

# FIDUCIARYNOW UPDATE

July 22, 2010

**THE ATTENTION SHIFTS TO AGENCY STUDIES AND RULE-MAKING.** The work is far from complete, for those interested in the public policy decisions which may further acknowledge the imposition of fiduciary status on various providers of investment and/or financial planning advice. The Dodd-Frank Wall Street Reform and Consumer Protection Act now calls upon several studies to be undertaken by the SEC, GAO, and other government agencies, affecting BD/RIA regulation, the application of the fiduciary standard of conduct, the regulation of financial planning, and other issues.

**NOW - THE NEED FOR GREATER RESEARCH ON FIDUCIARY STANDARDS.** I am constantly reminded of the need for a greater understanding of the fiduciary standards which arise under the law. While there are many reported cases applying fiduciary standards in various contexts, reported cases exploring the application of fiduciary duties to investment advisory and financial planning activities are not large in number (outside of the ERISA context, at least). Over the years I have identified over 100 law review articles and white papers which address, or touch upon, the application of fiduciary standards to the provision of investment advice or financial planning, but there remain a host of issues to be explored. Quite frankly, there is a lot to be learned, by all of us.

**CALL FOR PAPERS – FIDUCIARY, BD, AND RIA ISSUES.** To address the need for further research and education on the fiduciary standard of conduct, I am pleased to report that the prestigious Boston University *Review of Banking & Financial Law*, in cooperation with The Committee for the Fiduciary Standard, have issued a “Call for Papers” (see attached). By August 31, 2010, they seek short papers (1,250 to 4,000 words) which explore the many issues present by the Study the S.E.C. will be conducting this Fall. I encourage each one of you to write papers for submission on these many issues, and/or encourage others (especially law professors, financial planning program professors, and financial economics professors) to consider submitting a paper. Papers should reflect research and/or scholarship, and not just be “position papers” or “comment letters.” However, even scholars may disagree – hence; all points of view will be respected.

**UPCOMING: AN EDUCATIONAL CONFERENCE ON FIDUCIARY DUTIES.** I am also pleased to report that several organizations are considering co-sponsoring a one-day educational conference, to be held in Washington, D.C. this Fall, at which scholars may be invited to speak to address the fiduciary standard of conduct and its application to the financial world of today. Please stay tuned for further announcements about this conference.

**FYI – RESPONDING TO QUESTIONS ABOUT MY “SILENCE.”** Over the past year, I’ve received e-mails from several subscribers to FiduciaryNow.com updates wondering when the next “Update” would be issues. During the past year I have restrained myself, intentionally, from posting updates at FiduciaryNow.com. I have tremendous respect for those organizations, and their leaders, who have advocated for the bona fide fiduciary standard of conduct and for the creation of a true financial planning and/or investment adviser profession. Given the sensitive nature of many of the proposals (and speed of developments), I felt it best to remain largely silent.

**IT IS TIME - TO INFORM, EDUCATE, AND SEEK INSIGHTS AS TO THE APPLICATION OF THE FIDUCIARY STANDARD.** Now, however, is the time for education on the importance of the fiduciary standard of conduct to Americans and America itself. It is time to illuminate our policy makers on how a bona fide fiduciary standard can be properly applied to financial services today. To this end, I have many questions, which I hope will be explored through scholarly research and/or educational presentations in the weeks ahead.

***To that end, here’s a “short list” of possible research areas, addressing just some of the issues presented by upcoming studies on just the fiduciary standard as applied to RIA and BD regulation. If you are considering writing in this area, perhaps one of these suggested topics may appeal to you. And – if you are writing, please e-mail me and I’ll be happy to send to you, privately, a listing of existing white papers which touch upon fiduciary standards of conduct.***

**EXAMINING FIDUCIARY DUTIES, GENERALLY.**

- **Generally.** Examine fiduciary and/or quasi-fiduciary standards of conduct in financial services regulation – when they are applied, the specific duties arising therefrom, disclosures mandated by fiduciary advisors, the due diligence required of fiduciaries as to minimal requirements and time duration, the effectiveness of waivers of fiduciary duties and/or efforts to restrain the scope of engagements, and the nature of informed consent when a conflict of interest is present.
- **Legal, Factual and Public Policy Rationale for Imposition of Fiduciary Status.** What rationale exists to support the application of fiduciary status - both generally under the law and specifically upon broker dealers?

- **Examining Different Fiduciary Standards of Conduct.** Contrast the fiduciary standards of conduct found under state common law as to relationships based upon trust and confidence, principal-agency relationships involving de jure or de facto discretion, the Investment Advisers Act of 1940 (as applied by the SEC), ERISA, and specific state law and regulations (including but not limited to state statutes affecting trust services, mortgage brokers, viatical settlement providers, etc.), as they apply to the delivery of financial and investment advice. What is the difference between the “sole interests” and “best interests” standards found in state common law, and how have each of these standards been enhanced or diminished by statutes and/or rule-making in the context of delivery of investment advice? Where applicable, discuss rules or procedures adopted by other types of fiduciaries (i.e., attorneys, physicians) to handle conflict of interest situations, disclosures of material facts, etc.
- **“Flavors of Fiduciary” – What Standard Governs the Relationship?** Are there emerging different “flavors of fiduciary” - i.e., a fiduciary for an ERISA account governed by one set of standards, a fiduciary governed by SEC’s interpretation of rules, a fiduciary governed by state common law fiduciary standards? To what extent do ERISA’s fiduciary requirements affect non-ERISA accounts which an advisor might provide advice with regard to? Are different fiduciary standards to be applied in the context of the same overall advisory relationship?
- **Implied Preemption of State Common Law?** ERISA’s express preemption is well known - after NSMIA and the Dodd-Frank bill, to what extent does the '40 Act and SEC rule-making thereunder preempt (by implied preemption) state common law fiduciary standards of conduct? How does this affect private claims arising under state common law for breach of fiduciary duty?
- **Utmost Good Faith.** In the United States we commonly refer to a triad of fiduciary duties - due care, loyalty, and utmost good faith. But what is a breach of the duty of utmost good faith? Is it, in fact, a separate duty in the decisions and administrative proceedings which have applied the fiduciary standard upon investment advisers or brokers?
- **Fiduciary Duty of Due Care.** What is required – attained knowledge, diligence, etc., to fulfill an advisor’s duty of due care, as it arises under the fiduciary standard of conduct? How is this different than the suitability standard, as to its due care aspects? What is the difference between “substantive due care” and “procedural due care”?
  - **Knowledge Requirement.** What should be the base knowledge requirement for those who provide personalized investment advice? Contrast the current requirements of the Series 65 and Series 7 examinations.
  - **Due Diligence – Investment Strategy.** Due diligence is thought to require three separate aspects: (1) Is the investment strategy utilized sound? (2) Are the products selected to implement the investment strategy the “best” for the client? (3) Are the investment strategy and products altered appropriately to fit the client’s specific needs? As to the first aspect - What standard applies to the selection of an investment strategy; i.e., do the Daubert and Frye evidentiary standards for the admission of expert testimony possess any relevance? How is due diligence on investment strategy documented - and undertaken? What if an investment strategy is speculative in nature, and not supported by sound academic underpinnings or back-testing - can it still be used, and with what kind of disclosures to the client?

- **UPIA Influence.** To what extent does the UPIA and other uniform acts, and/or restatements of the law, influence the due diligence required of investment advisers, as it affects investment strategy selection, or the selection of specific investment products?
    - **Issues Involving Delegation.** What requirements are imposed upon an advisor when delegation of due diligence is undertaken by an advisor, either within the same firm or when outsourced to other firms, as it affects selection of investment strategy, or the selection of specific investment products?
  - **Due Diligence – Pooled Investment Vehicles.** Examine the due diligence currently conducted for pooled investment vehicles (mutual funds, ETFs, UITs, variable annuity sub-accounts, hedge funds, private equity funds, separately managed accounts, etc.) - how does due diligence vary among the foregoing? Is due diligence being undertaken - procedurally and substantively - correctly and thoroughly? What suggestions could aid due diligence steps? To what extent can due diligence be delegated? What role does benchmarking possess in due diligence?
  - **Disclosures of “Hidden Fees and Costs” – Should They Be Undertaken? How?** The 'hidden' transaction costs of mutual funds and ETFs are not included in the fund's annual expense ratio. To what extent do investors realize that additional costs, beyond those included in the annual expense ratio, exist? Is portfolio turnover fairly represented under current SEC rules for computing same? Can transaction costs be quantified or at least estimated? Should funds be permitted, or mandated, to disclose transaction costs estimates? Does a fiduciary advisor possess a duty to attempt to quantify transaction and other hidden costs and disclose them to clients?
  - **Due Diligence – Client-Specific.** Is "risk tolerance" a good means of assessing the client's needs, in the design of an investment portfolio to fit their needs? Does not a client's risk tolerance vary over time, and is it not substantially influenced by the market? What are the best techniques utilized now, in either "risk tolerance" measurements or otherwise, in "fitting" investment strategies to the needs of the specific clients?
- **Fiduciary Duty of Loyalty Issues.**
  - **The Nature of Informed Consent When A Conflict of Interest Is Present.** As to the issue of “informed consent” of the client as an essential precondition when a conflict of interest exists - what is the nature of informed consent? Have recent SEC rule-making efforts, or SEC administrative proceedings, or judicial or other proceedings, diminished the requirement of informed consent, and stressed only disclosure and agreement of the client to proceed? If so, what dangers are posed by these developments?
  - **Removing the Fiduciary Hat.** How does termination of fiduciary status occur in the context of a financial advisor (BD or RIA) - client relationship? What are the essential prerequisites to the termination of fiduciary status? Should termination of fiduciary status be restricted to just a few circumstances, and if so, what situations? How easily can the fiduciary "hat" be removed?

- **Hat-Switching.** Is it possible to switch back and forth from a fiduciary to a non-fiduciary hat, to engage in product sales following the delivery of investment advice and/or financial planning? Is the SEC's Sept. 2007 proposed rule, including its definition of "solely incidental" - appropriate? Could that rule be challenged as not conforming to the plain language of the IAA and also its legislative history, given the narrow construction the broker-dealer exclusion was to be given following FPA vs. SEC, given the increased authority given the SEC under the Dodd-Frank bill?
- **Fiduciary Status: Account-Specific or Extending to the Entire Relationship?** Does fiduciary status extend to all aspects of the relationship, or just a portion thereof? Can an investment adviser also have a broker-dealer (non-fiduciary) hat at the same time - i.e., can two hats be worn at the same time?
- **The "Choice of Type of Relationship" Concept.** How can a consumer be informed as to when they are protected by a fiduciary, or not? Are disclosures effective in such circumstances? Should consumers possess a choice in what standard of conduct governs the relationship? Is this contrary to the principle that fiduciary protections are imposed by law, due to lack of consumer understanding? What is the best method to confirm to a consumer whether he or she is in a fiduciary, or arms-length relationship? Should such a confirmation (or disclosure) even be undertaken?
- **Consumer Choice Once a Relationship Has Been Formed.** How easy is it to get a client to sign off on a disclosure form, once a relationship of trust and confidence has been formed? What do insights from behavioral science provide us, in this regard?
- **The Anti-Waiver Provision of the IAA – Still Applicable?** When? Does Sect 215 of the IAA prohibit waiver of an adviser's fiduciary duties? To what extent? Contrast blanket waivers with more limited waivers. How does this relate to scope of the engagement issues?
  - **"Scope of the Engagement" vs. "Waiver of Fiduciary Duty."** To what extent can the scope of the fiduciary relationship be confined by the "scope of the engagement" - and to what extent does an attempt to do so constitute an impermissible seeking of a client's waiver of a core fiduciary obligation? One specific issue, in this context - to what degree is there a continuing obligation to provide advice under a fiduciary standard once it has been provided? (The discount broker call center business model is one illustration of this.) Can the need to structure a portfolio tax-efficiently be negated by the engagement contract, or is this is "core" obligation of the portfolio which could only be negated in those circumstances where taxes don't matter to the individual client?
- **Benefits and Detriments Arising from Varied Standards of Conduct.** Generally, what are the benefits and/or detrimental impacts resulting from the application of varied fiduciary standards of conduct, and/or quasi-fiduciary duties, upon the delivery of financial and/or investment advisory services.

## EXAMINING THE REGULATION OF INVESTMENT ADVICE AND ITS EVOLUTION

- **Disclosure Regime vs. Fiduciary Standard of Conduct.** The SEC has long relied upon disclosure as the foundation of securities law and enforcement. But is disclosure a '33 Act and '34 Act regulatory regime? Does the IAA recognize, or does state common law explore, the limits of disclosure as a means of investor protection? What does academic research, especially that arising from the area of behavioral finance, teach us about the limits of disclosure's effectiveness? Are other consumer protections effective, such as standardization of investment products, suitability requirements imposed on brokers, and mandated or prohibited contractual terms? Do developments over the past few decades in the delivery of investment and financial advice, such as increased complexity in investment theory and/or proliferation of products, suggest the application of fiduciary status? Are other ways available to regulators, such as mandating certain knowledge requirements, continuing education, and/or certifications?
- **Effectiveness of Disclosure of Nature of Relationship.** How effective are disclosures in describing the nature of the relationship, when received by individual investors? Can such disclosures be made better and more effective?
- **Use of Titles.** What do investors perceive when various titles, such as 'financial consultant' - are utilized? Should the use of certain titles be restricted? Do any cases support the finding of fiduciary status under state common law due to the use of titles?
  - **Is "Fee-Based" A "Fraudulent" Term?** Is the term 'fee-based advisor' inherently fraudulent? Should the term 'fee-and-commission-based advisor' be mandated in its stead?
- **Design of Disclosures.** Under the Dodd-Frank legislation, the SEC is permitted to adopt rules which enhance disclosures of fees, costs, and conflicts of interest. What factors in designing disclosures best ensure their effectiveness? Do disclosures do a good job of influencing consumer behavior? Or, as some behavioral economists have opined, are disclosures – regardless of how “good” they are – generally ineffective (hence the need to apply fiduciary standards)?
- **Implications for the BD, Insurance, and Investment Management Industries Arising from Potential Application of Fiduciary Standards.** Examine the implications for the broker-dealer and/or insurance and/or investment management industries which could result from the application of a fiduciary standard of conduct, and whether exceptions to the application of fiduciary duties should be granted to accommodate certain business practices or whether certain business practices should instead be curtailed or prohibited.

- **Conforming Standards to Business Practices, vs. Conforming Business Practices to Standards.** Much is made of the need to conform industry practices to the fiduciary standard, or vice versa. Yet, the fiduciary standard fundamentally operates as a restraint upon conduct. What business practices of broker-dealer firms are irreconcilable with the fiduciary standard of conduct, and should be prohibited by a fiduciary? Which can be reconciled – either with restrictions or with no restrictions on current business practices?
  - **12b-1 Fees.** Are 12b-1 fees 'advisory fees in drag' - i.e., 'special compensation' which makes the BD exclusion from the IAA inapplicable? Does the Dodd-Frank legislation change this? Does the recent SEC Proposed Rule, which caps 12b-1 fees (both in terms of amount and in terms of time) change this?
  - **The Return of Fee-Based Brokerage Accounts?** Does the SEC now possess the authority to permit fee-based brokerage accounts? If so, should it, if a different standard is applied than that found in the IAA? What public policy arguments favor or oppose same? How does the work of economist George Akerlof affect these considerations?
  - **Fiduciary Commission-Based Compensation.** The Dodd-Frank Act specifically permits commission-based compensation for fiduciaries. Is such permitted? How, while preserving fiduciary principles? Is this only agreed-to-in-advance compensation, and/or level compensation? Is this to permit various business models, with the idea that small investors cannot be served only by commissions? But is this true?
  - **The Fiduciary with Proprietary Products.** Proprietary products as an exception to the fiduciary standard are also expressly permitted under the Dodd-Frank legislation.
    - **Prior State Law Adoption for Banks and Trust Companies.** Over a decade ago many states adopted statutes which expressly permitted banks and trust companies to utilize proprietary funds with trust clients; what restrictions did such statutes impose? What rule-making in this area has resulted from the OCC and FDIC? How are these rules being applied in practice? Are these rules a guide for the SEC, as it faces similar issues, or should similar rules not be adopted? What is the alternative?
    - **Conflicts Arising from Payments to Affiliates.** Payments to affiliates of fund companies create additional conflicts of interest if the fiduciary is authorized to sell proprietary products. To what degree are administrative fees, brokerage commissions, soft dollar payments, and other fees paid to affiliates higher for current affiliated funds, when compared to non-affiliated funds with similar characteristics? What about the sharing arrangements common for securities lending revenue? How do the findings from such an analysis inform policies during the rule-making process?

- **Principal Trading.** Does the Dodd-Frank bill affect the principal trading temporary rule? Is that temporary rule, as promulgated, consistent with fiduciary principles? Is the supply of certain securities so low that agency trades cannot be mandated for all accounts subject to the fiduciary standard? How do dual registrants establish fair pricing when engaging in principle trades? How do dual registrants prevent dumping of securities to clients; did any dumping of asset-backed securities occur, in either BD customer or RIA client accounts, during the recent blow-up in these products? Or auction rate securities? What procedures can firms put in place, if any, to prevent same? Should IPOs to clients of fiduciary advisors be permitted? To what extent will the market making activities of dual registrants or affiliates be affected by prohibiting or limiting principal trading for clients of fiduciary advisors - or will capital formation be adversely affected?
- **Is the Fiduciary Principle Being Eroded?** Justice Harlan Fiske Stone once observed: "Most of the mistakes and major faults of the financial era that has drawn to a close will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.'" Stone, *The Public Influence of the Bar*, (1934) 48 Harv. L. Rev. 1, 8-9.
  - To what extent have recent developments in Congress, the '40 Advisers Act, the '40 Investment Company Act, and SEC rule-making, weakened the fiduciary principle? Has the fiduciary principle been growing stronger or weaker in other areas of the law? How might developments in the fiduciary duties of investment advisers affect the application of fiduciary standards of conduct to other types of fiduciaries, or vice versa?
  - Has the 'disintegrating erosion' of 'particular exceptions' which Justice Cardoza warned against so many decades ago begun, or been accelerated, by the Dodd-Frank bill? Will the fiduciary standard survive as a principles-based regulatory regime, or will it evolve into a rules-based regime - and what are the implications of same?
- **Financial Services Regulatory Structure.**
  - **The Current Regulatory Structure: Propriety of the BD Exclusion.** Examine the propriety of the broker-dealer exclusion from the definition of investment adviser found in the Investment Advisers Act, given the evolution of the delivery of financial and investment advice in various types of financial services firms and other recent developments.
  - **Sources of Ethical and Professional Standards.** What current regulations at the State and Federal level provide adequate ethical and professional standards for those who deliver financial and/or investment advice (whether regulated as broker-dealers, investment advisers, insurance providers, trust officers, or otherwise), with a particular emphasis on the role of fiduciary standards of conduct in financial services regulation.
  - **Future Regulatory Models.** What are the possible regulatory models for effecting better oversight of the delivery of investment and financial planning advice, and the possible benefits to consumers of enhanced regulation and professional oversight of financial planners and/or those who provide investment advice?
  - **Regulatory Capture.** Address the challenges of compliance, regulatory arbitrage, and regulatory capture, as they relate to the regulation of financial and investment advice.

- **Federalism; Allocation of Regulatory Authority.** Contribute to the debate about the institutional structure of regulation and the competing bases for allocation of regulatory authority.
- **Financial Regulation: Insights Applied from Behavioral Science or other Fields.** Explore insights for financial regulation from other law disciplines, including behavioral fields.
- **FINRA and RIA/BD Oversight.** FINRA (f/k/a NASD) as regulator - has it lived up to the hopes of Senator Maloney, as to raising Wall Street's standards of conduct over time to "the highest"? Since the SEC did not get self-funding, what is the likelihood that FINRA may become the overseer of all RIA firms? Will this be a positive development, as to the evolution of fiduciary standards. (This is a related issue to the core understanding of fiduciary standards for RIAs, and if applied to BDs, but is an important one.)
- **Effectiveness of SROs.** The effectiveness, or lack of effectiveness, of self-regulatory organizations, in promoting enhanced standards of conduct for those who provide investment or financial advice;
- **Are PROs a Better Alternative?** Examine the distinctions between professional regulatory organizations (PROs) and other self-regulatory organizations, and whether PROs are any more effective at maintaining and/or enhancing the standards of conduct for their members, particularly in relation to fiduciary or quasi-fiduciary standards of conduct.

#### **IMPLICATIONS FOR CONSUMERS**

- **Consumer Understanding of Varied Standards of Conduct and Varied Qualifications.** Examine the ability of consumers to understand licensing requirements and standards of care that apply to individuals who provide financial and investment advice.
- **Effects of Conflicts of Interest, Generally.** What are the adverse effects of ongoing conflicts of interest in the financial services industry upon investors, and/or as they relate to enhancement of investor protection and or investor confidence in the integrity of the securities markets and capital formation (which may include a comparison of the U.S. compared with other countries).
- **Effectiveness of Disclosures, from Consumer Perspective.** Examine the effectiveness of disclosures in providing the relevant information and achieving understanding that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service that is typically sold to retail investors.
- **Fees and Costs Disclosures.** Examine the effectiveness of various methods which may be utilized to increase the transparency of fees, costs, expenses, and conflicts of interest in relation to the provision of investment products and services.
- **Conflict of Interest Disclosures.** Examine the effectiveness of various means utilized, or which could be utilized, to ensure adequate disclosure of conflicts of interest in relation to the provision of investment products and services.

- **Account Forms and Brochures.** The effectiveness of account forms, brochures, and other mandated disclosures by broker-dealers and registered investment advisers at the time of entry into a customer or client relationship;
- **Financial Literacy.** Examine the effectiveness of financial literacy campaigns, particularly as to the implications of the effectiveness (or lack thereof) for increased disclosure regimes and/or the imposition of different standards of conduct upon financial services providers.
- **Who Should Be Protected?**
  - **“Personalized Investment Advice”?** What is 'personalized investment advice' in the Dodd-Frank bill? What is not? How is the 'solely incidental' requirement to the BD exclusion from the definition of investment adviser affected - if at all?
  - **Accredited Investors.** What is the appropriate criteria for determining qualification for “accredited investor” status, and what are the implications of such status for clients of fiduciary advisors. If an investor was truly sophisticated, would they always bargain for fiduciary status for their advisor, anyway?
  - **Institutional Investors.** Should institutional investors not receive the protection of the fiduciary standard of conduct, unless it is contracted for?

**AS YOU CAN SEE, THERE IS MUCH WORK TO BE DONE.**

**I HOPE YOU CAN ASSIST IN THESE EFFORTS, OR SEEK OUT THE ASSISTANCE OF THOSE WHO CAN.**

## IN CLOSING.

Thank you for your kind comments over the past year, and for the insights so many readers of FiduciaryNow Updates have provided to me.

As many of you know, I am now writing an occasional column at [www.RIABiz.com](http://www.RIABiz.com). The editors of this online publication were kind enough to permit me to publish a lengthy article exploring the subject of fiduciary vs. arms-length relationships back in May, which can be found at <http://www.riabiz.com/a/1033001>. If you have not yet had to chance to review this article (titled: "Inside the legal issues of the Goldman Sachs hearings"), I reference it for your future review, and hope you find it informative.

Lastly, I continue to work on an upcoming book which explores the fiduciary standard of conduct as applied to the delivery of investment advice and financial planning. Given the importance of financial services reform, and my efforts in support of various advocacy groups involved in the Congressional lobbying efforts, my time dedicated to this project has not been as great as I had hoped ... but the upcoming studies will likely propel this work forward.

I look forward to providing you with further FiduciaryNow updates, in the busy months ahead.

*Thank you for subscribing.* And, as always, please drop me a line, occasionally, to share any thoughts you may have on these important issues.

Yours truly,

Ron

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