess 12b-1 fees of 1% annually) cannot be converted into Class A shares at the option of the investment consumer. Would not the sale of Class C shares, rather than a Class A shares, be improper, in much the same way as Class B shares are often improper? Stated differently, if 12b-1 fees were to be viewed as transactional compensation, and since most mutual funds are designed as long-term holdings for investors, a recommendation to purchase Class C shares over Class A shares would, in many instances, be contrary to the interests of the investor. One would also question whether the conflicts of interest arising from such recommendation would be adequately disclosed to the investor.

g. "Before enactment of the IAA, broker-dealers and others who offered investment advice received two general forms of compensation. Some charged only traditional commissions (earning a certain amount for each securities transaction completed). Others charged a separate advice fee (often a certain percentage of the customer's assets under advisement or supervision). See 11 Fed. Reg. 10,996 (Sept. 27, 1946). The Committee Reports recognized that the statutory exemption for broker-dealers reflected this distinction; the Reports explained that the term 'investment adviser' was 'so defined as specifically to exclude ... brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive **only brokerage commissions**).' S. Rep. No. 76-1775, at 22; H. R. Rep. No. 76-2639, at 28." *Financial Planning Association vs. SEC* (U.S. Ct. Appeals, D.C. Circuit, March 30, 2007) (slip opinion at p. 7). [**Emphasis added.**]

h. "The relevant language in the committee reports suggests that Congress deliberately drafted the exemption in subsection (C) to apply as written. Those reports stated that the 'term 'investment adviser' is so defined as specifically to exclude ... brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive *only* brokerage commissions).' S. Rep. No. 76-1775, at 22 (emphasis added); see also H.R. Rep. No. 76-2639, at 28. **By seeking to exempt broker-dealers beyond those who receive only brokerage commissions for investment advice, the SEC has promulgated a final rule that is in direct conflict with both the statutory text and the Committee Reports**." *Financial Planning*

Association vs. SEC, slip opinion at pp.14-15. [*Emphasis in original.*] [**Emphasis added.**] Hence, while Rule 12b-1 was adopted with the best of intentions, it subsequent evolution into a mechanism for providing additional compensation to brokerage firms and their registered representatives for ongoing investment advice is in direct conflict with the language of the IAA and Congressional intent.

i. It should be further noted that the U.S. Court of Appeals in its March 30, 2007 decision stated three times that the term "investment adviser" under the IAA should be broadly defined. Likewise, the very broad application of the IAA to financial planning activities was set forth in Advisers Act Release No. 1092, which states in pertinent part: "Generally, financial planning services involve preparing a financial program for a client based on the client's financial circumstances and objectives. This information normally would cover present and anticipated assets and liabilities, including insurance, savings, investments, and anticipated retirement or other employee benefits. The program developed for the client usually includes general recommendations for a course of activity, or specific actions, to be taken by the client. For example, recommendations may be made that the client obtain insurance or revise existing coverage, establish an individual retirement account, increase or decrease funds held in savings accounts, or invest funds in securities. A financial planner may develop tax or estate plans for clients or refer clients to an accountant or attorney for these services." Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) [52 FR 38400 (Oct. 16, 1987)] ("Advisers Act Release No. 1092"). [Emphasis added.]

j. Moreover, it should be noted that the "incidental advice" which was provided by broker-dealers and their representatives at the time of the enactment of the IAA was not financial planning advice, but rather advice related to the security, contrasting research reports as to other securities, and/or general economic conditions. "[I]n providing historical context to the Investment Advisers Act of 1940, the Commission noted that the 'extensive and varied' 'brokerage house advice' described in the Adopting Release nearly all relates to advice about individual securities [FN11] not to the many varied planning issues confronted by consumers relative to their comprehensive or discrete financial planning needs … [Fn.11 provides: The advice that broker-dealers provided as an auxiliary component of traditional brokerage services was referred to as 'brokerage house advice' in a leading study of the time. 'Brokerage house advice' was extensive and varied, and included information about various corporations, municipalities, and governments; broad analyses of general business and financial conditions; market letters and special analyses of companies' situations; information about income tax schedules and tax consequences; and 'chart reading.']" Advisers Act Release No. 2376 at pp.18-19, citing Twentieth Century Fund, THE SECURITY MARKETS (1935) at 633-646, and other publications." Please note that none of the "extensive and varied" advice provided by brokerage firms in 1940 was in the nature of financial planning advice; rather, all such advice related directly to the attributes or analysis of a security or broad analyses of general business and market conditions. Hence, it is clear that the "incidental" "brokerage house advice" provided in 1940 does not extend to ongoing personal advisory services and financial planning. Accordingly, 12b-1 fees do not constitute payment to broker-dealer for "incidental advice" for providing ongoing advice to investors; instead, they have developed over time to become an asset-based management fee.

k. In addition, it should be noted that the receipt of ongoing compensation by a registered representative is likely to be a significant factor in determining whether a registered representative is a fiduciary to his or her customer under state common law, even when the brokerage account is non-discretionary. A fiduciary relationship may arise under state common law by virtue of an informal relationship where both parties understand that a special trust or confidence has been reposed. A confidential relationship is defined as one in which one person comes to rely on and trust another in his important affairs and the relations there involved are not necessarily legal, but may be moral, social, domestic or merely personal. "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 (Bankr. N.H., 2005). It should be noted that once a relationship between two parties is established, its classification as fiduciary and its legal consequences are primarily determined by the law rather than any contract or agreement between the parties. Hence, the combination of ongoing financial advice to a customer, combined with the receipt of ongoing 12b-1 fees by a broker-dealer firm, and especially when a registered representative holds himself or herself out as a "financial consultant," "wealth manager," or some similar term, is highly likely to result in a finding of fiduciary status under state common law. Furthermore, it is clear that neither the '34 Act nor the IAA preempt state common law. While further discussion of this specific issue is beyond the scope of this commentary, registered representatives and their broker-dealer firms, as well as regulatory authorities, should recognize that state common law will in many instances likely impose fiduciary duties upon registered representatives where ongoing advisory relationships, especially when fueled by payment of repetitive special compensation. Rule-making at either the federal or state level should not seek to counter state common law when it provides important protections for individual investors.

l. It should be noted that the repeal of 12b-1 fees, at least as to those which are paid to those "financial consultants" (i.e., registered representatives and their broker-dealer firms) who are not subject to the IAA's imposition of fiduciary duties, will not result in an end to advice from broker-dealer firms. This is because registered representatives can undertake the effort and registrations necessary to become investment adviser representatives. The cessation of payment of 12b-1 fees to broker-dealer firms not acting as investment advisers will, however, raise substantially the standards of conduct to which those who provide ongoing advice to investment consumers are held – i.e., to the fiduciary standards of due care, loyalty, and utmost good faith - as the U.S. Congress intended.

m. It should further be noted that choice for consumers will not be affected. The argument that the disappearance of fee-based brokerage accounts as a result of the Financial Planning Association vs. SEC decision will limit consumer choice is nothing but a red herring. Fee-based accounts will continue, but as Congress intended they will all be subject to the IAA. What will change are the substantially higher standards of conduct governing the provision of advisory services – with the application of broad fiduciary standards of due care, loyalty, and utmost good faith.

n. I would further take note of recent incomprehensible statements by certain securities industry officials, to the effect that NASD rules and other broker-dealer regulation somehow equate or exceed the broad fiduciary standards imposed upon investment advisers by the IAA. Broker-dealer and NASD rules are numerous and complex because of the many diverse activities which broker-dealer firms are involved (agency transactions, principal transactions, investment underwriting, securities analysis, custodial duties, etc., etc., etc.). Broker-dealer rules are hence more numerous in order to cover such diverse activities and the many conflicts of interest which arise as a result. Moreover, the fiduciary standard of conduct has long been recognized in legal circles to constitute the highest duty under the law. It is without logic to state that broker-dealer regulation, including the duty of suitability (which relates mainly to risk tolerance of an investor, not as to the total fees and costs the investor may bear, nor as to tax suitability of the investment in the context of the customer's overall portfolio and personal tax situation, in most instances), is equivalent or exceeds the broad fiduciary standards of conduct imposed upon investment advisers. Recent statements by industry officials touting the supremacy of broker-dealer regulation must result in the query as to whether our securities regulation should be entrusted to persons within self-regulatory organizations who fail to understand of fiduciary standards of conduct and the important role such standards perform in the preservation of our capital markets system in an ever-more-complex society.

o. The NASD, ICI, SIFMA, and many broker-dealer firm representatives all recognize that 12b-1 fees are utilized under current practices, and especially with regard to Class C shares, to primarily compensate broker-dealer firms for the provision of ongoing investment advisory services to brokerage customers. When utilized for such purpose, 12b-1 fees are indistinguishable from "special compensation" arrangements, such as those paid as a percentage of assets under management (i.e., fee-based brokerage accounts), and such special compensation is not permitted under the IAA.

p. Many commentators have pointed out that 12b-1 fees can be utilized to more closely align the interests of investors, especially smaller investors, with broker-dealers. There is no denying the truth in this statement. Indeed, fee-based brokerage accounts were advanced under the "Merrill Lynch Rule" utilizing the same proposition. However, and regardless of the good intentions of these commentators, the same fatal flaws exist. Providing ongoing advisory services under a standard of conduct which is far less than that of the fiduciary standard of conduct can lead to substantial abuse of investors, results in non-functional regulation of the securities industry, and economically places investment advisers at a disadvantage, for reasons I have set forth in prior comments on other rule proposals. Moreover, and more importantly, the payment of fee-based ongoing compensation, even when indirectly paid by a mutual fund company to the broker-dealer firm and not directly by the individual investor (although the individual investor's returns are reduced dollar-for-dollar by the amount of such fee payments), violates the letter, spirit, and intent of the IAA.

I. **<u>Is Mere Disclosure of "Conflicts Of Interest" Sufficient?</u>** A prevailing attitude in much of the securities industry is that conflicts of interest need only be disclosed in order to fulfill the fiduciary duty of an investment adviser. However, should fiduciaries seek to *avoid* conflicts of interest?

1. ***The States Get It Right - From the NASAA Investment Adviser Manual.*** "The anti-fraud provisions of the Investment Advisers Act of 1940 and most state laws impose a duty on investment advisers to act as fiduciaries in dealings with their clients. This means the adviser must hold the client's interest above its own in all matters. *Conflicts of interest should be avoided at all costs*. However, there are some conflicts that will inevitably occur, such as a person being licensed as a securities agent as well as an adviser. In these instances, the adviser must take great pains to clearly and accurately describe those conflicts and how the adviser will maintain impartiality in its recommendations to clients." [*Emphasis added*.]

2. ***Disclosure Does Not Negate The Best Interests Standard.*** "Even with written disclosure and consent, though, the adviser must reasonably believe that the transactions are in the best interests of the clients — that is, the adviser's fiduciary obligation is not discharged after disclosure and consent." "Regulation of Financial Planners," White Paper Prepared for the Financial Planning Association by Jonathan R. Macey, April 2002, at p.30, available at http://www.fpanet.org, under "Government Relations" / "White Papers", citing to *Rocky Mountain Financial Planning*, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2132 (Mar. 28, 1983). In other words, even with disclosure of the conflict of interest, policies and procedures should be adopted to properly manage the conflict in order that the best interests of the client are preserved at all times.

J. **How To Attack Sales of Equity-Indexed Annuities (EIAs) and Variable Annuities (VAs)**. Incredible abuses continue in the sale of these complex, usually high-commission products which possess many tax, costs, and other disadvantages. These products are not "bought," they are "sold."

1. ***Require IA Registration***, as fiduciaries would be required to undertake fuller disclosure, and fiduciary duties would not permit many EIAs to be sold. In addition to the position taken by Alabama securities administrators, previously discussed, other states have taken this approach.

   a. The Kentucky Division of Securities has stated that "any person offering services such as 'full financial review'; 'asset analysis'; 'estate planning'; or substantially similar financial services who is not registered as a broker-dealer, agent, investment adviser, or investment adviser representative will be deemed to be engaged in misleading and deceptive practices unless the communication offering said services contains concomitant and equally conspicuous language that indicates that the person is licensed to sell only insurance products." Interpretive Release, Misleading And Deceptive Practices In The Sale Of Equity-Indexed Annuities ("EIAs") Or Fixed-Indexed Annuities (Dec. 5, 2005). [*Query:* Would a "full financial review" or substantially similar financial services trigger IAR registration, not just broker-dealer agent registration, by a more expansive application of the state's investment adviser act?]

   b. Missouri appeared to take this position. *See In The Matter Of: Michael Glenn Grimes and Financial Solutions & Associates, Inc*, Case No. AP-07-04, State of Missouri (Feb. 7, 2007),

wherein an insurance agent (not a RR nor IAR) was ordered to cease and desist from transacting business as an investment adviser where, among other actions, he recommended to a customer that the customer "roll over a 403(b) annuity (with no surrender charges) to an equity-indexed annuity IRA at Fidelity and Guaranty (with a 10-year surrender charge period)."

c. Massachusetts continues to take this position, as well. *In the Matter of James Maltz,* Case No. E-2007-0053, Commonwealth of Massachusetts Securities Division, wherein the Complaint filed on Aug. 22, 2007 alleged that the insurance agent provided advice to "sell mutual funds, stocks and other products and to purchase annuities and other insurance products" in violation of state investment adviser registration statutes.

2. ***Adopt Model Disclosure For Sales Of VAs And EIAs,*** under state anti-fraud authority relating to sales activities? (A suggested disclosure for EIA sales is set forth in Exhibit A hereto.)

3. EIAs Are Securities If Marketed as Investments. The "safe harbor" for equity-indexed annuities found in 17 CFR 230.151 promulgated by the SEC provides that the contract would not be a "security" under certain conditions including that …(3) The contract is not marketed as an investment."

a. What is "marketing as an investment"? Is it the emphasis provided during the sales process as an "investment" rather than as a "stable" "long term accumulation product"?

(1) In its 1997 Concept Release the SEC was concerned that the nature of equity index insurance products makes it particularly difficult to market these products *without* primary emphasis on their investment aspects.

(2) "Insurance has traditionally offered the policyholder guaranteed benefits contingent on the unpredictable occurrence of a future event. In contrast, investment arrangements offer a probability of increasing, rather than safeguarding, such income." "Redefining Insurance: Distinguishing between Life Insurance and Investment under Volatile Inflation," The Yale Law Journal, Vol. 91, No. 8 (Jul., 1982), pp. 1659-1677.

(3) "The Securities Act provides on its face that insurance and annuities are excluded from the reach of the Act. As this audience well knows, that is not the end of the story because not all products that are called insurance or annuities qualify for the exclusion. There are products such as variable annuities and variable life insurance that, despite their names, cross the line into the realm of securities. **In determining whether insurance products are securities, the Commission and the courts have looked to two primary factors: first, the extent to which the investment risk is assumed by the insurance company or the contract owner, and, second, whether the product is marketed on the basis of stability and security or as an investment that is intended to appeal to the purchaser based on the prospect of growth through sound investment**

management. The Division is currently taking a close look at equity index annuities and their status under the federal securities laws. Our review is the result of a variety of factors, including concerns that have been raised about the marketing of equity index annuities, changes to the products and applicable state laws in the years since their introduction, and concerns articulated by some in the insurance industry regarding the regulatory uncertainty surrounding equity index annuities." Remarks Before the ALI-ABA Conference on Life Insurance Company Products by Andrew J. Donohue, Director, Division of Investment Management, SEC, Nov. 17, 2006. [**Emphasis added.**]

(4) Example: "Would you like an investment that pays gains based on the stock market, yet helps protect your principal when the market declines?" (from www.TheMoneyAlert.com; "This site has been published for residents of AZ, CA, FL, IL, MI, MO, and TX.") [Emphasis added.]

(5) Example: "Equity indexed annuities provide the ***same upside potential*** offered by variable annuities, while providing built in guarantees similar to traditional fixed rate annuities. Participation in the market, with guarantees to principal have created a great deal of interest in these annuities over the past several years." (from www.annuitybrokerageservices.com; physical address of the firm is Charlotte, N.C.) Given that upside potential in EIAs is capped by participation rates in the index and by the exclusion of dividends, is this a misleading statement?

(6) Example: "Equity Indexed Annuities are a perfect investment option for the person who wants access to their money, security, growth and asset protection for their retirement." (from www.firstnationalequity.com, Akron, Ohio) [Emphasis added.] Again, given the long surrender period of many annuity products, is this a misleading statement?

b. NASD Notice to Members 05-50 imposes certain supervisory responsibilities on broker-dealers concerning EIAs, even when the equity-indexed annuity is not a security. This has added to the confusion over whether EIAs are securities. As stated in the Notice, "It is often unclear whether a particular EIA qualifies for the exemption under Section 3(a)(8) [of the Securities Act of 1933], since the analysis is made on a case-by-case basis and may turn on the particular features and marketing materials associated with the product."

4. ***Challenge Suitability.*** As prior state enforcement actions have noted, VAs and EIAs as "unsuitable" products for many senior citizens. For example, Minnesota Attorney General Lori Swanson, using the state's suitability statute, which requires an insurance company to ensure that an annuity is suitable for the particular customer filed a complaint against American Equity in May 2007, alleging that the company "sold approximately $46 million in long term annuities to more than 1,200 Minnesotans who were over 75 years of age at the time of purchase, essentially locking up their savings for up to ten to sixteen years … The maturity date of the

annuities in some cases was longer than the life expectancy of the senior citizen … Swanson also described the 25 percent surrender penalty in the early years of certain annuities as particularly outrageous."

5. ***Challenge Breach of Fiduciary Duties.*** If sold by a person who is registered as an investment adviser representative, or who should be (by virtue of his or her activities) registered as same, state securities regulators could bring an action not only for suitability [see NASAA Model Rule 102((a)(4)-1(a)], but also for breach of fiduciary duties of due care (lack of diligence in review of the EIA product, or in review of the client's needs relative to the attributes of the investment product, especially true when the client's liquidity is substantially affected by the EIA sale] and loyalty [incomplete disclosure of the limitations of the product; deceptive sales practices as misleading or failure to disclose all material facts about the product, including all of its tax and other disadvantages/limitations, and sales compensation received].

K. **Federal-State Securities Regulation: Is There Cooperation In Rule-Making?** To this observer it must also be asked as to why the SEC moved has moved forward with the adoption of regulations which the states have, through the NASAA, so adamantly opposed? There seems little communication between the SEC and the NASAA in the rule-making processes (at least prior to the announcement of a proposed rule), as one would think would naturally occur given the expressed desire for uniformity in federal/state securities regulation. Furthermore, why does the SEC appear to disregard substantial objections raised by the NASAA to its proposed rules so casually? One must ask whether the desire for uniform federal and state securities regulation is actually a desired goal or merely a façade.

L. **If State Securities Regulators Assert Their Authority, Is There Any Increased Risk of Pre-emption?** Perhaps not, given the pro-consumer stances taken by state securities regulators, and the powerful consumer organization allies they may possess in dealing with Congressional proposals which might pre-empt state authority. In any event, increased cooperation between federal and state regulators should be attempted in the ongoing struggle to protect individual consumers, including a renewed application of fiduciary status.

M. **It Is Time For Some "Common Sense"?** While state securities regulators are faced with outright fraud on a daily basis, there is a subtle but far more damaging occurrence each and every day as billions and billions of dollars are fleeced from unsuspecting investors through sales of high-expense products. It is time for state securities regulators to step up their actions to protect investors. In conjunction with the SEC, if possible. Otherwise, through carefully chosen opportunities to expand the reach of the fiduciary standard of conduct in accordance with state statutory law and state common law.

1. Individual investors are led to believe that they can trust the "financial consultant" before them, when in reality the vast majority of investors today are not served by fiduciary investment advisers at the retail level and instead are served by those who are not legally bound to put the

best interests of the client first. The result is a taking of a substantial portion of the gains the capital markets have to offer. Specific disclosures of the amount of total fees and compensation paid by investors, in dollar or percentage terms, is not required. And product manufacturers and product salesperson have been able to hide such fees through such descriptive terms as 12b-1 fees, or undertake no meaningful disclosure at all (such as transaction and opportunity costs within mutual funds) so that their slow drain on the future financial security of investors is hardly noticed.

2. Americans deserve more. Individual consumers deserve a better deal. They deserve to know who they can trust. They should be able to clearly identify between a product manufacturer's representative and a trusted fiduciary advisor. Given the complexity of the capital markets, and the need for substantial knowledge in order to undertake sound financial and tax planning decisions, individual investors are in need of, and should receive at all times – as a matter of public policy – the benefits of fiduciary advice under a fiduciary standard of conduct which is not diminished over time.

Additional Resources on The Fiduciary Duties of "Financial Advisors":

Available at www.JosephCapital.com, under "Resources" / "SEC Comments":

- The pamphlet, "Common Sense: Addressed To Policymakers And Participants Of The Financial Advisory Community On The Following Interesting Subjects" (July 30, 2007)
- A proposal for broad regulatory reform, entitled "Financial Intermediaries: Opportunities to Enhance Standards of Conduct" (April 2007)
- Financial Planning Association's Fiduciary Task Force Final Report, June 1, 2007

Available at the SEC Historical Society:

- "Report of Special Study of Securities Markets of the Securities and Exchange Commission" (1963) (an interesting historical document describing both the activities of registered representatives and of registered investment advisers

[EXHIBIT A: SUGGESTED MODEL DISCLOSURE FOR EQUITY INDEXED ANNUITY SALES]

MANDATORY DISCLOSURE FOR EQUITY INDEX ANNUITY SALES
This is an insurance product. If this product is being sold to you as an "investment" and not as "insurance," this equity index annuity must be accompanied by a prospectus and the salesperson must be licensed as a registered representative or investment adviser representative.

The Costs of Equity Index Annuities: Something To Watch Closely. The costs found in equity index annuity contracts can have a significant effect on the investment performance of the annuity contract. Equity index annuities that are sold by agents are likely to involve sales charges (which the issuer pays the agent) and/or lengthy surrender fees (which the insurance company charges the annuity owner if he or she cancels the contract prematurely, and which are often utilized to compensate the insurance company for fees already paid to the agent). If you purchase an equity index annuity, be certain to understand the withdrawal rules associated with any removal of funds from the annuity product.

Warning From The North American Securities Administrators Association. This warning has been issued regarding variable annuity sales: "What might be a suitable investment for one investor might not be right for another. Securities professionals must know their customers' financial situation and refrain from recommending investments that they have reason to believe are unsuitable. For example, variable and equity indexed annuities are often unsuitable for senior citizens because those products are generally long-term investments that limit access to invested funds. But sales agents stand to earn high commissions on these investment products so they don't always adhere to the suitability standards – with dire consequences for seniors. Remember: Make sure your investments match up with your age, your need for access to money, and your risk tolerance." (From "State Securities Regulators Identify Top 10 Traps Facing Investors," May 15, 2007.) For more information, visit www.nasaa.org.

Disclosure of Returns Offered By Investment Options: For this product, the following are required disclosures:

Annualized Returns Over 1 Year (2006)			Annualized Returns Over 5 Years (Jan. 1, 2002-Dec. 31, 2006)			Annualized Returns Over 10 Years (Jan. 1, 1997 – Dec. 31, 2006)			Annualized Returns Over __ Years (equal to max. period for surrender charges)		
Annuity Option, No Surrender	Annuity Option, With Full Surrender After 1 Year	S&P 500 Index	Annuity Option, No Surrender	Annuity Option, With Full Surrender After 5 Years	S&P 500 Index	Annuity Option, No Surrender	Annuity Option, With Full Surrender After 50 Years	S&P 500 Index	Annuity Option, No Surrender	Annuity Option, With Full Surrender After __Years	S&P 500 Index
%	%	%	%	%	%	%	%	%	%	%	%

Returns are shown for the Standard and Poors' 500 Index, an unmanaged stock index. Index returns assume that dividends are reinvested. Returns for the annuity account tied to the index are shown assuming: (1) no withdrawals are undertaken; and (2) assuming that no funds are withdrawn until the end of the period shown, but that at the end of such period all funds are withdrawn and any applicable surrender charge is paid. All returns are calculated based upon the formulas utilized in the annuity contract.
[Repeat disclosure for each other indexed option. Also show historical returns for any fixed account.]

If you desire to proceed to purchase an equity index annuity contract, your must read and initial each of the following:

☐ I believe that the equity index annuity is appropriate for my insurance needs, given my financial objectives and needs. I am purchasing this annuity with funds that I do not need for current (or near-term) expenses.

☐ I understand that the credit given to me during any period for index returns during that period does not include dividends which would have been received by an index fund tied to that index and which would otherwise have been be reinvested in that index. I also understand that there are caps on index returns credited to my contract.

☐ I understand that I will possess limited rights to withdraw funds from the annuity product, and that any withdrawals in excess of the amounts permitted under the annuity contract will incur a substantial surrender fee until such time as surrender fees disappear.

☐ I have been provided with a specimen copy of the actual annuity contract, have reviewed it, and have compared the contract terms against any representations the salesperson may have made to me.

☐ I am aware that the insurance salesperson does not possess a broad fiduciary duty to act in my best interests, and instead represents the insurance company.

☐ I understand that the ability of the insurance company to make payments to me, upon surrender, is dependent upon the financial strength of the insurance company, and that this investment is not insured against loss of principal due to default by the insurance company by any federal or state government agency.

☐ I understand that any withdrawals from the annuity of gains in the annuity will be taxed at my ordinary income tax rates, and will not receive more favorable long-term capital gain treatment which may have been available through a stock mutual fund.

☐ I understand that withdrawals from the annuity before I reach age 59⁄2, like early withdrawals from other tax-deferred products, may be subject to a 10% federal penalty tax.

☐ I understand that, unlike mutual funds held in taxable accounts, annuities do not receive any stepped-up basis which eliminates capital gains at the death of the mutual fund owner, and that beneficiaries of the annuity will be taxed on the annuity's gains at their ordinary income tax rates, which (combined federal, state and local) tax rates may be higher or lower than my ordinary income tax rate, depending upon the situation.

☐ I understand that if I replace an existing annuity or life insurance policy with a equity indexed annuity contract, the death benefit promised under the prior annuity or insurance policy (including any guarantee that my beneficiary will receive more than the annuity's current market value) will not transfer to my new annuity. Furthermore, I understand that I may incur new sales charges and a new surrender fee period without necessarily receiving any major benefit as a result of the replacement.

THIS FORM MUST BE INITIALED, SIGNED, AND RETAINED BY THE ANNUITY SALESPERSON AND/OR HIS OR HER FIRM. A COPY OF THIS DISCLOSURE MUST BE PROVIDED TO THE CONSUMER WITH THE ORIGINAL ANNUITY CONTRACT.

[EXHIBIT B: SUGGESTED MODEL DISCLOSURE FOR VARIABLE ANNUITY SALES]

This disclosure is required by the laws and/or regulations of this state and may not be altered by any entity of person. Please read this disclosure carefully.

MANDATORY DISCLOSURE FOR VARIABLE ANNUITY SALES

The Costs Of Variable Annuities: Something To Watch Closely. The combined costs found in variable annuity contracts can have a significant effect on the investment performance of the annuity contract. Even seemingly small differences in mutual fund and annuity contract expenses can, over time, have a dramatic effect on the performance of your investments. Variable annuities charge mortality and expense charges and certain administrative fees. These fees are in addition to the management and administrative fees of the funds (subaccounts) offered within the variable annuity product. In addition, annuities that are sold by agents are likely to involve sales charges (which the issuer pays the agent) and/or surrender fees (which the insurance company charges the annuity owner if he or she cancels the contract prematurely, and which are often utilized to compensate the insurance company for fees already paid to the agent). In addition, certain optional features of annuities (such as guaranteed income benefits) also result in additional annual expense charges. The fees charged by a variable annuity are described in its prospectus. When comparing variable annuities always obtain the prospectus prior to your purchase – and read the prospectus carefully.

A Variable Annuity Is A Long-Term Investment. It may take ten, twenty or more years for the benefits of tax deferral to offset the costs associated with a variable annuity under current income tax laws.

Warning From The North American Securities Administrators Association. This warning has been issued regarding variable annuity sales: "What might be a suitable investment for one investor might not be right for another. Securities professionals must know their customers' financial situation and refrain from recommending investments that they have reason to believe are unsuitable. For example, variable and equity indexed annuities are often unsuitable for senior citizens because those products are generally long-term investments that limit access to invested funds. But sales agents stand to earn high commissions on these investment products so they don't always adhere to the suitability standards – with dire consequences for seniors. Remember: Make sure your investments match up with your age, your need for access to money, and your risk tolerance." (From "State Securities Regulators Identify Top 10 Traps Facing Investors," May 15, 2007.) For more information, visit www.nasaa.org.

If you desire to proceed to purchase a variable annuity contract, your must read and initial each of the following:

☐ I believe that the variable annuity is appropriate for my insurance needs and financial objectives, considering my tax bracket, investments, and financial status.

☐ I understand that a nonqualified variable annuity is a deferred annuity and that I may not see a benefit from tax-deferred compounding for 10-20 years or more.

☐ I understand that there is no tax advantage for holding a variable annuity in a traditional IRA, Roth IRA, 401(k), or other qualified retirement plan.

☐ I am purchasing this annuity with funds that I do not need for current (or near-term) expenses.

☐ I understand that withdrawals from the annuity before I reach age 59½, like early withdrawals from other tax-deferred products, may be subject to a 10% federal penalty tax.

I understand that I should invest in a variable annuity only after contributing the maximum amount to qualified plans (such as IRAs and 401(k) plans) that are available to me. Qualified plans may feature tax-deductible contributions, often offer more investment options than annuity contracts, and do not charge the mortality and expense risk charges and administrative fees that annuities do.

I am in a higher income tax bracket. I understand that an annuity's expenses (including underlying portfolio expenses) can outweigh the benefits of tax-deferred compounding for investors in lower tax brackets. Those investors may be able to earn higher total returns by investing in mutual funds outside of an annuity.

I understand that any growth in the value of the variable annuity, when withdrawn from the annuity contract, will be taxed at ordinary income tax rates and will not receive long-term capital gains treatment as to gains (as mutual funds held in taxable accounts would receive as to long-term capital gains), nor qualified dividend treatment, which results in lower marginal rates of taxation in most instances. I also understand that foreign tax credits are not available to me for international investments held in variable annuities. I further understand that tax-managed or otherwise tax-efficient mutual funds nearly always result in less taxation to the owner than variable annuities, as cash funds are pulled from these types of investments and utilized to meet expense needs.

I understand that, unlike mutual funds held in taxable accounts, annuities do not receive any stepped-up basis which eliminates capital gains at the death of the mutual fund owner, and that beneficiaries of the annuity will be taxed on the annuity's gains at their ordinary income tax rates, which (combined federal, state and local) tax rates may be higher or lower than my ordinary income tax rate, depending upon the situation.

I understand that a variable annuity, like other securities, is subject to market risk and that the contract does not protect me from losing money. I understand that accumulation values fluctuate and that the contract I am applying for does not guarantee a fixed dollar value for my assets. I understand that any "guarantees" only result in a return of the principal amount invested (or some other amount) (less withdrawals) only upon the death of the annuitant and/or annuity contract owner, as set forth in the prospectus.

I understand that if I replace an existing annuity or life insurance policy with a variable annuity contract, the death benefit promised under the existing policy (including any guarantee that my beneficiary will receive more than the annuity's current market value) will not transfer to my new annuity. Furthermore, I understand that I may incur new sales charges and a new surrender fee period without necessarily receiving any major benefit as a result of the replacement.

______________________________ Customer Signature
Date: _________________________

______________________________ Customer Signature
Date: _____________________________

THIS FORM MUST BE INITIALED, SIGNED, AND RETAINED BY THE ANNUITY SALESPERSON AND/OR HIS OR HER FIRM. A COPY OF THIS DISCLOSURE MUST BE PROVIDED TO THE CONSUMER WITH THE ORIGINAL ANNUITY CONTRACT.