Ron A. Rhoades, JD, CFP®

April 12, 2011

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Definition of Fiduciary Proposed Rule
Room N–5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Re: Proposed Rule, Definition of the Term “Fiduciary”

Rhoades Cmt. Ltr. #2

Ladies and Gentlemen:

I submit these comments in support of the Department of Labor’s proposal. These comments are submitted personally and not as the representative of any firm or organization.

Some of the comments frequently received by DOL/EBSA with regard to the proposed rule regarding the definition of “fiduciary” is that fiduciary duties are too “ill-defined” or “vague” to be applied to investment advisory activities. These comments ignore several important realities:

First, fiduciary duties have been successfully applied to other professionals, such as attorneys, for centuries;

Second, the fiduciary regime is by its very nature a “principles-based” regime and not a “rules-based” regime;

Third, there is a significant amount of jurisprudence applying the broad fiduciary duties of due care, loyalty, and utmost good faith upon the activities of those who provide investment advice, not only under ERISA but also under the Investment Advisers Act of 1940 and state common law;

Fourth, reciting more specific fiduciary duties may be difficult, but one need only make the effort.

With respect to this last point I offer the attached outline, “What Are the Specific Fiduciary Duties of Those Who Provide Investment Advice to Retail Consumers?” This outline, prepared for a conference presentation later this year, further delineates for investment advisers the parameters of their fiduciary obligation by suggesting more specific principles, found within proposed “Investment Adviser Standards of Professional Conduct.”

The attached draft "Investment Adviser Standards of Professional Conduct," which include discussion and recitation to authority, are designed to serve as one of many resources to aide in the eventual adoption of more specific standards of conduct. Such more specific fiduciary standards of professional conduct can serve to guide the activities of fiduciary providers of investment advice. These Standards could be adopted, and then promulgated, by either a firm, an industry association, a self-regulatory organization, a professional regulatory organization, or a government agency. Of course, in the process of adoption additional research, analysis, and scrutiny would be required, and necessary modifications undertaken. I would also note that many industry associations of a voluntary nature possess voluntary standards of conduct and/or codes of ethics which serve to assist their members.

I would urge the Employee Benefits Security Administration to consider, as it expands the applicability of the definition of "fiduciary" to better fit the scope which is set forth by the plain language of ERISA, to consider additional rule-making. Such rule-making might involve either:

(1) the formulation and promulgation by DOL/EBSA of Standards of Professional Conduct for investment advisers providing services covered under ERISA; or

(2) the requirement that those providing investment advice to plan sponsors and/or plan participants (however those who provide the advice are regulated) adopt, within their own firm, and as part of their firm's Code of Ethics, specific Standards of Professional Conduct to guide each and every provider of fiduciary investment counsel.

The latter suggestion (i.e., requiring firms to adopt more specific fiduciary standards of conduct within their own Code of Ethics) can foster the further development and understanding of specific standards of professional conduct within the entire securities industry. Moreover, as investment theories, strategies and products evolve, firms can move quickly to adopt their Code of Ethics to provide more specific guidance on adherence to aspects of the fiduciary standard of conduct.

In conclusion, the expanded definition of "fiduciary" is a highly significant step in the evolution of protections for both plan sponsors and plan participants. Fiduciaries can and should glean from reported decisions, no-action letters, and other authorities more specific principles which can serve to guide their conduct.

I urge DOL/EBSA to adopt the broadened definition of fiduciary, without delay, and then proceed with rule-making to expand the Code of Ethics required to be maintained by fiduciary investment counsel.

Thank you.

Sincerely,

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WHAT ARE THE SPECIFIC FIDUCIARY DUTIES OF THOSE WHO PROVIDE INVESTMENT ADVICE TO RETAIL CONSUMERS?

Investment and financial advisors must exercise "due care" and "act in the best interests" of their clients. But can we elicit from these general legal concepts more specific principles?

This outline explores the sources and parameters of fiduciary law, suggesting more detailed principles – derived from case law and administrative rulings – which can serve to guide the actions of fiduciary advisors.

Ron A. Rhoades, JD, CFP® serves as the Chief Compliance Officer and Director of Research for Joseph Capital Management, LLC, an RIA firm with offices in Florida, North Carolina, and New York, and providing services in both wealth management and retirement services. Commencing in August 2011, Ron will serve as Program Chair of the Personal Financial Planning Program within the Business Department of Alfred State College in upstate New York. Ron served as Reporter for FPA's Fiduciary Task Force and on its Government Relations Committee. He currently serves on the Board of Directors of NAFPA, where he chairs its Industry Issues Committee and is a representative to the Financial Planning Coalition. Ron also serves on the Board of Advisors to The Committee for the Fiduciary Standard. In recent years, Ron has written numerous articles relating to the fiduciary duties of financial planners and investment advisers and has been a guest speaker at numerous conferences. The author of several books and RIABiz's "One-Man Think Tank" column, Ron is frequently quoted by the national media.

This outline is in an ongoing process of development. Suggestions are welcomed. Please contact the author via e-mail at Ron@ScholarFi.com. Thank you.

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AN EXAMINATION OF THE CHARACTERISTICS OF ARMS-LENGTH VS. FIDUCIARY RELATIONSHIPS

INTRODUCTION

Recent objections have arisen from various industry associations to the application of the fiduciary standard of conduct to investment and financial advisory activities, both under ERISA and by the SEC. Yet, both the U.S. Securities and Exchange Commission (SEC) staff and the U.S. Department of Labor (DOL and/or DOL/EBSA) have indicated a willingness to proceed to apply the fiduciary standard of conduct more broadly, and to more specifically define specific fiduciary obligations which are imposed. Do these industry objections possess merit? And, if so, are there means to address any legitimate concerns?

This outline explores the fiduciary duties of due care, loyalty, and utmost good faith. Setting forth this general "triad" of fiduciary duties does little, however, to lead to better understanding by fiduciaries of their specific fiduciary obligations. Accordingly, following a summary of the distinctions between arms-length and fiduciary relationships, this outline explores the sources of fiduciary status and the important public policy reasons behind its imposition.

Thereafter this outline suggests "Investment Adviser Standards of Conduct" which could, following due review and appropriate modification, be adopted as a regulation in order to better guide the actions of fiduciary advisors in the realm of providing investment and financial advice. Alternatively, it is suggested that these "Investment Adviser Standards of Conduct" (as modified following further analysis) could be required to be incorporated, with modification as appropriate, into each investment adviser's "Code of Ethics." The SEC, state securities administrators, and/or DOL/EBSA could impose such a requirement, by

I begin, however, with an examination of the common arguments of opponents to the application of fiduciary status:

- Flexibility and choice should be permitted, in the sense that those providing investment advice, and their clients or customers, should be permitted to define whether or not their relationship is to be governed by fiduciary principles; and
- Fiduciary principles are "imprecise" or "vague."

The first argument I address in the section of this outline immediately hereafter. The bulk of this outline addresses the concerns embodied in the second argument stated above.

Another common argument, that the imposition of fiduciary duties results in "higher fees and costs" for individual investors, is so spurious a contention that I do not address it in this outline, having previously addressed it in prior writings.[1] I encourage, however, as part of the economic analysis required for the adoption of any federal regulation, both the U.S. Dept. of Labor and the U.S. Securities and Exchange Commission to undertake a survey of the various business models under which investment advisory

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[1] *See* Cmt. Letter (April 2011), Ron A. Rhoades, to U.S. Dept. of Labor, regarding "Definition of the Term 'Fiduciary'" Proposed Rule, available at http://www.dol.gov/ebsa/regs/cmt-1210-AB32.html; *see also* "One-Man Think Tank: The fiduciary standard may sink Wall Street's advisors-on-yachts. Should we care?," RIABiz (12/7/2010), available at http://www.riabiz.com/a/4598123.

services are provided and to ascertain the "total fees and costs" borne by clients or customers under each business model. I am confident that the results of such an objective study will demonstrate that the provision of fiduciary advice results, on average, in far less costs of intermediation, and as a result a greater flow of the returns of the capital markets flow under a fiduciary business model into the pockets of individual investors.

"FLEXIBILITY AND CHOICE": SHOULD A RELATIONSHIP BE CAPABLE OF BEING DEFINED BY THE PARTIES AS FIDUCIARY OR NON-FIDUCIARY IN NATURE?

Should an advisee should be able to "opt out" of the fiduciary relationship? Many securities industry participants appear to believe that the fiduciary relationship is a matter of contract. For example, the SPARK Institute[2] recommended in its March 1, 2011 testimony to the U.S. Department of Labor (in hearings relating to the DOL's expanded definition of "fiduciary"): "We believe that service providers and plan sponsors should have flexibility and discretion in determining and agreeing on a service provider's role and whether a fiduciary relationship is mutually expected."[3] Similarly, the Financial Services Institute opined that a "practical approach" should exist which "preserves investor choice and accommodates a range of business models."[4]

Yet these "investor choice" arguments ignore several fundamental aspects of fiduciary law.

First and foremost, fiduciary obligations are imposed to restrict certain forms of conduct; in this respect, it should be of no surprise that certain business models (or aspects thereof, or certain practices) are inconsistent with an investment or financial advisor's fiduciary obligations and hence should be avoided. Business models should conform to the law; fiduciary law should not be eroded through "particular exceptions" in order to accommodate various business practices.

Second, fiduciary obligations are imposed not as a result of the terms of the agreement between the parties, but rather are imposed by either statutory law (Advisers Act, ERISA, etc.) or state common law. Additionally, fiduciary duties are not capable of broad waiver.

Third, even if parties could bargain as to fiduciary status, what client would *ever* decide to *not* have fiduciary status imposed? Any knowledgeable, sophisticated investor, if truly cognizant of the important protections afforded to the investor by the fiduciary status of his or her advisor, would *nearly always* bargain for the continued application of fiduciary status, rather than move to an arms-length commercial relationship. While not the subject of this outline, arguments that fiduciary status results in "greater

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[2] The SPARK Institute represents the interests of a broad based cross section of retirement plan service providers and investment managers, including banks, mutual fund companies, insurance companies, third party administrators, trade clearing firms and benefits consultants.

[3] Testimony of Larry H. Goldbrum, Esq., General Counsel, The SPARK Institute, Before the United States Department of Labor, Employee Benefits Security Administration, Regarding the Proposed Definition of Fiduciary (March 1, 2011), available at http://www.dol.gov/ebsa/pdf/1210-AB32-T6.pdf. *See also* comment letter to DOL of SIFMA dated Feb. 3, 2011 ("The proposed rule eliminates this central part of commercial and trust relationships. We believe plan sponsors and IRA holders should have the ability to dictate the terms of their relationships, rather than have the Department create a rule under which all of their service providers could be deemed fiduciaries.)

[4] Comment letter of the Financial Services Roundtable, dated Feb. 3, 2011, to the DOL regarding the proposed definition of fiduciary, available at http://www.dol.gov/ebsa/pdf/1210-AB32-164.pdf. The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services.

costs" to clients of fiduciaries, compared to customers of non-fiduciary financial services intermediaries, are unsupported and false. To the contrary, this author's experience in reviewing the investment portfolios of thousands of individual investors is that the clients of fiduciary advisors generally receive far greater and better investment advice for total fees and costs which are far less.

MORE SPECIFIC PRINCIPLES CAN BE DISCERNED TO GUIDE THE CONDUCT OF FIDUCIARIES

A second common objection to the application of the fiduciary standard of conduct is that fiduciary standards are "imprecise" and hence subject investment and financial advisors to uncertainty as to the parameters of their conduct and potential liability.

Indeed, the SEC staff, acting under Section 913 of the Dodd Frank Act, noted in its January 21, 2011 "Study on Investment Advisers and Broker-Dealers" that greater understanding of fiduciary standards of conduct would be helpful:

> Dodd-Frank Act Section 913(g) provides that any rules that the Commission promulgates under the uniform fiduciary standard "shall provide that such standard of conduct shall be no less stringent that the standard applicable to investment advisers under Section 206(1) and (2) of [the Advisers] Act when providing personalized investment advice about securities…." The Staff interprets the uniform fiduciary standard to include at a minimum, the duties of loyalty and care as interpreted and developed under Sections Advisers Act Section 206(1) and 206(2).
>
> The Staff is of the view that the existing guidance and precedent under the Advisers Act regarding fiduciary duty, as developed primarily through Commission interpretive pronouncements under the antifraud provisions of the Advisers Act, and through case law and numerous enforcement actions, will continue to apply to investment advisers and be extended to broker-dealers, as applicable, under the uniform fiduciary standard.
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> In addition, the Staff believes that rulemaking and/or interpretive guidance regarding the uniform fiduciary standard would be useful to both investment advisers and broker-dealers, but that such rulemaking and/or interpretive guidance would be especially beneficial for broker-dealers, who may not be as familiar with the application of the uniform fiduciary standard to advice-giving activities. Therefore, any Commission rulemaking or guidance relating to the uniform fiduciary standard should particularly focus on assisting broker-dealers with complying with the minimum requirements of the uniform fiduciary standard and what it means to generally operate under the uniform fiduciary standard.
>
> Clarification will be particularly important in applying the obligation to eliminate or at least disclose all material conflicts of interest, as contemplated by the Dodd-Frank Act. With investment advisers, the Commission and Staff have identified numerous conflicts of interest over time through interpretive guidance, rulemakings, enforcement actions and no-action letters. The Staff believes that the Commission should help broker-dealers similarly identify their conflicts of interest as specifically as possible so as to facilitate broker-dealers' smooth transition to compliance with the uniform fiduciary standard. Similarly, the Commission should continue to help advisers further identify their conflicts of interest.

> The implementation of a uniform standard of conduct would be most effective only if the standard is applied uniformly.[5]

The SEC staff then specifically recommended that the "Commission should engage in rulemaking and/or issue interpretive guidance on the components of the uniform fiduciary standard: the duties of loyalty and care."[6]

Not only do regulators sense the need for greater delineation of the specific fiduciary duties of those providing investment advisory services. Admittedly, within the investment adviser and financial planning communities there has long existed confusion over what the "fiduciary standard" requires, in part due to lack of guidance from regulators and/or lack of education within the investment advisory community.

Yet the fiduciary standard of conduct is capable of much more definition, as more specific principles can be elicited to guide the conduct of fiduciary advisors through an examination of court decisions, administrative decisions, no-action letters, and agency rules. Indeed, it is possible to derive from this collective body of knowledge the more specific fiduciary principles which can serve to guide the conduct of financial and investment advisors, regardless of how they may be regulated (as investment advisers, subject to ERISA's stricter prohibitions, as registered representatives, as trust officers, or as financial planners).

This outline attempts to shed light on the fiduciary standard of conduct applicable to investment advisers, as well as to those providing financial planning advice, in the United States. As we will see, far from being a mere disclosure-based regulatory regime, the fiduciary standard of conduct imposes many well-defined legal obligations upon those who acquire fiduciary status.

Achieving a greater understanding of these legal requirements can assist advisors and firms in serving the needs of their clients. In addition, reputational and other risks which investment and financial advisors may face can be minimized by adherence to these more specific fiduciary principles.

Before exploring the specific parameters of fiduciary standards of conduct, it is first necessary to summarize how fiduciary relationships differ from arms-length relationships. Understanding these distinctions, and the public policies which underlie the imposition of fiduciary status, are at the heart of understanding one's fiduciary obligations. This outline then explores the various sources of fiduciary status, noting that state common law fiduciary obligations are not pre-empted by regulations which may be adopted under the Advisers Act. However, state common law fiduciary obligations are generally preempted by ERISA. Finally this outline explores specific fiduciary principles which can be gleaned from statutes, case law, and other sources, as they relate to the provision of investment advice.

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[5] SEC Staff "Study on Investment Advisers and Broker Dealers," at pp. 110-112 (Jan. 21, 2011), available at http://sec.gov/news/studies/2011/913studyfinal.pdf.

[6] *Id.* at p.112.

TWO TYPES OF RELATIONSHIPS EXIST UNDER THE LAW

Understanding fiduciary duties begins with an understanding of the two general types of relationships between product and service providers and their customers or clients under the law – "arms-length relationships" and "fiduciary relationships."[7] "Arms-length" relationships apply to the vast majority of service provider–customer engagements.[8] In arms-length relationships, the doctrine of "caveat emptor"[9] generally applies,[10] although there are many exceptions made to this doctrine which effectively compel affirmative disclosure of adverse material facts in diverse contexts.[11] In other words, non-fiduciaries who contract with each other can engage in "conduct permissible in a workaday world for those acting at arm's length."[12]

In arms-length, commercial relationships, the level of trust or confidence reposed by the customer in the other party is not exceptional. "Mere subjective trust does not transform arms-length dealing into a fiduciary relationship."[13] "Absent express agreement of the parties[14] or extraordinary circumstances,

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[7] "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." Georgakopoulos, Nicholas L., "Meinhard v. Salmon and the Economics of Honor" (April 1998, revised Feb. 8, 1999). Available at SSRN: http://ssrn.com/abstract=81788 or DOI: 10.2139/ssrn.81788.

[8] *See*, *for example, Hartman v. McInnis, No. 2006-CA-00641-SCT (Miss. 11/29/2007)* ([O]rdinarily a bank does not owe a fiduciary duty to its debtors and obligors under the UCC … the power to foreclose on a security interest does not, without more, create a fiduciary relationship … a mortgagee-mortgagor relationship is not a fiduciary one as a matter of law."). "[T]he significant weight of authority holds that franchise agreements do not give rise to fiduciary ... relationships between the parties." *GNC Franchising, Inc. v. O'Brien*, 443 F.Supp.2d 737, 755 (W.D. Pa., 2006).

[9] *Caveat emptor* is Latin for 'Let the buyer beware.' In its purest form at common law, in the absence of fraud, misrepresentation or active concealment, the seller is under no duty to disclose any defect; it therefore provides a safe harbor to a seller to not to disclose any information to a buyer. *See* Alex M. Johnson, Jr., "An Economic Analysis Of The Duty To Disclose Information: Lessons Learned From The Caveat Emptor Doctrine" (2007), available at

http://law.bepress.com/cgi/viewcontent.cgi?article=9154&context=expresso. It means that a customer should be cautious and alert to the possibility of being cheated. The doctrine supports the idea that buyers take responsibility for the condition of the items they purchase and should examine them before purchase. This is especially true for items that are not covered under any warranty. *See, e.g. SEC v. Zandford*, 535 U.S. 813 (2002).

[10] "When parties deal at arm's length the doctrine of caveat emptor applies, but the moment that the vendor makes a false statement of fact, and the falsity is not palpable to the purchaser, he has an undoubted right to implicitly rely upon it. That would indeed be a strange rule of law which, when the seller has successfully entrapped his victim by false statements, and was called to account in a court of justice for his deceit, would permit him to escape by urging the folly of his dupe was not suspecting that he (the seller) was a knave." *Holcomb v. Zinke*, 365 N.W.2d 507, 511 (N.D., 1985).

[11] It is well settled that fraud may occur without the making of a false statement. *Dvorak v. Dvorak*, 329 N.W.2d 868 (N.D.1983). The suppression of a material fact, which a party is bound in good faith to disclose, is equivalent to a false representation. *Verry v. Murphy*, 163 N.W.2d 721 (N.D.1969).

[12] *Meinhard v Salmon*, 249 NY 458, 464 (N.Y. 1928).

[13] *Exxon Corp. v. Breezevale Ltd.*, 82 S.W.3d 429 (Tex. App., 2002).

[14] *Pension Committee v. Banc of America Securities*, 592 F.Supp.2d 608, 624 (S.D.N.Y., 2009) ("a fiduciary relationship may arise where the parties to a contract specifically agree to such a relationship ….").

however, parties dealing at arms-length in a commercial transaction lack the requisite level of trust or confidence between them necessary to give rise to a fiduciary obligation."[15] Ordinary "buyer-seller relationships" do not give rise to the imposition of fiduciary duties upon the seller.[16]

Yet, commercial good faith is always required in contract performance. Actors in arms-length relationships are always subject to the requirement of "mere good faith and fair dealing"[17] in the performance of their obligations; this doctrine is fundamental to all commercial transactions.[18] Good faith requires that each party perform their respective obligations and enforce their rights honestly and fairly.[19]

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[15] *Pension Committee v. Banc of America Securities*, 592 F.Supp.2d 608, 624 (S.D.N.Y., 2009) ("no fiduciary duties arise where parties deal at arm's length in conventional business transaction"); *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423, 460 (S.D.N.Y., 2006), *citing Nat'l Westminster Bank, U.S.A. v. Ross*, 130 B.R. 656, 679 (S.D.N.Y.1991) ("Where parties deal at arms length in a commercial transaction, no relation of confidence or trust sufficient to find the existence of a fiduciary relationship will arise absent extraordinary circumstances." (*citing, inter alia, Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 738-39 (2d Cir.1984); *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, N.A.*, 731 F.2d 112, 122 (2d Cir. 1984))), *aff'd, Yaeger v. Nat'l Westminster*, 962 F.2d 1 (2d Cir.1992) (table); *Beneficial Commercial Corp. v. Murray Glick Datsun, Inc.*, 601 F.Supp. 770, 772 (S.D.N.Y. 1985) ("[C]ourts have rejected the proposition that a fiduciary relationship can arise between parties to a business transaction." (*citing Grumman Allied Indus., Inc.*, 748 F.2d at 738-39; *Wilson-Rich v. Don Aux Assocs., Inc.,* 524 F.Supp. 1226, 1234 (S.D.N.Y.1981); *duPont v. Perot,* 59 F.R.D. 404, 409 (S.D.N.Y.1973))); *WIT Holding Corp. v. Klein*, 282 A.D.2d 527, 724 N.Y.S.2d 66, 68 (App.Div.2001) ("Under these circumstances, where the parties were involved in an arms-length business transaction involving the transfer of stocks, and where all were sophisticated business people, the plaintiff's cause of action to recover damages for breach of fiduciary duty should have been dismissed.").

[16] *In re Prudential Ins. Co. of America Sales Prac.*, 975 F.Supp. 584 (D.N.J., 1996), where, in a case involving sales by life insurance agents of variable appreciable life insurance products as "investment plans," the court stated: "An essential feature and consequence of a fiduciary relationship is that the fiduciary becomes bound to act in the interests of her beneficiary and not of herself. Obviously, this dynamic does not inhere in the ordinary buyer-seller relationship. Thus, 'the efforts of commercial sellers — even those with superior bargaining power — to profit from the trust of consumers is not enough to create a fiduciary duty. If it were, the law of fiduciary duty would largely displace both the tort of fraud and much of the Commercial Code.' *Committee on Children's Television, Inc., v. General Foods Corp.*, 35 Cal.3d 197, 221, 197 Cal.Rptr. 783, 789, 673 P.2d 660, 675 (1983) (en banc)." *In re Prudential Ins. Co. of America Sales Prac.* At 616.

[17] *See GNC Franchising, Inc. v. O'Brien*, 443 F.Supp.2d 737, 755 (W.D. Pa., 2006) ("A party bound by a fiduciary duty must advance the interests of the *cestui que* trust above its own and act scrupulously in the other's interests. Imposition of this degree of duty—*i.e.,* selfless service as opposed to merely good faith and fair dealing—would generally be inapplicable as between parties to a commercial relationship knowingly entered into for each party's own profit").

In arms-length relationships, the burden of proof of lack of fair dealing rests on the person alleging that the other party acted in such manner. This contrasts with the burden of proof where a fiduciary relationship exists, where the burden of proof of fair dealing rests with the fiduciary. *See ABN Amro Mortgage Group, Inc. v. Pristine Mortgage, LLC,* No. CV 04-4005389 (CT 9/8/2005) (CT, 2005) ("The significance of the establishment of a fiduciary relationship is twofold. First, the burden of proving fair dealing shifts to the fiduciary. Secondly, the standard of proof for establishing fair dealing is not the ordinary standard of fair preponderance of evidence but requires proof of clear and convincing evidence.")

[18] The doctrine of good faith requires that the parties also perform their respective obligations and enforce their rights honestly and fairly. *See* Restatement (Second) Contracts (1981) at §205, "Duty of Good Faith and Fair Dealing," stating: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." The *Comment* to this section adds: "Good faith is defined in Uniform Commercial Code § 1-201(19) as 'honesty in fact in the conduct or transaction concerned.' 'In the case of a merchant' Uniform Commercial Code §2-103(1)(b) provides that good faith means 'honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.' The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified

While there is no general duty to disclose material facts in arms-length transactions, actual or "common law" fraud is prohibited in the formation of commercial relationships. There is generally no duty to undertake full disclosure of material facts in the negotiation of commercial contracts,[20] except where one party's superior knowledge renders non-disclosure of an essential fact inherently unfair[21] or a "special relationship" exists.[22] Instead, actors in commercial relationships generally possess a duty to undertake diligent inquiry in order to ascertain facts.[23] However, if disclosures are undertaken by a party, the statements made must be truthful and complete[24] or actual fraud[25], also called "common law fraud," exists.

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expectations of the other party; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness. Failure to abide by the duty of good faith may constitute fraud (in the event of intentional misrepresentation) or breach of contract."

[19] For example, the Uniform Commercial Code, adopted by every state except Louisiana, explicitly imposes a good faith obligation on the performance and enforcement of every contract falling within its scope. UCC § 1-304, as amended (2003). Essentially, the Restatement of Contracts adopts the view that "bad faith in performance" is a violation of the good faith obligation. As stated by Professor Emily S.H. Hough: "The subcategories of bad faith in performance further delineated by Summers include 'evasion of the spirit of the deal,' 'lack of diligence and slacking off,' 'willfully rendering only 'substantial performance,'' 'abuse of power to determine compliance,' and 'interfering with or failing to cooperate in the other party's performance.'" All of these subcategories contemplate cases in which judges would feel comfortable using their discretionary and equitable powers to find a breach of good faith where the express language of the contract might not otherwise support a claim for breach of contract." Houh, Emily, "The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessell?" Utah Law Review, 2005. Available at SSRN: http://ssrn.com/abstract=622982.

[20] *See Southern Intermodal Logistics, Inc. v. Smith & Kelly Co.*, 190 Ga.App. 584, 379 S.E.2d 612, 613-4 (1989) ("While concealment of material facts may amount to fraud when the concealment is of intrinsic qualities the other party could not discover by the exercise of ordinary care ... in an arms-length business or contractual relationship there is no obligation to disclose information which is equally available to both parties").

[21] *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423 (S.D.N.Y., 2006), stating: "Even absent the existence of a fiduciary relationship, however, a party's duty to disclose a material fact to another party it is negotiating with is triggered where 'one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge.' *Grumman Allied Indus., Inc.*, 748 F.2d at 739 (*quoting Aaron Ferer & Sons Ltd.*, 731 F.2d at 123; Jana *L. v. W. 129th St. Realty Corp.*, 22 A.D.3d 274, 802 N.Y.S.2d 132, 134 (App.Div.2005) ('It is well established that, absent a fiduciary relationship between the parties, a duty to disclose arises only under the `special facts' doctrine `where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair.'' (*quoting Swersky v. Dreyer & Traub*, 219 A.D.2d 321, 643 N.Y.S.2d 33, 37 (App.Div. 1996)." *Henneberry* at 461.

[22] *See Giles v. General Motors Acceptance Corp.*, 494 F.3d 865, 881 (9th Cir., 2007) ("Nevada also recognizes "special relationships" giving rise to a duty to disclose, such that '[n]ondisclosure . . . become[s] the equivalent of fraudulent concealment.' *Mackintosh v. Jack Matthews & Co.*, 109 Nev. 628, 855 P.2d 549, 553 (1993). In order to prove the existence of a special relationship, a party must show that (1) 'the conditions would cause a reasonable person to impart special confidence' and (2) the trusted party reasonably should have known of that confidence. *Mackintosh v. Cal. Fed. Sav. & Loan Ass'n*, 113 Nev. 393, 935 P.2d 1154, 1160 (1997) (per curiam). '[T]he existence of the special relationship is a factual question . . . .' *Id.*)

[23] *See Burger King Corp. v. Austin*, 805 F.Supp. 1007, 1019 (S.D. Fla., 1992) ("Florida law additionally charges a claimant with knowledge of all facts that he could have learned through diligent inquiry ... In absence of a fiduciary relationship, mere nondisclosure of material facts in an arm's length transaction is ordinarily not actionable misrepresentation unless some artifice or trick has been employed to prevent the representee from making further independent inquiry, though non-disclosure of material facts may be fraudulent where the other party does not have an equal opportunity to become appraised of the facts."), *citing Taylor v. American Honda Motor Co.*, 555 F.Supp. 59, 64 (M.D.Fla.1982).

[24] *See Playboy Enterprises v. Editorial Caballero,* 202 S.W.3d 250, 260 (Tex. App., 2006), stating: "In addition to situations where there is a fiduciary or confidential relationship … a duty to speak may arise in an arms-length transaction in at least three other situations: (1) when one voluntarily discloses information, he has a duty to disclose the whole truth; (2) when

Hence, while commercial good faith does not automatically extend to the area of contract negotiations, misrepresentations made during the formation of a contract may constitute either actual fraud or breach of contract.[26] To put it much more simply, don't lie, cheat, deceive or steal – even in commercial arms-length relationships.

No fiduciary obligations exist in most arms-length relationships. "An arms-length relationship can support no implied-in-law fiduciary obligations."[27] Instead, the standard of conduct expected of the actors in arms-length relationships has been described by the courts as the "morals of the marketplace."[28]

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one makes a representation, he has a duty to disclose new information when the new information makes the earlier representation misleading or untrue; and (3) when one makes a partial disclosure and conveys a false impression, he has the duty to speak."

[25] "Actual fraud is where one person causes pecuniary injury to another by intentionally misrepresenting or concealing a material fact which from their mutual position he was bound to explain or disclose." Charles Sweet, *A Dictionary of English Law* (1883).

[26] Waller, Spencer Weber and Brady, Jillian G., "Consumer Protection in the United States: An Overview; Strengthening the Consumer Protection Regime" (2007), available at SSRN:

http://ssrn.com/abstract=1000226. Private actions alleging actual fraud form an important, though often expensive and difficult, avenue for protection of the rights of a contracting party. "A consumer may file a lawsuit for deceit or fraud when a vendor intentionally conceals a material fact or makes a false representation of a material fact, knows that the representation is false, and meant to induce the consumer to act based on the misrepresentation. In order for the consumer to be successful in court, a plaintiff must also reasonably rely on the misrepresentation and suffer damage as a result of the reliance. Deceit can occur when a vendor makes a direct false statement, or when a misrepresentation is achieved through silence, concealment, half-truths, or ambiguity about a good. While misrepresentation of product facts may bring legal action, mere puffery and sales representative opinions are generally not subject to lawsuits for deceit." *Id.* at p. 13.

[27] *Marine, Inc. v. Brunswick Corporation*, No. 07-13907 Non-Argument Calendar (11th Cir. 5/14/2008) (11th Cir., 2008) , at p.5; *see Taylor Woodrow Homes Florida, Inc. v. 4/46-A Corp.*, 850 So.2d 536, 541 Fla. 5th DCA 2003 ("When the parties are dealing at arm's length, a fiduciary relationship does not exist because there is no duty imposed on either party to protect or benefit the other."). *See also Greenberg v. Chrust*, 198 F.Supp.2d 578, 585 (S.D.N.Y., 2002) ("parties to arms length commercial contracts do not owe each other a fiduciary obligation").

[28] *In re Auto Specialties Mfg. Co.,* 153 B.R. 457, 488 (Bankr. W.D. Mich., 1993) (Courts have described the standard of conduct to which a non-fiduciary will be held in the vernacular as the 'morals of the marketplace'").

ARMS-LENGTH VS. FIDUCIARY RELATIONSHIPS: CHART

ARMS-LENGTH SALES RELATIONSHIPS

PRODUCT MANUFACTURERS, SECURITIES ISSUERS, SECURITIES DEALERS

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

REPRESENTATIVE OF

MANUFACTURERS / ISSUERS

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

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

CUSTOMER

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

FIDUCIARY ADVISORY RELATIONSHIPS

CLIENT

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

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

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

PRODUCT MANUFACTURERS / ISSUERS / SECURITIES DEALERS

Investment product / securities providers.

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

MODIFICATION OF THE CAVEAT EMPTOR DOCTRINE, SHORT OF THE IMPOSITION OF BROAD FIDUCIARY DUTIES, THROUGH LEGISLATION FOR CONSUMER PROTECTION

While some often think of our society as "free" and capitalism as best undertaken when it is "unfettered," not all arms-length relationships are free from government intervention. Though not arising to the level of fiduciary protections, specific statutes or regulations may nevertheless protect consumers.[29] In essence, the "caveat emptor" doctrine has been legislatively modified by the imposition of specific rules or doctrines which seek to provide government (public) redress for certain bad acts, provide enhanced disclosures, or provide additional rights which can be privately enforced, in recognition that unfettered capitalism[30] can have ill effects.

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[29] There always exists a tension between calls for "freedom and independence" in commercial relations and "consumer protection." "In a contract society, individuals can provide for their basic needs, and can gain by exchanging the surplus they produce. In addition, such a society offers many options for its members to satisfy their needs. A contract society values freedom and independence highly, but it provides little security for its members." Tamar Frankel, "Fiduciary Law," 71 Calif. L. Rev. 795 (1983). "Freedom" and "competition" in contract societies provide substantial opportunities for innovation and profit. However, as seen during the recent financial crisis, unfettered capitalism[29] can also lead to abuses – and dangers – not only to those individuals who seek out service providers, but to entire financial and economic systems. Hence, at times legislatures or the courts have seen fit to provide certain protections to one of the contracting parties, typically the consumer of a product or service, through either the imposition of certain disclosure regimes, mandating certain contract formats or terms, or other consumer protection measures. When circumstances dictate the need for greater security for consumer members of society, in order to combat forces which transform opportunism into greed and/or to achieve other public aims, the law applies fiduciary status upon the service provider.

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

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

(Smith, p. 14, Modern Library edition, 1937). As Adam Smith pointed out, capitalism has its positive effects. Actions based upon self-interest often lead to positive forces which benefit others or society at large. As capital is formed into an enterprise, jobs are created. Innovation is spurred forward, often leading to greater efficiencies in our society and enhancement of standards of living. However, as Adam Smith also noted, a person in the pursuit of his own interest "frequently promotes that of the society more effectually than when he really intends to promote it." (Smith, p. 423)

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

Gordon Gekko in the film Wall Street, who famously declared that "Greed, for lack of a better word, is good," got it wrong. Greed is not good in society. However, opportunism itself – acting in pursuit of one's self-interest - does not always lead to greed. Rather, it is only when the pursuit of wealth causes significant undue harm to others does such activity arise to the level of greed, and in such circumstance greed is not "good."

FEDERAL SECURITIES LAWS AND THE LIMITS OF DISCLOSURE

In the context of securities regulation, various federal statutes provide for enhanced protection of consumers, beyond that found in pure arms-length relationships, through government oversight of certain activities, and by other means. For example, the 1933 Securities Act and the Securities and Exchange Act of 1934 both adopt a "full disclosure" regime as a protection for individual investors.[31] 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."[32]

The SEC's emphasis on disclosure, drawn from the focus of the 1933 and 1934 Securities Acts on enhanced disclosures, results from the myth that investors carefully peruse[33] the details of disclosure documents that regulation delivers. However, under the scrutinizing lens of stark reality, this picture gives way to an image of a vast majority of investors who are unable, due to behavioral biases[34] and lack of knowledge of our complicated financial markets, to comprehend the disclosures provided, yet alone undertake sound investment decision-making. As stated by Professor (now SEC Commissioner) Troy A. Parades:

> The federal securities laws generally assume that investors and other capital market participants are perfectly rational, from which it follows that more disclosure is always better than less. However, investors are not perfectly rational. Herbert Simon was among the first to point out that people are boundedly rational, and numerous studies have since supported Simon's claim. Simon recognized that people have limited cognitive abilities to process information. As a result, people tend to economize on cognitive effort when

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[31] Section 10(b) of the Securities Exchange Act makes it "unlawful for any person ... [t]o use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U. S. C. §78j. Rule 10b-5, which implements this provision, forbids the use, "in connection with the purchase or sale of any security," of "any device, scheme, or artifice to defraud" or any other "act, practice, or course of business" that "operates ... as a fraud or deceit." 17 CFR §240.10b-5 (2000). Among Congress' objectives in passing the Act was "to insure honest securities markets and thereby promote investor confidence" after the market crash of 1929. *United States v. O'Hagan*, 521 U. S. 642, 658 (1997); *see also United States v. Naftalin*, 441 U. S. 768, 775 (1979). More generally, Congress sought "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." *Affiliated Ute Citizens of Utah v. United States*, 406 U. S. 128, 151 (1972) (*quoting SEC v. Capital Gains Research Bureau, Inc*., 375 U. S. 180, 186 (1963)).

[32] Thomas Lee Hazen, *The Law Of Securities Regulation*, Vol. 1, § 8.1[1][B], at 740 (4th ed. 2002).

[33] For years it has been known that that investors do not read disclosure documents. *See, generally,* Homer Kripke, *The SEC and Corporate Disclosure: Regulation In Search Of A Purpose* (1979); Homer Kripke, The Myth of the Informed Layman, 28 Bus.Law. 631 (1973). See also Baruch Lev & Meiring de Villiers, Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis, 47 Stan. L. Rev. 7, 19 (1994) ("[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures ….."); Kenneth B. Firtel, *Note*, "Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933, 72 S. Cal. L. Rev. 851, 870 (1999) ("[T]he average investor does not read the prospectus ….").

[34] For an overview of various individual investor bias such as bounded irrationality, rational ignorance, overoptimism, overconfidence, the false consensus effect, insensivity to the source of information, the fact that oral communications trump written communications, and other heuristics and bias, *see* Robert Prentice, "Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future," 51 Duke L. J. 1397 (2002).

> making decisions by adopting heuristics that simplify complicated tasks. In Simon's terms, when faced with complicated tasks, people tend to "satisfice" rather than "optimize," and might fail to search and process certain information.[35]

Other investor biases overwhelm the effectiveness of disclosures. As stated by Professor Fisch:

> The primary difficulty with disclosure as a regulatory response is that there is limited evidence that disclosure is effective in overcoming investor biases. … It is unclear … that intermediaries offer meaningful investor protection. Rather, there is continued evidence that broker-dealers, mutual fund operators, and the like are ineffective gatekeepers. Understanding the agency costs and other issues associated with investing through an intermediary may be more complex than investing directly in equities …."[36]

The inadequacy of disclosures was known even in 1930's. Even back during the consideration of the initial federal securities laws, the perception existed that disclosures would prove to be inadequate as a means of investor protection. As stated by Professor Schwartz:

> 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.[37]

Behavioral biases also negate the abilities of "do-it-yourself" investors. As shown in DALBAR, Inc.'s 2009 "Quantitative Analysis of Investor Behavior", most individual investors underperform benchmark indices by a wide margin, far exceeding the average total fees and costs of pooled investment vehicles.[38] A growing body of academic research into the behavioral biases of investors reveals substantial obstacles individual investors must overcome in order to make informed decisions,[39] and reveal the inability of individual investors to contract for their own protections.[40]

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[35] Parades at p.3.

[36] Jill E. Fisch, "Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst," 10 Lewis & Clark L. Rev. 57, 74-83 (2006).

[37] 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).

[38] *Supra* n. 17.

[39] As stated by Professor Ripken: "[E]ven if we could purge disclosure documents of legaleze and make them easier to read, we are still faced with the problem of cognitive and behavioral biases and constraints that prevent the accurate processing of information and risk. As discussed previously, information overload, excessive confidence in one's own judgment, overoptimism, and confirmation biases can undermine the effectiveness of disclosure in communicating relevant information to investors. Disclosure may not protect investors if these cognitive biases inhibit them from rationally incorporating the disclosed information into their investment decisions. No matter how much we do to make disclosure more meaningful and accessible to investors, it will still be difficult for people to overcome their bounded rationality. The disclosure of more information alone cannot cure investors of the psychological constraints that may lead them to ignore or misuse the information. If investors are overloaded, more information may simply make matters worse by causing investors

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."[41] 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."[42] Indeed, many brokers and other financial advisors have received training, time and again, stressing the need to first and foremost establish a relation of trust and confidence with the client; after trust is established, it is taught that the client usually defers to the judgment of the advisor as to recommendations made, usually without further inquiry by the client, thereby permitting the financial advisor to take advantage of the client.

Professor Langevoort undertook these further observations regarding "trust-based selling":

> [W]hen faced with complex, difficult and affect-laden choices (and hence a strong anticipation of regret should those choices be wrong), many investors seek to shift responsibility for the investments to others. This is an opportunity – the core of the full-service brokerage business – to use trust-based selling techniques, offering advice that customers sometimes too readily accept. Once trust is induced, the ability to sell vastly more complicated, multi-attribute investment products goes up. Complex products that have become widespread in the retail sector, like equity index annuities, can only be sold by intensive, time-consuming sales effort. As a result the sales fees (and embedded incentives) are very large, creating the temptation to oversell. In the mutual fund area, the broker channel – once again, driven by generous incentives - sells funds aggressively. Recent empirical research suggests that buyers purchase funds in this channel at much

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to be distracted and miss the most important aspects of the disclosure … The bottom line is that there is 'doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases' … While disclosure has its place in a well-functioning securities market, the direct, substantive regulation of conduct may be a more effective method of deterring fraudulent and unethical practices." Ripken, Susanna Kim, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation. Baylor Law Review, Vol. 58, No. 1, 2006; Chapman University Law Research Paper No. 2007-08. Available at SSRN: http://ssrn.com/abstract=936528.

[40] *See* Robert Prentice, Whither Securities Regulation Some Behavioral Observations Regarding Proposals for its Future, 51 Duke Law J. 1397 (March 2002). Professor Prentices summarizes: "Respected commentators have floated several proposals for startling reforms of America's seventy-year-old securities regulation scheme. Many involve substantial deregulation with a view toward allowing issuers and investors to contract privately for desired levels of disclosure and fraud protection. The behavioral literature explored in this Article cautions that in a deregulated securities world it is exceedingly optimistic to expect issuers voluntarily to disclose optimal levels of information, securities intermediaries such as stock exchanges and stockbrokers to appropriately consider the interests of investors, or investors to be able to bargain efficiently for fraud protection." Available at http://www.law.duke.edu/shell/cite.pl?51+Duke+L.+J.+1397.

[41] Stephen J. Choi and A.C. Pritchard, "Behavioral Economics and the SEC" (2003), at p.18.

[42] 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).

higher cost but performance on average is no better, and often worse, than readily available no-load funds.[43]

FINRA'S REGULATIONS: GOOD FAITH PLUS SUITABILITY

Through rules adopted by a self-regulatory organization (FINRA, previously NASD), broker-dealer firms and their registered representatives are prohibited from an act which would "effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."[44] Additionally, broker-dealers and their registered representatives must ensure that a securities product be "suitable" for an individual investor as it relates to a recommendation or a particular transaction.[45] Once applied, the suitability obligation generally ceases within the same timeline of the transaction itself.

The SEC staff recently contrasted the fiduciary duties of investment advisers with the more limited duties of broker-dealers, stating:

> A core difference, observed by many commentators and commenters, is that investment advisers are fiduciaries under the federal securities laws, while broker-dealers generally are not. The Commission has stated that the fiduciary duty of investment advisers includes a duty of loyalty and a duty of care (encompassing, among other things, a duty of suitability), with the duty of loyalty requiring investment advisers to act in the best interests of clients and to avoid or disclose conflicts. The standard of conduct for broker-dealers has been characterized as primarily to deal fairly with customers and to observe high standards of commercial honor and just and equitable principles of trade, and they also are subject to a number of specific obligations, including a duty of suitability, as well as requirements to disclose certain conflicts. In practice, with broker-dealers, required

[43] Donald C. Langevoort, "The SEC, Retail Investors, and the Institutionalization of the Securities Markets" (Jan. 2009), prior version available at vailable at SSRN: http://ssrn.com/abstract=1262322.

[44] FINRA Rule 2020, which further states: "(a)(1) Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public. (2) This does not mean that legitimate sales efforts in the securities business are to be discouraged by requirements which do not take into account the variety of circumstances which can enter into the member-customer relationship. It does mean, however, that sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers."

[45] FINRA Rule 2310, Recommendations to Customers (Suitability), states: "(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."

> disclosures of conflicts have been more limited than with advisers and apply at different points in the customer relationship.[46]

"[S]uitability is also applied to investment advisers – it is part of (but does not supersede) the adviser's fiduciary obligations.[47] In Release No. 1406, the SEC proposed a rule under the Act's anti-fraud provisions requiring advisers give clients only suitable advice. Although the rule was never adopted, the SEC staff takes the position that the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the Act."[48]

Suitability essentially looks at the risks of a security vis-à-vis the client. Suitability does not generally require registered representatives to recommend a lower cost product with similar risk and return characteristics, if one is available. Nor does the suitability doctrine require monitoring of an investment portfolio, nor management of the investment portfolio for a client in a tax-efficient manner.

UNDERSTANDING FIDUCIARY RELATIONSHIPS GENERALLY

In contrast to arms-length relationships, the law imposes upon one party to some relationships the status of a fiduciary. This form of relationship is called the "fiduciary relationship" or "fiducial relationship." One upon whom fiduciary duties are imposed is known as the "fiduciary" and is said to possess "fiduciary status." The fiduciary standard of conduct is consistently described by the courts as the "highest standard of duty imposed by law."[49]

The term "fiduciary" comes to us from Roman law, and means "a person holding the character of a trustee, or a character analogous of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires."[50] Indeed, the Latin root of the word fiduciary – *fiduciarius* – means one in whom trust – *fiducia* - reposes. Legal usage in many jurisdictions also developed an overlay - an implication of a particular relationship of confidence between the fiduciary and those who had placed their trust in that person.

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[46] SEC Staff "Study on Investment Advisers and Broker Dealers," at p.106 (Jan. 21, 2011), available at http://sec.gov/news/studies/2011/913studyfinal.pdf.

[47] *See* Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994).

[48] Plaze, Robert E. Plaze, Outline, The Regulation of Investment Advisers by The Securities and Exchange Commission, at p.39, fn. 82, available at http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042006.pdf.]

[49] *See, generally* BLACK'S LAW DICTIONARY 523 (7th ed. 1999) ("A duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another."); *also see F.D.I.C. v. Stahl*, 854 F.Supp. 1565, 1571 (S.D. Fla., 1994) ("Fiduciary duty, the highest standard of duty implied by law, is the duty to act for someone else's benefit, while subordinating one's personal interest to that of the other person); *and see Perez v. Pappas*, 98 Wash.2d 835, 659 P.2d 475, 479 (1983) ("Under Washington law, it is well established that 'the attorney-client relationship is a fiduciary one as a matter of law and thus the attorney owes the highest duty to the client.'"), *cited by Bertelsen v. Harris*, 537 F.3d 1047 (9th Cir., 2008); *also see Donovan v. Bierwirth*, 680 F. 2d 262, 272, n.8 (2nd Cir., 1982) (fiduciary duties are the "highest known to law").

[50] BLACK'S LAW DICTIONARY, 5th Edition (1979)].

At the beginning of the nineteenth century, in *Gibson*, 31 Eng. Rep. 1044 (1801), the court, while explaining the decision to rescind the sale of an annuity by an attorney to his client, announced that "[one] who bargains in matter of advantage with a person placing confidence in him is bound to sh[o]w, that a reasonable use has been made of that confidence; a rule applying to trustees, attorneys or anyone else." The courts eventually settled on "fiduciary" to denominate relationships of trust and confidence and denominated the doctrine (applied in *Gibson*) regulating these confidential relationships as "constructive fraud." By the mid-nineteenth century, the doctrine of constructive fraud was said to arise from some peculiar confidential or fiduciary relation between the parties.

More recently, Justice Philip Talmadge of the State of Washington Supreme Court summarized the core aspects of current fiduciary relationships:

> A fiduciary relationship is a relationship of trust, which necessarily involves vulnerability for the party reposing trust in another. One's guard is down. One is trusting another to take actions on one's behalf. Under such circumstances, to violate a trust is to violate grossly the expectations of the person reposing the trust. Because of this, the law creates a special status for fiduciaries, imposing duties of loyalty, care, and full disclosure upon them. One can call this the fiduciary principle.[51]

PUBLIC POLICY CONSIDERATIONS UNDERLIE THE IMPOSITION OF FIDUCIARY STATUS

The key to understanding fiduciary principles, and why and how they are applied, rests in discerning the various public policy objectives the fiduciary standard of conduct is designed to meet.

Fiduciary Status Address "Overreaching" When Person-to-Person Advice is Provided

The Investment Advisers Act of 1940 "recognizes that, with respect to a certain class of investment advisers, a type of personalized relationship may exist with their clients … The essential purpose of [the Advisers Act] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful."[52] "The Act was designed to apply to those persons engaged in the investment-advisory profession -- those who provide personalized advice attuned to a client's concerns, whether by written or verbal communication[53] … The dangers of fraud, deception, or overreaching that motivated the enactment of the statute are present in personalized communications …."[54]

Consumers' Lack of Desire to Expend Time and Resources on Monitoring

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[51] *Von Noy v. State Farm Mutual Automobile Insurance Company*, 2001 WA 80 (WA, 2001) (J. Talmadge, concurring opinion).

[52] *Lowe v. SEC*, 472 U.S. 181, 200, 201 (1985).

[53] *Id.* at 208.

[54] *Id.* at 210.

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

The Shifting of Monitoring Costs to Government

In service provider relationships which arise to the level of fiduciary relations, it is highly costly for the client to monitor, verify and ensure that the fiduciary will abide by the fiduciary's promise and deal with the entrusted power only for the benefit of the client. Indeed, if a client could easily protect himself or herself from an abuse of the fiduciary advisor's power, authority, or delegation of trust, then there would be no need for imposition of fiduciary duties. Hence, fiduciary status is imposed as a means of aiding consumers in navigating the complex financial world, by enabling trust to be placed in the advisor by the client.

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

Consumers' Difficulty in Tying Performance to Results

The results of the services provided by a fiduciary advisor are not always related to the honesty of the fiduciary or the quality of the services. For example, an investment adviser may be both honest and diligent, but the value of the client's portfolio may fall as the result of market events. Indeed, rare is the instance in which an investment adviser provides substantial positive returns for each incremental period over long periods of time – and in such instances the honesty of the investment adviser should be suspect (as was the situation with Madoff).

Consumers' Difficulty in Identifying and Understanding Conflicts of Interest

Most individual consumers of financial services in America today are unable to identify and understand the many conflicts of interest which can exist in financial services. For example, a customer of a broker-dealer firm might be aware of the existence of a commission for the sale of a mutual fund, but possess no understanding that there are many mutual funds available which are available without commissions (i.e., sales loads). Moreover, brokerage firms have evolved into successful disguisers of conflicts of interest arising from third-party payments, including payments through such mechanisms as contingent deferred sales charges, 12b-1 fees, payment for order flow, payment for shelf space, and soft dollar compensation.

Survey after survey (including the Rand Report) has concluded that consumers place a very high degree of trust and confidence in their investment adviser, stockbroker, or financial planner. These consumers deal with their advisors on unequal terms, and often are unable to identify the conflicts of interest their "financial consultants" possess. As evidence of the lack of knowledge possessed by consumers, the Rand Report noted that 30% of investors believed that they did not pay their financial consultant any fees! This calls into substantial question the conclusion derived from the Rand Report's survey that most customers of brokers are happy with their financial consultant.

Transparency is important, but even when compensation is fully disclosed, few individual investors realize the impact high fees and costs can possess on their long-term investment returns; often individual investors believe that a more expensive product will possess higher returns.[55]

For Fiduciaries, the Cost of Proving Trustworthiness is Quite High

How does one prove one to be "honest" and "loyal"? The cost to a fiduciary in proving that the advisor is trustworthy could be extremely high – so high as to exceed the compensation gained from the relationships with the advisors' clients.

In his influential article discussing the creation of the federal securities acts, and in particular their moral purpose, John Walsh (of the SEC's OCIE) reviewed the legislative history underlying the creation of the Investment Advisers Act:

> As part of a congressionally mandated review of investment trusts the agency also studied investment advisers. The Advisers Act was based on that study. By the time it passed, it was a consensus measure having the support of virtually all advisers.

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[55] In a recent study, Professors "Madrian, Choi and Laibson recruited two groups of students in the summer of 2005 -- MBA students about to begin their first semester at Wharton, and undergraduates (freshmen through seniors) at Harvard. All participants were asked to make hypothetical investments of $10,000, choosing from among four S&P 500 index funds. They could put all their money into one fund or divide it among two or more. 'We chose the index funds because they are all tracking the same index, and there is no variation in the objective of the funds,' Madrian says … 'Participants received the prospectuses that fund companies provide real investors … the students 'overwhelmingly fail to minimize index fund fees,' the researchers write. 'When we make fund fees salient and transparent, subjects' portfolios shift towards lower-fee index funds, but over 80% still do not invest everything in the lowest-fee fund' … [Said Professor Madrian,] 'What our study suggests is that people do not know how to use information well.... My guess is it has to do with the general level of financial literacy, but also because the prospectus is so long." Knowledge@Wharton, "Today's Research Question: Why Do Investors Choose High-fee Mutual Funds Despite the Lower Returns?" citing Choi, James J., Laibson, David I. and Madrian, Brigitte C., "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds" (March 6, 2008). Yale ICF Working Paper No. 08-14. Available at SSRN: http://ssrn.com/abstract=1125023.

> Investment advisers' professionalism, and particularly their professional ethics, dominated the SEC study and the legislative history of the Act. Industry 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." Recognizing this range, "a group of people in the forefront of the profession realized that if professional standards were to be maintained, there must be some kind of public formulation of a standard or a code of ethics." As a result, the Investment Counsel Association of America was organized and issued a Code of Ethics. Nonetheless, the problem remained that the Association could not police the conduct of those who were not members nor did it have any punitive power.
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> The SEC Study noted that it had been the unanimous opinion of all who had testified at its public examination, both members and nonmembers of the Association, that the industry's voluntary efforts could not cope with the "most elemental and fundamental problem of the investment counsel industry—the investment counsel 'fringe' which includes those incompetent and unethical individuals or organizations who represent themselves as bona fide investment counselors." Advisers of that type would not voluntarily submit to supervision or policing. Yet, all counselors suffered from the stigma placed on the activities of the individuals on the fringe. Thus, an agency was needed with compulsory and national power that could compel the fringe to conform to ethical standards.
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> As a result of the Commission's report to Congress, the Senate Committee on Banking and Currency determined that a solution to the problems of investment advisory services could not be affected without federal legislation. In addition, both the Senate and House Committees considering the legislation determined that it was needed not only to protect the public, but also to protect bona fide investment counselors from the stigma attached to the activities of unscrupulous tipsters and touts. During the debate in Congress, the special professional relationship between advisers and their clients was recognized. It is, said one representative, "somewhat [like that] of a physician to his patient." The same Congressman continued that members of the profession were "to be complimented for their desire to improve the status of their profession and to improve its quality."[56]

This is why it is important to fiduciary advisors to be able to distinguish themselves from non-fiduciaries. A recent example of the problems faced by investment advisers was the "fee-based brokerage accounts" final rule adopted by the SEC in 2005, which would have permitted brokers to provide the same functional investment advisory services as investment advisers but without application of fiduciary

56 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, 1066-8 (2001), *citing* SEC, REPORT ON INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES (1939).

standards of conduct. This would have negated to a large degree economic incentives[57] for persons to become investment advisers and be subject to the higher standard of conduct. The SEC's fee-based accounts rule was overturned in *Financial Planning Ass'n v. S.E.C.*, 482 F.3d 481 (D.C. Cir., 2007).

Monitoring and Reputational Threats are Largely Ineffective

The ability of "the market" to monitor and enforce a fiduciary's obligations, such as through the compulsion to preserve a firm's reputation, is often ineffective in fiduciary relationships. This is because revelations about abuses of trust by fiduciaries can be well hidden (such as through mandatory arbitration clauses and secrecy agreements regarding settlements), or because marketing efforts by fiduciary firms are so strong and pervasive that they overwhelm the reported instances of breaches of fiduciary duties.

Public Policy Encourages Specialization, Which Necessitates Fiduciary Duties

As Professor Tamar Frankel, long the leading scholar in the area of fiduciary law as applied to securities regulation, once noted: "[A] prosperous economy develops specialization. Specialization requires interdependence. And interdependence cannot exist without a measure of trusting. In an entirely non-trusting relationship interaction would be too expensive and too risky to maintain. Studies have shown a correlation between the level of trusting relationships on which members of a society operate and the level of that society's trade and economic prosperity."[58] 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.

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[57] One might reasonably ask why "honest investment advisers" (to use the language of the U.S. Supreme Court in *SEC vs. Capital Gains*) had to be protected by the Advisers Act. Was it not enough to just protect consumers? The answer can be found in economic principles, as set forth in the classic thesis for which George Akerlof won a Nobel Prize:

> There are many markets in which buyers use some market statistic to judge the quality of prospective purchases. In this case there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group whose statistic is affected rather than to the individual seller. As a result there tends to be a reduction in the average quality of goods and also in the size of the market.

George A. Akerloff, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, The Quarterly Journal of Economics, Vol. 84, No. 3. (Aug., 1970), p.488. George Akerloff demonstrated "how in situations of asymmetric information (where the seller has information about product quality unavailable to the buyer), 'dishonest dealings tend to drive honest dealings out of the market.' Beyond the unfairness of the dishonesty that can occur, this process results in less overall dealing and less efficient market transactions." Frank B. Cross and Robert A. Prentice, The Economic Value of Securities Regulation, 28 Cardoza L.Rev. 334, 366 (2006). As George Akerloff explained: "[T]he presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence." Akerloff at p. 495.

[58] Tamar Frankel, Trusting And Non-Trusting: Comparing Benefits, Cost And Risk, Working Paper 99-12, Boston University School of Law.

Public Policy Encourages Participation in our Capital Markets

Investment advisory services encourage participation by investors in our capital markets system, which in turn promotes economic growth. The first and overriding responsibility any financial professional has is to all of the participants of the market. This primary obligation is required in order to maintain the perception[59] and reality that the market is a fair game and thus encourage the widest possible participation in the capital allocation process. The premise of the U.S. capital market is that the widest possible participation in the market will result in the most efficient allocation of financial resources and, therefore, will lead to the best operation of the U.S. and world-wide economy. Indeed, academic research has revealed that individual investors who are unable to trust their financial advisors are less likely to participate in the capital markets.[60]

Public Policy Encourages Saving and Proper Investing

As stated in a 2002 white paper authored by Professor Macy:

> If people do not make careful, rational decisions about how to self-regulate the patterns of consumption and savings and investment over their life cycles, government will have to step in to save people from the consequences of their poor planning. Indeed the entire concept of government-sponsored, forced withholding for retirement (Social Security) is based on the assumption that people lack the foresight or the discipline, or the expertise to plan for themselves. The weaknesses in government-sponsored social security and retirement systems places increased importance on the ability of people to secure for themselves adequate financial planning.[61]

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[59] "Applying the Advisers Act and its fiduciary protections is essential to preserve the participation of individual investors in our capital markets. NAPFA members have personally observed individual investors who have withdrawn from investing in stocks and mutual funds due to bad experiences with registered representatives and insurance agents in which the customer inadvertently placed his or her trust into the arms-length relationship." Letter of National Association of Investment advisers (NAPFA) dated March 12, 2008 to David Blass, Assistant Director, Division of Investment Management, SEC re: Rand Study.

[60] "We find that trusting individuals are significantly more likely to buy stocks and risky assets and, conditional on investing in stock, they invest a larger share of their wealth in it. This effect is economically very important: trusting others increases the probability of buying stock by 50% of the average sample probability and raises the share invested in stock by 3.4 percentage points … lack of trust can explain why individuals do not participate in the stock market even in the absence of any other friction … [W]e also show that, in practice, differences in trust across individuals and countries help explain why some invest in stocks, while others do not. Our simulations also suggest that this problem can be sufficiently severe to explain the percentage of wealthy people who do not invest in the stock market in the United States and the wide variation in this percentage across countries." Guiso, Luigi, Sapienza, Paola and Zingales, Luigi. "Trusting the Stock Market" (May 2007); ECGI - Finance Working Paper No. 170/2007; CFS Working Paper No. 2005/27; CRSP Working Paper No. 602. Available at SSRN: http://ssrn.com/abstract=811545.

[61] Macy, Jonathan R., "Regulation of Financial Planners" (April 2002), a White Paper prepared for the Financial Planning Association; http://fpanet.org/docs/assets/ExecutiveSummaryregulationoffps.pdf provides an Executive Summary of the paper.

FIDUCIARIES POSSESS A MUCH HIGHER STANDARD OF CONDUCT UNDER THE LAW

"There is a crucial distinction between surrendering control of one's affairs to a fiduciary or confidant or party in a position to exercise undue influence and entering an arms length commercial agreement, however important its performance may be to the success of one's business."[62] The "fiduciary relationship" is distinct from arms-length relationships, as those whom the law classifies as fiduciaries must carry on their dealings with beneficiaries at a level high above ordinary commercial standards. Perhaps the most famous judicial expression of fiduciary duties is Justice Cardozo's famous lines expressing a lofty vision of the duties owed by fiduciaries. "Generations of corporate lawyers have been schooled in its memorable language finding broad fiduciary obligations on managers of other peoples' money."[63]

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. 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 [citation]. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court. [64]

This much higher standard of conduct flows from the requirement of the fiduciary "to adopt the principal's goals, objectives, or ends."[65] "It is what makes fiduciary law unique and separates fiduciaries from other service providers."[66] As Professor Laby further explains:

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[62] *Ettol, Inc. v. Elias/Savion Advertising, Inc.*, 811 A.2d 10, 23 (Pa. Super. Ct., 2002), stating: "Most commercial contracts for professional services involve one party relying on the other party's superior skill or expertise in providing that particular service. Indeed, if a party did not believe that the professional possessed specialized expertise worthy of trust, the contract would most likely never take place. This does not mean, however, that a fiduciary relationship arises merely because one party relies on and pays for the specialized skill or expertise of the other party. Otherwise, a fiduciary relationship would arise whenever one party had any marginally greater level of skill and expertise in a particular area than another party. Rather, the critical question is whether the relationship goes beyond mere reliance on superior skill, and into a relationship characterized by "overmastering influence" on one side or "weakness, dependence, or trust, justifiably reposed" on the other side. *Basile v. H & R Block,* 777 A.2d 95, 101 (Pa.Super.2001). A confidential relationship is marked by such a disparity in position that the inferior party places complete trust in the superior party's advice and seeks no other counsel, so as to give rise to a potential abuse of power." *Id.*

[63] Georgakopoulos, Nicholas L.,Meinhard v. Salmon and the Economics of Honor(April 1998). Available at SSRN: http://ssrn.com/abstract=81788 or DOI: 10.2139/ssrn.81788.

[64] *Meinhard vs. Salmon*, 164 N.E. 545 (N.Y. 1928). "Justice Cardozo held that a nonmanaging partner could share in a deal that the owner of the property the partnership managed had offered to the managing partner although the deal would begin after the termination of the partnership's 20-year term and included significant property beyond what the partnership had managed. Meinhard provides a workable definition of fiduciary duties as requiring the obligated party to act with the 'finest loyalty' to the owner's interests." Ribstein, Larry E., "The Structure of the Fiduciary Relationship" (January 4, 2003). U Illinois Law & Economics Research Paper No. LE03-003. Available at SSRN: http://ssrn.com/abstract=397641 or DOI: 10.2139/ssrn.397641

[65] A fiduciary is "a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking." RESTATEMENT (2D) AGENCY § 13 comment (a) (1958). "[T]he general fiduciary principle requires that the agent subordinate the agent's interests to those of the principal and place the principal's interests first as to

> Some even use the phrase "alter ego" to reference the fiduciary norm. This personalizes the duty in a particular way. The fiduciary must appropriate the objectives, goals, or ends of another and then act on the basis of what the fiduciary believes will accomplish them – a happy marriage of the principal's ends and the fiduciary's expertise. The fiduciary does not eliminate its own legal personality, rather it must consider the principal's delegation of authority to the fiduciary from the perspective of fidelity to the principal's objectives as the fiduciary understands them.[67]

THE TWO MAIN CONSEQUENCES OF FIDUCIARY STATUS

The two main consequences of imposition of fiduciary status are both significant and possess profound ramifications for those who attain fiduciary status.

First, the range of remedies broadens significantly. Rather than just recover for proximate damages caused by negligence, a breach of fiduciary duty claim can invoke other remedies, such as the equitable remedies of fee disgorgement, imposition of an constructive trust, and the remedy of injunction (sometimes utilized to prevent a fiduciary's threatened or continued fiduciary breach).

Second, once fiduciary status is demonstrated, and the fiduciary duty is proven, the burden of persuasion shifts to the fiduciary defendant. In essence, the law adopts the proposition that, given the occasional need to evaluate the conduct of the fiduciary at some later time, and given the need to look objectively at the facts and circumstances surrounding the fiduciary's judgment at the time the fiduciary exercised his or her judgment, that the fiduciary preserve such proof. It is therefore right that the fiduciary - who was in the best position to have anticipated and obviated the need for proof in a later evidentiary showing – bears the burden of persuasion that his, her or its conduct is in accord with the fiduciary standard of conduct.

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matters connected with the agency relationship." RESTATEMENT (3D) AGENCY § 8.01 cmt. b (2007). *See also* Laby, Arthur B., "The Fiduciary Obligation as the Adoption of Ends," Buffalo L. Rev 99, 103 (2008), available at available at: http://ssrn.com/abstract=1124722. *See also Varity Corp. v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996), in which the U.S. Supreme Court, applying ERISA, stated that: "There is more to plan (or trust) administration than simply complying with the specific duties imposed by the plan documents or statutory regime; it also includes the activities that are *"ordinary and natural means" of achieving the "objective" of the plan*. Bogert & Bogert, supra, § 551, at 41-52. Indeed, the primary function of the fiduciary duty is to constrain the exercise of discretionary powers which are controlled by no other specific duty imposed by the trust instrument or the legal regime. If the fiduciary duty applied to nothing more than activities already controlled by other specific legal duties, it would serve no purpose." *Id.* (*Emphasis added.*)

[66] Laby, *supra* n.65, at 130.

[67] Laby, *supra* n.65, at 135.

THE MULTIPLE SOURCES OF FIDUCIARY STATUS

FIDUCIARY DUTIES ARISING UNDER THE INVESTMENT ADVISERS ACT OF 1940

In the first year of his administration, faced with a financial crisis of epic proportions, Franklin Delano Roosevelt told the press that his principal objective was to restore the idea that dealers in securities, both new and old, are fiduciaries. Shortly thereafter, in 1934, Justice Harlan Stone explained the need for fiduciary capitalism, stating: "I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults 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.'"

In 1940, in the last of the major securities acts, the fiduciary standard of conduct was imposed upon those engaged in giving advice about securities for a fee through the Investment Advisers Act of 1940 ("Advisers Act"). The Advisers Act went much further than the federal securities acts which preceded it. The Advisers Act was the only one of the federal securities laws enacted following the Great Depression to impose upon certain securities industry participants broad fiduciary duties of due care, loyalty, and utmost good faith, as a means of combating not only actual fraud but constructive fraud. As stated by the U.S. Supreme Court: "As we have previously recognized, §206 [of the Advisers Act] establishes 'federal fiduciary standards' to govern the conduct of investment advisers[68] … Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations."[69]

Since its enactment, the fiduciary standards of conduct for registered investment advisers have developed primarily through SEC Commission and SEC Staff pronouncements, as well as through case law and numerous enforcement actions.

QUASI-FIDUCIARY DUTIES UNDER THE SECURITIES AND EXCHANGE ACT OF 1934

Are broker-dealer firms and their registered representatives fiduciaries? Yes, and always, 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 registered representatives owe "limited fiduciary duties" or "quasi-fiduciary duties" to the customer. However, no broad fiduciary duties to exist with respect to most registered representatives and their broker-dealer firms, under the law of agency, at least with respect to non-discretionary accounts. Instead, the discrete duties arise out of the agency relationship were summarized in a recent decision:

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[68] *Transamerica Mortgage Advisors, Inc v. Lewis*, 444 U.S. 11, 17-18, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979), *citing Santa Fe Industries, Inc. v. Green, supra*, 430 U.S., at 471, n. 11, 97 S.Ct., at 1300; *Burks v. Lasker*, 441 U.S. 471, 481-482, n. 10, 99 S.Ct. 1831, 1839, 60 L.Ed.2d 404; *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192, 84 S.Ct. 275, 282-283, 11 L.Ed.2d 237.

[69] *Transamerica Mortgage Advisors, Inc v. Lewis*, 444 U.S. 11, 17-18, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979), *citing See* H.R.Rep.No.2639, 76th Cong., 3d Sess., 28 (1940); S.Rep.No.1775, 76th Cong., 3d Sess., 21 (1940); SEC, Report on Investment Trusts and Investment Companies (Investment Counsel and Investment Advisory Services), H.R.Doc. No.477, 76th Cong., 2d Sess., 27-30 (1939).

> Where the account is a nondiscretionary account such as the account maintained by the Millars, the duties of the broker include: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis; (2) the duty to carry out the customer's orders promptly m a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security; (5) the duty not to misrepresent any fact material to the transaction; and (6) the duty to transact business only after receiving prior authorization from the customer.[70]

Other duties may exist.[71]

By way of further explanation, often the question is posed, "Are broker-dealer firms and their registered representatives (RRs) fiduciaries?" The answer is always "yes" under the general law of agency, which imposes fiduciary obligations commensurate with the scope of the 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 registered representatives and their broker-dealer firms, under the law of agency, at least with respect to non-discretionary accounts.

FIDUCIARY DUTIES ARISING UNDER ERISA

FIDUCIARY STATUS

Section 3(21)(A)(ii) of ERISA sets out a simple two-part test for determining fiduciary status. First, does a person render investment advice with respect to any moneys or other property of a plan, or has any authority or responsibility to do so. Second, does the person receives a fee or other compensation, direct or indirect, for doing so. If both parts of this test are met, then under the plain language of the statute the "person" (who may be an individual or a business entity) is a "fiduciary" and ERISA's fiduciary duties attach.

Status as a fiduciary under ERISA is to be determined by the person's functions, with respect to the employee benefit plan. As stated by the U.S. Supreme Court, "In defining the term "fiduciary" in § 3(21)(A) of ERISA, Congress struck a balance that it believed would protect plan participants without impinging on the ability of employers to make business decisions. In recognition that ERISA allows trustee-beneficiary arrangements that the common law of trusts generally forbids, Congress "define[d] 'fiduciary' not in terms of formal trusteeship, but in functional terms of control and authority over the plan.""[72]

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[70] *Merrill Lynch, Pierce, Fenner & Smith v. Millar*, (W.D. Pa. 2003), citing *Merrill Lynch, Pierce, Fenner & Smith v. Perelle*, 514 A.2d 552,561 (Pa. Super. 1986), quoting *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951,953 (E. D. Mich.1978).

[71] "These duties as outlined in *Perelle*, however, are not all encompassing." *Millar*.

[72] *Varity Corp. v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996).

Unfortunately, shortly after the enactment of ERISA the U.S. Department of Labor (DOL) enacted a regulation which substantially constrained the plain language of the statute.[73] Recently, however, the DOL has proposed a regulation which could substantially broaden the application of fiduciary status,[74] albeit the proposal will still permit sellers of securities to opt out of fiduciary status if the plan sponsor or plan participant knows of seller's status as a seller whose interests are adverse to those of the purchaser, and the plan sponsor or plan participant knows that the person is not undertaking to provide impartial investment advice, and that the seller does not hold itself out as a possessing ERISA fiduciary status.[75]

ERISA'S ELICITATION OF FIDUCIARY DUTIES, GENERALLY

As the U.S. Supreme Court stated, "Congress went to great lengths to enumerate ERISA's fiduciary obligations and duties, see §§ 401-408; §§ 410-412, to create liability for breach of those obligations, see § 409, and to authorize a civil suit to enforce those provisions, see § 502(a)(2)."[76]

THE HIGHER ERISA FIDUCIARY STANDARD, GENERALLY.

Aside from the likely broader application of fiduciary status for advisors to ERISA accounts (and possibly to IRA rollover accounts), the fiduciary standard found under ERISA is different than that found under the Advisers Act and state common law. As recently stated by the Phyllis Borzi, current head of the

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[73] The regulation significantly narrowed the plain language of section 3(21)(A)(ii), creating a 5-part test that must be satisfied in order for a person to be treated as a fiduciary by reason of rendering investment advice. For advice to constitute "investment advice," an adviser who does not have discretionary authority or control with respect to the purchase or sale of securities or other property for the plan must: (1) Render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property; (2) On a regular basis; (3) Pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, that; (4) The advice will serve as a primary basis for investment decisions with respect to plan assets, and that; (5) The advice will be individualized based on the particular needs of the plan.

[74] The DOL recently proposed to amend paragraph (c) of Sec. 2510.3–21. Among many other changes, the DOL's proposal does not require that the advice be provided on a regular basis. "The Department does not believe that the significance of the advice on a plan fiduciary's decisions diminishes merely because it is rendered only once, rather than on a regular basis, or that fiduciary status under section 3(21)(A)(ii) should depend on such a distinction. For example, a fiduciary may retain a person to provide advice on a particular real estate investment in the plan's portfolio, and never have a reason to use this adviser again. Nevertheless, such advice may be critical to an important investment decision and the plan's agreement with the adviser may give the plan every expectation that the adviser is competent and has no conflicts of interest." The proposal also does not require that the parties have a mutual understanding that the advice will serve as a primary basis for plan investment decisions. Nothing in ERISA compels conditioning fiduciary status on a requirement that an adviser and plan fiduciary have a mutual understanding as to the primacy of the advice given, in relation to other advice or information that the fiduciary may consider in making a decision. The Department believes that when a service provider is retained to render advice, the plan should generally be able to rely on the advice without regard to whether the parties intend it be a primary or lesser basis in the fiduciary's decision-making … Accordingly, under the proposal it is sufficient if the understanding of the parties is that the advice will be considered in connection with making a decision relating to plan assets." *See* the Proposed Rule at http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24328.

[75] The DOL's proposal provides some exceptions, including that fiduciary status would not result "if the purchaser knows of the person's status as a seller whose interests are adverse to those of the purchaser, and that the person is not undertaking to provide impartial investment advice." The DOL's provision of such an exception, not found in the statute, is questionable, especially given recent academic research which indicates the general ineffectiveness of disclosures.

[76] *Varity Corp. v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996).

Employee Benefits Security Administration of the U.S. Department of Labor, "the fiduciary standard under ERISA is much higher than under security laws."[77] Some of these differences are due to the presence of the "sole interests" standard under the ERISA statute itself (see discussion of "best interests" vs. "sole interests", *infra.*), while other parts of the distinction arise from the application of the specific prohibited transaction rules found in ERISA.

ERISA'S FIDUCIARY DUTIES ARE GROUNDED IN TRUST LAW

"ERISA does not expressly enumerate the particular duties of a fiduciary, but rather 'relies on the common law of trusts to define the general scope of a fiduciary's responsibilities.'"[78] "[T}he Supreme Court first recognized that ERISA protects employee benefit plans by setting forth certain fiduciary duties applicable to their management. Although these duties find their basis in the common law of trusts, the Court cautioned that ERISA's standards and procedural protections 'partly reflect a congressional determination that the common law of trusts did not offer completely satisfactory protection.' In some instances 'trust law will offer only a starting point, after which courts must go on to ask whether, or to what extent, the language of the statute, its structure, or its purposes require departing from common-law trust requirements.' In so doing, courts should take account of competing congressional purposes, 'such as Congress'[s] desire to offer employees enhanced protection for their benefits, on the one hand, and, on the other, its desire not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering welfare benefit plans in the first place.'"[79]

THE "TWO HATS" DOCTRINE UNDER ERISA

"ERISA allows an employer to act as a plan administrator, leaving open the potential that the employer could be subject to conflicting loyalties in such a situation: "A loyalty to do what is in the best interest of the company, and a fiduciary duty of loyalty to do what is in the best interest of the [participants and beneficiaries]." As the Supreme Court has noted, although a traditional trustee "is not permitted to place himself in a position where it would be for his own benefit to violate his duty to the beneficiaries[, u]nder ERISA ... a fiduciary may have financial interests adverse to beneficiaries." Thus, employers "can be ERISA fiduciaries and still take actions to the disadvantage of employee beneficiaries, when they act as employers (e.g., firing a beneficiary for reasons unrelated to the ERISA plan), or even as plan sponsors (e.g., modifying the terms of a plan as allowed by ERISA to provide less generous benefits)." To assist in resolving this potential conflict, the Supreme Court created the "two hats" doctrine, which acknowledges that the employer is subject to fiduciary duties under ERISA only "to the extent" that it performs three specific functions identified by Congress: (i) exercising "any discretionary authority or discretionary control respecting management of [a benefits] plan or exercis[ing] any authority or control respecting management or disposition of its assets"; (ii) rendering "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan," or having "any authority or

[77] Brooke Southall, "Q&A: Phyllis Borzi says DOL won't defer to SEC," RIABiz.com (March 8, 2011), available at http://www.riabiz.com/a/5857389.

[78] *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407, 412 (5th Cir., 2003), *citing* Edward E. Bintz, Fiduciary Responsibility Under ERISA: Is There Ever a Fiduciary Duty to Disclose?, 54 U. PITT. L. REV. 979, 985 (1993).

[79] *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407 (5th Cir., 2003), *citing Varity Corp. v. Howe*, 516 U.S. 489, 494, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996).

responsibility to do so"; or (iii) having "any discretionary authority or discretionary responsibility in the administration of" the plan. Therefore, in suits charging breach of fiduciary duty under ERISA, "the threshold question is not whether the actions of some person employed to provide services under a plan adversely affected a plan beneficiary's interest, but whether that person was acting as a fiduciary (that is, was performing a fiduciary function) when taking the action subject to complaint."”[80]

STATE COMMON LAW IMPOSITION OF FIDUCIARY STATUS

Franklin D. Roosevelt’s vision for a world of professional, fiduciary investment advisers was not plucked from the air. Nor was the Investment Advisers Act of 1940 new in its approach to the duties imposed on investment advisers. As stated by the U.S. Supreme Court in its seminal 1963 decision, there was “growing recognition by common-law[81] 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.”[82]

Generally Accepted Fiduciary Relationships

The recognition of the existence of a fiduciary relationship under the common law is said to consist of two main branches. The first branch of fiduciary status consists of a list of accepted and prescribed relationships — principal and agent, attorney and client, executor or trustee and beneficiary, director or officer in the corporation, partners, joint venturers, guardian and ward, and parent and child. The common law has defined, over the years, these relationships to be fiduciary in nature, and they are generally accepted as such. When an investment adviser accepts actual discretion over a client’s account, under this branch of fiduciary relationships fiduciary status for the advisor will result (due to the application of agency law). Various court decisions note that common law fiduciary duties arise from the principal-agent relationship, and that these duties will usually be interpreted quite broadly. In essence, since the scope of the agency includes the exercise of discretionary authority to undertake sales and purchases in the account, the agent (registered representative) owes a fiduciary duty to the principal (the customer) in the actions undertaken which exercise that discretion.

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[80] *Id.* at 412-3, *citing Varity Corp. v. Howe.*

[81] The common law forms a major part of the law of those countries of the world with a history as British colonies. In the United States, the common law includes extensive non-statutory law reflecting precedent derived from centuries of court decisions, both in the United States and England. Among other prescriptive aspects, the common law imposes duties upon parties to various contracts and relationships, independent of the existence of any statute or regulation.

[82] *SEC v. Capital Gains Research Bureau*, 375 U.S., at 194, 84 S.Ct., at 284. “[The] 1909 New York case of *Ridgely v. Keene*, 134 App. Div. 647, 119 N. Y. Supp. 451, illustrates the continuing development in the application of fiduciary duties under state common law. An investment adviser, who published an investment advisory service, agreed for compensation paid by a promoter of the security to influence his clients to buy shares in that certain security. The investment adviser did not disclose the agreement to his client. The court declared the act in question ‘a palpable fraud.’” *SEC v. Capital Gains Research Bureau*, 375 U.S. ___.

The Arizona Supreme Court early on held that a confidential relationship exists between a client and his or her financial adviser when there is an imbalance of knowledge so that the client relies heavily on the adviser for advice. *Stewart v. Phoenix Nat'l Bank*, 49 Ariz. 34, 64 P.2d 101, 106 (1937) (holding that a confidential relationship existed when the bank had acted as the plaintiff's financial adviser for many years and he relied upon the bank's advice).

Facts and Circumstances Based Relationships

The second branch of fiduciary status arises from those relationships which, on their particular facts, are appropriately categorized as fiduciary in nature. Under this test, a variety of circumstances may indicate that a fiduciary relationship exists, as opposed to an arms-length relationship. Such circumstances, or indicia or evidential factors, include influence, placement of trust, vulnerability or dependency, substantial disparity in knowledge, the ability to exert influence, and placement of confidence. Another factor may lie in the ability of the fiduciary, by virtue of his or her position or authority, to derive profits at the expense of his or her client. It is under this branch that most financial advisors will find fiduciary status applied by the common law.

The development of this second branch of fiduciary relationships accelerated during the 20th Century and continues today, in response to the increased complexity of our modern world. Increased amounts of specialization are required in modern society, and this in turn leads to greater reliance on others in order to obtain greater affluence. As stated by Professor Frankel, "Courts, legislatures, and administrative agencies increasingly draw on fiduciary law to answer problems caused by these social changes."[83]

Courts have held that a fiduciary relationship, resulting from a relationship based upon trust and confidence, need not be created by contract. It may arise out of any relationship where both parties understand that a special trust or confidence has been reposed. "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."[84] Stated differently, once a relation between two parties is established, "its classification as fiduciary and its legal consequences are primarily determined by the law rather than the parties. Thus, unlike a party to a contract, a person may find himself in a fiduciary relation without ever having intended to assume fiduciary obligations. The courts will look to whether the arrangement formed by the parties meets the criteria for classification as fiduciary, not whether the parties intended the legal consequences of such a relation."[85]

Moreover, while it is often believed that fiduciary duties were only applied in early law to situations in which control over property (such as in a "trustee-beneficiary" relationship) was shifted, this is clearly not the case. Fiduciary status was also imposed, very early on in the law, upon those providing advice.[86]

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[83] Tamar Frankel, *Fiduciary Law,* 71 Calif. L. Rev. 795, 796 (1983).

[84] *In re Clarkeies Market, L.L.C.*, 322 B.R. 487, 495 (Bankr. N.H., 2005).

[85] Tamar Frankel, "Fiduciary Law," 71 Calif. L. Rev. 795, 817 (1983).

[86] "The rule in *Keech v. Sandford* is not confined to trustees. 'Whenever a person clothed with a fiduciary or quasi fiduciary character or position gains some personal advantage by availing himself of such character or position, a constructive trust is raised by courts of equity, such person becomes a constructive trustee, and the advantage gained must be held by him for the benefit of his cestui que trust.' [*citing* Walter G. Hart, The Development of the Rule in *Keech v. Sandford*, Law Q. Rev., 21 (1905): 258, 259]." Joseph F. Johnston, Jr., "Natural Law and the Fiduciary Duties of Business Managers," 8 J. MARKETS & MORALITY 8 (2005): 27, 30, noting that the Court in *Michould v. Girod* cited examples of the general rule from Roman law as well as from English law. *See also* John McGhee, "The Role of Fiduciary Obligations in Commercial Disputes," stating: "[T]he early use of the word 'trust' was not confined to private settlements. A person had a confidence reposed or entrusted in him not only where he had been asked to hold property belonging to another but also where he was given some power to exercise on behalf of another or where another person relied upon him for advice. All these situations were known as 'trusts'. In due course, however, as detailed rules for private settlements grew up in the eighteenth and nineteenth

Many state courts, applying state common law, have held that the relationship is or may constitute a fiduciary relationship between registered representatives, insurance agents, bankers, financial planners, and their clients, when a relationship of trust and confidence is formed.[87] Some commentators have attempted to cull from the cases the major factors which tend to result in a finding of fiduciary status:

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centuries, 'trust' acquired a technical meaning. Other relationships in which equity intervened on the basis of confidence were referred to as 'quasi-trusts', trusts 'for limited purposes' or as being 'similar to' trusts. The word 'fiduciary' eventually became used to describe these relationships." *Id.*, (1998) 114 L.Q.R. 214, 399 (UK).

[87] The following provides a survey of recent select cases where common law fiduciary status was found for either registered representatives, insurance agents, or banks when providing investment or financial advice:

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. *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007).

"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 … Depending on the circumstances, a stock broker's or financial advisor's relationship with his or her client may be far from a simple arm's length relationship." *Johnson v. John Hancock Funds,* 217 S.W.3d 414 (Tenn. App., 2006).

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).

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).

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).

In a bankruptcy case involving an insurance agent (Mr. Smith) who filed for bankruptcy and sought to discharge a claim based upon breach of fiduciary duty, the Court stated: "In the present instance [the customers] were parties devoid of any financial sophistication. On the other hand, Mr. Smith claimed to be and, in fact, was a 'financial advisor' who certainly possessed a far superior expertise concerning investments than either [of the customers]. Mr. Smith was fully aware of the financial conditions of both considering their age and their situation in life … Even to suggest and recommend, let alone persuade [the customers] to invest their entire retirement assets in such a [Ponzi] scheme, was while not fraudulent, certainly amounted to a breach of the fiduciary duty owed by Mr. Smith to Ms. Wilson and Ms. Judson." *In re Gregory Smith*, (Bkrpt.Ct. M.D. Fl. 2005).

In a case involving "wealth management" services, a federal court opined: "Merrill Lynch invited the Millars to its headquarters in New York City to meet with some of its highest ranking executives [as the clients sought] to find advisors to help them manage their wealth and achieve their investment objectives … the program that Menill Lynch presented Doug Millar was its Private Advisory Services … Merrill Lynch told the Millars it would work with them to formulate strategies with the most suitable recommendations for their investment needs … after selling the Millars on its experience and ability to advise, manage and achieve their financial objectives, Merrill Lynch contends its only duty was to act with diligence and competence in the execution of an order. The Court finds such contention untenable … whether a fiduciary duty exists cannot be determined "by recourse to rigid formulas" … Rather, it depends upon "whether one person has reposed trust or confidence in another who thereby gains a resulting superiority or influence over the first." … More simply, "the existence of fiduciary duties depends on the facts of a particular relationship" … the relationship between the Millars and Merrill

Lynch exceeded that found ordinarily between a broker and a nondiscretionary account holder … ."*Merrill Lynch, Pearce, Fenner & Smith vs. Millar* (W.D. Pa. 2003).

"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).

A registered representative and his firm were found to be liable for breach of common law fiduciary duties involving a recommendation that unsophisticated clients switch from corporate bonds to options trading, even though no violation of federal or state securities law was found. "Since not every instance of financial unfairness or breach of fiduciary duty will constitute a fraudulent activity under Sec. 10(b) or Rule 10b-5, federal courts should be wary of foreclosing common law breach of fiduciary duty actions which supplement existing federal or state statutes … The fiduciary concept derives from trust and agency principles. Actions contrary to the duties of loyalty and care are remedied by giving the beneficiary of the relationship the right to recover for the fiduciary's breach." *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042 (11th Cir.1987).

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).

A court found a fiduciary relationship under Oklahoma law between a broker and his client, a savings and loan association. "MidAmerica as a securities broker-dealer with expertise in the area of this transaction and who had knowledge of MidAmerica's specific needs. Although it cannot be said that MidAmerica was completely ignorant regarding the business of buying and selling securities, at the time of these transactions MidAmerica was temporarily without the advice of an in-house financial investment advisor. MidAmerica informed Crow of this fact and Crow knew MidAmerica was relying on his advice. MidAmerica justifiably put its trust in Crow based, in part, on their long-standing business relationship and Crow's knowledge of MidAmerica's situation." In these 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 found a fiduciary relationship existed, based upon the Oklahoma Supreme Court's definition of a fiduciary relationship. *MidAmerica Federal Savings and Loan Ass'n v. Shearson / American Express Inc.*, 886 F.2d 1249 (10th Cir. 1989).

A U.S. District Court in 1985 held that a fiduciary relationship existed in part because of a defendant's holding out as a financial planner to clients. CSCC was primarily in the business of real estate syndication, but also in business under the name Creative Financial Planning. "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 ...." *Koehler v. Pulvers*, 614 F. Supp. 829 (USDC, Cal, 1985).

Lest this author leaves you with the impression that it is easy to find a confidential relationship between a registered representative and his or her client, a recent case illustrates when fiduciary relationships were not applied, even for an unsophisticated senior investor: "On March 4, 1999, Janco, then a sixty-nine year old widow, opened a brokerage account with First Union. She had no investment experience. Her formal education ended following high school and she previously worked as a part-time receptionist. Janco invested approximately $800,000 with First Union. Over the next three years, as the value of her account declined, Janco called Quinn. He either failed to respond to her calls or assured her that her

Much academic ink has been spilt on seeking a definition of a fiduciary relationship. Four central ideas have predominated. Firstly, the fact that one person has undertaken or is to be taken to have undertaken to act for and on behalf of another person. Secondly, the fact that the other person in the relationship has relied or is entitled to rely on the other to act in his interests to the exclusion of his own interests. Thirdly, the fact that the alleged fiduciary has control over some of the property or affairs of the other. And fourthly, the fact that the relationship between the parties is such that the fiduciary is in a position to act to the detriment of another person and that other person is accordingly vulnerable to abuse by the fiduciary of his position. The problem is that whilst one or more of these four factors appears in most if not all established cases of fiduciary relationship they also appear in many relationships which are not generally considered as fiduciary.[88]

The test of whether a fiduciary relationship exists under the common law often requires a fact-intensive inquiry.[89] 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[90] or dependency, substantial disparity in knowledge,[91] the ability to exert influence,

investments were doing fine. Defendants never offered Janco alternative investments. She lost in excess of $600,000. The Complaint seeks damages for breach of fiduciary duty … Janco asserts that a confidential relationship existed between herself and Defendants because she was an unsophisticated investor who trusted and relied upon Defendants to recommend and make investments for her … she has not put forward sufficient facts to demonstrate the existence of a confidential relationship." *Janco vs. First Union, (Ct. of Common Pleas, Philadelphia County, PA, 2004*, unpublished memorandum decision). Please also note that there exist several cases, involving sophisticated investors, in which fiduciary duties implied in law are not found to exist, and the relationship between the parties is deemed "arms-length" in nature under state common law, due to the sophistication of the investor.

88 John McGhee, "The Role of Fiduciary Obligations in Commercial Disputes," at p. 8, available at http://www.maitlandchambers.com/Files/Article/PDF/art-fiduciaryobligations-jmqc.pdf, citing

Oakley, *Constructive Trusts* (1997) p.90 *et seq*., and noting: "[S]ociety has seen an enormous growth in the number of types of professionals who are trusted for their advice. The courts can be expected increasingly to impose fiduciary duties on such persons knowing that they are paid for their advice and are generally insured against the consequences of litigation."

89 *See ARA Automotive Group v. Central Garage, Inc*., 124 F.3d 720,723 (C.A.5 (Tex.), 1997) ("The existence of a fiduciary relationship, outside of formal relationships that automatically give rise to fiduciary duties, is usually a fact intensive inquiry").

90 However, merely because some degree of vulnerability exists does not necessarily give rise to a fiduciary relationship. *See New England Surfaces v. E.I. Du Pont De Nemours*, 517 F.Supp.2d 466, 488-9 (D. Me., 2007) ("In *Webber Oil Co. v. Murray*, Webber agreed to provide gasoline to the public through pumps owned by Webber at a convenience store owned by Murray … Murray staffed the pumps, collected the sales and paid the proceeds to Webber. Id Through the course of their relationship, Webber loaned money to Murray, and Murray and his wife signed promissory notes to Webber … the Law Court declined to find a fiduciary relationship in this situation. 'The evidence here showed no such relationship, but rather only a conventional business deal. Certainly one party was economically stronger than the other, but that is often the case in a business deal, and not the basis for a finding of a relationship of confidence.'" *Quoting Webber Oil Co. v. Murray*, 551 A.2d 1371(Me.1988).)

91 Yet, superior knowledge or expertise, standing alone, has been held to be insufficient to impose fiduciary status on the one with the higher level of knowledge or expertise. *See Henneberry v. Sumitomo Corp. of America*, 532 F.Supp.2d 523, 550 (S.D.N.Y., 2007) ("a fiduciary obligation will not be imposed on one party 'merely because it possesses relative expertise

placement of confidence,[92] the actual exercise of control over a party, and (in a commercial transaction) whether "the parties have shared goals in each other's commercial activities."[93] 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. Factors indicating that fiduciary duties should not be applied include, in the context of commercial relations, the presence of legal counsel or other professional advisors representing both parties.[94]

State Common Law and "De Facto" Discretion by Registered Representatives

The fiduciary duties of a broker-dealer and its registered representatives expand when the broker-dealer firm (through its registered representative) assumes discretion[95] over an account. In one sense, this is another way in which broad, or at least broader, fiduciary obligations are imposed upon broker-dealers and their investment advisers.

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as compared to the other' … 'Allegations of reliance on another party with superior expertise, standing by themselves, will not suffice'") (*citations omitted*).

[92] A fiduciary relationship "is a relationship founded upon trust or confidence reposed by one person in the integrity and fidelity of another ... in which influence has been acquired and abused, in which confidence has been reposed and betrayed …." *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423, 458 (S.D.N.Y., 2006). "A fiduciary relationship may exist where one party reposes confidence in another and reasonably relies on the other's superior expertise or knowledge." *WIT Holding Corp. v. Klein*, 282 A.D.2d 527, 724 N.Y.S.2d 66, 68 (App.Div.2001). However, the mere exchange of confidential information does not give rise to a fiduciary relationship. *See U.S. v. Cassese*, 273 F.Supp.2d 481, 487 (S.D.N.Y., 2003) ("The present case is also similar to *Walton v. Morgan Stanley & Co. Inc.*, 623 F.2d 796 (2d Cir.1980). In *Walton*, the Second Circuit held that when two corporations' management were 'at all times responsible for different interests, and ... had no relationship to each other before or other than in the acquisition discussions,' they 'must be presumed to have dealt, absent evidence of an extraordinary relationship, at arm's length.' *Id.* at 798. The fact that information exchanged between the two parties is confidential does nothing to change their relationship from arms-length into a fiduciary relationship. *Id.* at 799.")

[93] *Hartman v. McInnis*, No. 2006-CA-00641-SCT (Miss. 11/29/2007) ("This Court considers a number of factors in determining whether a fiduciary relationship exists in a commercial transaction, including: whether (1) the parties have shared goals in each other's commercial activities, (2) one of the parties places justifiable confidence or trust in the other party's fidelity, and (3) the trusted party exercises effective control over the other party.")

[94] *See Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438, 512 (Bankr. S.D.N.Y., 1994) ("[A] fiduciary relationship generally cannot be implied between parties to a commercial transaction when each party is represented by counsel and other professional advisors who have been retained to protect their best interests. *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 739 (2d Cir.1984).")

[95] It has been an assumption by some commentators that the Advisers Act was intended to only regulate accounts for which discretion over the making of investment decisions and placement of trades was granted by the client. This is not the case, and confuses concepts arising from the law of agency with the adoption in the Advisers Act of fiduciary status arising from relationships built upon trust and confidence. As the U.S. Supreme Court noted in reviewing the legislative history of the Advisers Act: "The Report also analyzed the nature of services of investment-counsel firms to their clients: 'The powers of investment counsel firms with respect to the management of the funds of their investment company clients were either discretionary or advisory. Discretionary powers imply the vesting with an investment counsel firm control over the client's funds, with the power to make the ultimate determination with respect to the sale and purchase of securities for the client's portfolio. In contrast, vesting advisory powers with an investment counsel firm merely means that the firm may make recommendations to its client, with whom rests the ultimate power to accept or reject such recommendations.'" *Lowe v. SEC,* 472 U.S. 181 (1985), fn. 31.

In September 2007, the SEC issued a proposed rule that it will continue to view discretionary brokerage accounts are subject to the IAA and its fiduciary duties. Some exceptions exist for brokerage accounts when limited or temporary forms of discretion are undertaken.

Beyond such proposed rule, however, are various court decisions arising under state common law which address the issue of discretionary accounts through the application of agency law. It is clear that common law fiduciary duties arise from the principal-agent relationship, the scope of those duties being dependent upon the scope of the agency. Applying agency law, courts interpret fiduciary duties quite broadly, when *de jure* or *de facto* discretion over a client's account is assumed. 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 (registered representative) 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.[96]

Furthermore, even though an account may be "non-discretionary" on paper, some state courts find that the registered representative 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.[97]

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[96] *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."].

[97] *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc. & Smith, Inc*., 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd* 647 F. 2d. 165 (6th Cir. 1981) (recognizing that broker who has *de facto* control over nondiscretionary account generally owes customer duties of a fiduciary nature; looking to customer's sophistication, and the degree of trust and confidence in the relationship, among other things, to determine duties owed); *Paine Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d. 508 (Colo. 1986) (evidence "that a customer has placed trust and confidence in the broker" by giving practical control of account can be "indicative of the existence of a fiduciary relationship"); *MidAmerica Federal Savings & Loan v. Shearson/American Express*, 886 F.2d. 1249 (10th Cir. 1989) (fiduciary relationship existed where broker was in position of strength because it held its agent out as an expert); *SEC v. Ridenour*, 913 F.2d. 515 (8th Cir. 1990) (bond dealer owed fiduciary duty to customers with whom he had established a relationship of trust and confidence); C. Weiss, "A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty," 23 Iowa J. Corp. Law 65 (1997). *Cf. De Kwiatkowski v. Bear, Stearns & Co*., 306 F.3d 1293, 1302-03, 1308-09 (2d Cir. 2002) (noting that brokers normally have no ongoing duty to monitor non-discretionary accounts but that "special circumstances," such as a broker's de facto control over an unsophisticated client's account, a client's impaired faculties, or a closer-than-arms-length relationship between broker and client, might create extra-contractual duties).

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. In each instance it is a "facts and circumstances" analysis. For example, a key factor is the investment sophistication of the customer, since an inexperienced or naive customer is more likely to leave the control of an account in the broker's hands. *Kaufman*, 464 F.Supp. at 536; *Leib*, 461 F.Supp. at 954; *Hecht v. Harris, Upham & C*o., 283 F.Supp. 417, 433 (N.D.Cal.1968). Conversely, a customer who has sufficient understanding and intelligence to be able to evaluate a broker's recommendations and exercise independent judgment as to those recommendations can be viewed as controlling the account. *Follansbee v. Davis, Skaggs & Co*., 681 F.2d 673 (9th Cir.1982); *Marshak v. Blyth Eastman Dillon & Co., Inc*., 413 F.Supp. 377 (N.D.Okla.1975). Thus, for example, the court in *Leib* considered the customer's age, education, intelligence, and investment experience as among the relevant considerations in determining that the customer was sufficiently involved in and informed about his account to be deemed in control of the account. 461 F.Supp. at 954. Additionally, the *Lieb* court

State Common Law: More Difficult to Apply Fiduciary Status When Insurance Agents' Activities Are Scrutinized

Outside of ERISA, it is generally harder to find an insurance agent to be a fiduciary, applying state common law, as it is more difficult to find that it is reasonable for the consumer to conclude that a relationship of trust and confidence was formed.[98]

THE CLOSE RELATIONSHIP BETWEEN STATE COMMON LAW AND STATUTORY LAW

The existence of a "federal fiduciary standard" under the Investment Advisers Act of 1940 and under ERISA does not mean that deference is not provided to the scope of fiduciary duties as they exist under state common law. "Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law."[99]

While the federal fiduciary standard imposed by the Advisors Act is informed by state common law, it is not necessarily identical to the fiduciary standards found in the common law of one or all of the states. "Federal courts applying a 'federal fiduciary principle' … could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system."[100]

The Advisers Act's Fiduciary Duties Establish a Floor, Not a Ceiling (No Preemption of State Common Law Fraud, including Fiduciary Duty, Claims Exist)

Neither the (federal) Investment Advisers Act nor similar state statutes establish a ceiling as to the duties of investment advisers. Section 206 of the Advisers Act imposes "minimum standards on the behavior of investment … advisers …."[101] Moroever, neither federal nor state securities laws generally preempt

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noted that if the broker is socially or personally involved with the customer, this suggests relinquishment of control by the customer because of the relationship of trust and confidence. The *Patsos* court enumerated similar factors.

[98] "[A] fiduciary relationship is not established under Minnesota law in the context of commercial transactions simply by a long acquaintance between the parties or by the plaintiff having faith and confidence in the defendant where the plaintiff should have known the defendant was representing an adverse interest." *Hope vs. Klabal* (2006), *citing Stark v. Equitable Life Assurance Soc'y*, 285 N.W. 466, 470 (Minn. 1939) (absent a policy provision explicitly assuming a duty to the plaintiff, an insurance agent would not have had a fiduciary duty to a plaintiff who was illiterate, had limited business experience, and had been close friends and business acquaintances with the agent for years).

"Ohio courts have held that the relationship between an insurance agent and his client is generally not a fiduciary relationship, but, rather, an ordinary business relationship. *Advent v. Allstate Ins. Co.*, Franklin App. No. 05AP-1092, 2006-Ohio-2743, at ¶14 …. 'While the law has recognized a public interest in fostering certain professional relationships, such as the doctor-patient and attorney-client relationships, it has not recognized the insurance agent-client relationship to be of similar importance.' *Nielsen Ent., Inc. v. Ins. Unlimited Agency, Inc.* (May 8, 1986), Franklin App. No. 85AP-781. Thus, without more, the relationship between an insurance agent and an insured is not a fiduciary relationship. *Roberts v. Maichl*, Hamilton App. No. C-040002, 2004-Ohio-4665, at ¶15." *Nichols v. Schwendeman*, 2007-Ohio-6602.

[99] *U.S. v. Brennan*, 938 F.Supp. 1111 (E.D.N.Y., 1996) , *citing Varity v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996); *F.D.I.C. v. Wright*, 87 B.R. 1011 (D.S.D. 1988) (bankruptcy).") Id. at 1119.

[100] *Santa Fe Industries, Inc v. Green*, 430 U.S. 462, 479, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). (Whether implied preemption of state law occurs in order to achieve such uniformity is a subject deserving of its own outline.)

[101] *Burks v. Lasker*, 441 U.S. 471 (concurring opinion of Stewart, J., fn. 10).

common law claims based upon breach of fiduciary duty.[102] This is because the securities statutes were modeled after the common law actions of fraud and deceit.[103]

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 the 2007 decision of *Capital Research and Management Company v. Brown*, 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' antifraud 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'[104] …
>
> 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 … The Attorney General's enforcement action, which challenges broker-dealer conduct, cannot reasonably be construed as an effort to regulate a non-party issuer."

[102] "[I]nvestment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship." SEC Release IA-40 (Jan. 5, 1945).

[103] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-215, 96 S.Ct. 1375, 1381-1391, 47 L.Ed.2d 668 (1976) (review of legislative history); *see also* Securities Regulation, 69 Am.Jur.2d Sec. 1 *et seq*.

[104] 53 Cal.Rptr.3d 770, 147 Cal.App.4th 58 (Cal. App., 2007). *See also People v. Edward D. Jones & Co.*, 65 Cal.Rptr.3d 130, 154 Cal.App.4th 627 (Cal. App., 2007) ("Edward Jones's argument fails because the People's action is a type of action expressly permitted by the NSMIA. That which is expressly permitted cannot be implicitly prohibited." *Id.* at 138.

ERISA Preemption of State Common Law Fiduciary Claims

Despite the general aversion of the courts to find that federal law preempts state common law claims based upon actual or constructive fraud, some specific federal statutes, such as ERISA and SLUSA, preempt state common law in specific situations. For example, ERISA preempts state common law when investment advice is provided on an account governed by ERISA.[105]

OTHER SOURCES OF FIDUCIARY STATUS

Various state statutes may apply fiduciary status upon particular actors.

- In most cases, securities statutes and regulations adopted by various states (so-called Blue Sky laws) prohibit conduct similar to that prohibited by Section 206 of the Advisers Act. Applying the same rationale utilized by the U.S. Supreme Court in *SEC vs. Capital Gains Research Bureau*, these state provisions could be interpreted to impose a fiduciary duty upon investment advisers. In addition, NASAA Model Rule USA 2002 502(b), Prohibited Conduct in Providing Investment Advice, states in part: "A person who is an investment adviser, an investment adviser representative or a federal covered investment adviser is a fiduciary and has a duty to act primarily for the benefit of its clients." NASAA Model Rule 102(a)(4)-1, "Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers," repeats the foregoing statement.
- In Minnesota, persons who represent that they are financial planners (including "financial counselor" and certain other terms) possess a fiduciary duty to persons for whom services are performed for compensation;[106]

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[105] Section 514 of ERISA provides, with certain exceptions specifically enumerated, that the provisions of Titles I and IV of ERISA supersede any and all laws of the States as they relate to any employee benefit plan covered under ERISA.

[106] Minnesota Statutes §45.026 (2010): "REGULATION OF BUSINESS OF FINANCIAL PLANNING.

Subdivision 1.Definitions. For the purposes of this section, the following terms have the meanings given them:

(a) "Person" means an individual, corporation, partnership, joint venture, joint stock association, trust, or unincorporated association.

(b) "Financial planner" means a person who, on advertisements, cards, signs, circulars, letterheads, or in another manner, indicates that the person is a "financial planner," "financial counselor," "financial adviser," "investment counselor," "investment adviser," "financial consultant," or other similar designation, title, or combination is considered to be representing that the person is engaged in the business of financial planning.

(c) "Advertisement" includes:

(1) printed or published material, audiovisual material, and descriptive literature of a financial planner used in direct mail, newspapers, magazines, other periodicals, radio scripts, television scripts, billboards, and other similar displays, excluding advertisements prepared for the sole purpose of obtaining employees, agents, or agencies;

(2) descriptive literature and sales ads of all kinds issued by a financial planner for presentation to members of the public, including but not limited to, circulars, leaflets, booklets, depictions, illustrations, and form letters;

(3) prepared sales talks, presentations, and materials for use by a financial planner and any representations made by a financial planner in accordance with these talks, presentations, and materials; and

(4) statements, written or oral, by a financial planner.

- Viatical settlement brokers are fiduciaries, under statutes adopted by many states;[107]
- Mortgage brokers within the State of Washington are fiduciaries,[108] and
- Any person who "has responsibility for the … investment … of money or property of another" is a "fiduciary" for purposes of the Prudent Investor Rule, within in the State of Florida.[109]

Subd. 2.Fiduciary duty.Persons who represent that they are financial planners have a fiduciary duty to persons for whom services are performed for compensation. In an action for breach of fiduciary duty, a person may recover actual damages resulting from the breach, together with costs and disbursements.

[107] *See, e.g.,* Section 2.K. of the Viatical Settlements Model Act: "'Viatical settlement broker' means a person that on behalf of a viator and for a fee, commission or other valuable consideration offers or attempts to negotiate viatical settlement contracts between a viator and one or more viatical settlement providers. Notwithstanding the manner in which the viatical settlement broker is compensated, a viatical settlement broker is deemed to represent only the viator and owes a fiduciary duty to the viator to act according to the viator's instructions and in the best interest of the viator. The term does not include an attorney, certified public accountant or a financial planner accredited by a nationally recognized accreditation agency, who is retained to represent the viator and whose compensation is not paid directly or indirectly by the viatical settlement provider or purchaser."

[108] RCW 19.146.095 "Fiduciary duties" (2010) provides:

(1) A mortgage broker has a fiduciary relationship with the borrower. For the purposes of this section, the fiduciary duty means that the mortgage broker has the following duties:

(a) A mortgage broker must act in the borrower's best interest and in the utmost good faith toward the borrower, and shall disclose any and all interests to the borrower including, but not limited to, interests that may lie with the lender that are used to facilitate a borrower's request. A mortgage broker shall not accept, provide, or charge any undisclosed compensation or realize any undisclosed remuneration that inures to the benefit of the mortgage broker on an expenditure made for the borrower;

(b) A mortgage broker must carry out all lawful instructions provided by the borrower;

(c) A mortgage broker must disclose to the borrower all material facts of which the mortgage broker has knowledge that might reasonably affect the borrower's rights, interests, or ability to receive the borrower's intended benefit from the residential mortgage loan;

(d) A mortgage broker must use reasonable care in performing duties; and

(e) A mortgage broker must provide an accounting to the borrower for all money and property received from the borrower.

(2) A mortgage broker may contract for or collect a fee for services rendered if the fee is disclosed to the borrower in advance of the provision of those services.

(3) The fiduciary duty in this section does not require a mortgage broker to offer or obtain access to loan products and services other than those that are available to the mortgage broker at the time of the transaction.

[109] Florida Statutes § 518.10 (2010) defines "fiduciary " as used in ss. 518.11-518.14 (Florida's version of the Prudent Investor Rule, generally) as "an executor, administrator, trustee, guardian (except any guardian holding funds received from or currently in receipt of funds from the United States Department of Veterans Affairs, to the extent of those funds alone), or other person, whether individual or corporate, who by reason of a written agreement, will, court order, or other instrument has the responsibility for the acquisition, investment, reinvestment, exchange, retention, sale, or management of money or property of another."

FIDUCIARY LAW AS A PRINCIPLES-BASED REGIME: CONTINUED EVOLUTION; "SOLE INTERESTS" VS. "BEST INTERESTS" DISTINCTIONS

THE ADVISERS ACT AS A "PRINCIPLES-BASED REGULATORY REGIME"

Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 ("Advisers Act") make it unlawful for an investment adviser to "employ any device, scheme, or artifice to defraud any client or prospective client"[110] or to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[111] In the landmark decision *SEC vs. Capital Gains Research Bureau*, the U.S. Supreme Court confirmed a widely held previous understanding when it held that these provisions imposed broad fiduciary duties upon investment advisers. [112]

The Advisers Act places few substantive burdens on investment advisers compared to the more detailed proscriptions found in the Investment Company Act and the Securities and Exchange Act of 1934. Instead, it relies upon broad proscriptions to curtail fraudulent conduct by investment advisers. The SEC has acknowledged that the Advisers Act is a "principles-based" regulatory regime, rather than one based upon rules.[113]

THE FIDUCIARY STANDARD MUST BE PERMITTED TO EVOLVE

Fiduciary duties are not static; rather, they must evolve over time to meet the ever-changing business practices of advisors and fraudulent conduct successfully circumscribed.

The need for evolution of the fiduciary standard of conduct has been known for well over a century. "Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition. Messieurs, the fraud-feasors, would like nothing half so well as for courts to say they would go thus far, and no further in its pursuit."[114]

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[110] 15 U.S.C. § 80b-6(1).

[111] 15 U.S.C. § 80b-6(2).

[112] 375 U.S. 180, 194 (1963). In this landmark decision, the Investment Advisers Act of 1940 ("Advisers Act"), which does not utilize the term "fiduciary" at any time in its statutory text, was construed to apply broad fiduciary duties upon investment advisers. An "investment adviser" as defined under the Advisers Act is a fiduciary. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 191-92, 194, 201; *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). Section 206 of the Advisers Act establishes "a statutory fiduciary duty for [investment advisers] to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients*." SEC v. DiBella*, Slip Copy, 2007 WL 2904211 (D.Conn. 2007) (*citing SEC v. Moran*, 922 F.Supp. 867, 895-96 (S.D.N.Y. 1996)); *see also Capital Gains Research Bureau, Inc.*, 375 U.S. at 194.

[113] In 2008, the Director of the SEC's Division of Investment Management, who is responsible for implementation of the provisions of the Investment Advisers Act, noted, for example: "When enacting the Investment Advisers Act of 1940, Congress recognized the diversity of advisory relationships and through a principles-based statute provided them great flexibility, with the overriding obligation of fiduciary responsibility." Andrew J. Donohue, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Keynote Address at the 9th Annual International Conference on Private Investment Funds (Mar. 10, 2008), available at http://www.sec.gov/news/speech/2008/spch031008adj.htm.

[114] *Stonemets v. Head*, 248 Mo. 243, 154 SW 108 (1913) (Judge Lamb, writing for the Missouri Supreme Court). *See also* Justice Douglas's majority opinion in *Pepper v. Litton*, 308 U.S. 295, 311 (1939), wherein he stated: "He who is in such a

Because fraud is by its very nature boundless, the one fiduciary standard of conduct applicable to investment advisers should not be subjected to attempts to define or restrict it legislatively, by means of any particular definition. In an early speech, an SEC attorney noted:

> Like fraud, abuse of trust is not a fact but a conclusion to be drawn from facts. *The terms 'gross abuse of trust' or 'gross misconduct' should not be limited by any hard and fast definition.* Both constitute fraud in its general sense … the interpretation of gross misconduct and gross abuse of trust as used in Section 36 will depend not only upon relevant common law principles but also upon the declaration of policy as set forth in the Act … I believe that any substantial deviation from that codification of the fiduciary obligations imposed upon directors and officers of investment companies, ipso facto, constitutes gross misconduct and gross abuse of trust.[115] [*Emphasis added.*]

DISTINCTIONS BETWEEN THE "BEST INTERESTS" AND THE "SOLE INTERESTS" STANDARD

One recent comment letter to the U.S. Department of Labor complained of "the differing approaches of the DOL and the SEC with respect to fiduciaries' conflicts of interest. Although the [DOL] generally prohibits, absent an exemption, conduct that is characterized by conflicts of interest, in some instances the SEC allows broker-dealers to manage and disclose conflicts, including by obtaining customers' consents."[116] This author is quite surprised that a securities industry organization would even attempt to make the argument that an "integrated approach" by the SEC and DOL be undertaken, given the distinctions (long known in the legal community) between the "sole interests" (under ERISA) and "best interests" (under the Advisers Act) fiduciary standard of conduct, and ERISA's additional imposition of prohibited transaction rules.

Generally, the fiduciary standard of conduct is a tough standard, often called "the highest standard under the law." How the fiduciary standard of conduct is applied (when it is found to exist) is surprisingly uniform. Yet, distinctions do exist in some contexts, such as between the regulatory regimes of the SEC and DOL, primarily in the distinctions between the "best interests" and "sole interests" standard of conduct. Distinctions also arise due to differences resulting from specific modifications to the standards by statutes or the regulations promulgated thereunder, distinctions in the public policies which the various regulatory regimes serve to promote, and differing case law interpreting statutes and regulations.

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

[115] Speech, "Diversiform Dishonesty" by Edward H. Cashion, Counsel to the Corporation Finance Division, U.S. Securities and Exchange Commission, on November 17, 1945 to the National Association of Securities Commissioners, where in reference to Section 36 of the Investment Company Act of 1940.

[116] Comment letter of the Financial Services Institute, Feb. 3, 2011, regarding the proposed DOL rule on the definition of "fiduciary." The comment letter can be viewed at http://www.dol.gov/ebsa/pdf/1210-AB32-164.pdf.

The Advisers' Act fiduciary standard of conduct is generally described as a "best interests" fiduciary standard of conduct. The Advisers Act has always adopted the "best interests" standard[117] as a codification of state common law applicable to relationships based upon trust and confidence.

In contrast, the "sole interests" standard of conduct found in trust law and (with some modification) under ERISA, is generally believed to be somewhat stricter, particularly with regard to the fiduciary's obligations with respect to conflicts of interest. Generally, under state common law in which a "sole interests" standard is applied (generally, in trustee-beneficiary relationships), any form of self-dealing is essentially prohibited.[118] [ERISA therefore has stricter prohibitions against self-dealing, and also possesses additional restrictions in the form of the prohibited transaction rules.]

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[117] As to the "best interests" standard being present under the Advisers Act, *see S.E.C. v. Moran*, 922 F.Supp. 867, 895-6 (S.D.N.Y., 1996) ("the SEC alleges that by allocating Liberty stock to his personal and family accounts and requiring his clients to pay a higher price for the stock the next day, Moran Sr. and Moran Asset placed their own interests ahead of their clients thereby violating the fiduciary duty owed to those clients … Section 206 of the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients, requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17, 100 S.Ct. 242, 246, 62 L.Ed.2d 146 (1979); *Burks v. Lasker*, 441 U.S. 471, 482 n. 10, 99 S.Ct. 1831, 1839 n. 10, 60 L.Ed.2d 404 (1979); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 n. 11, 97 S.Ct. 1292, 1300 n. 11, 51 L.Ed.2d 480 (1977); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92, 84 S.Ct. 275, 282-83, 11 L.Ed.2d 237 (1963) … [T]he court interprets Section 206 to establish a fiduciary duty which in addition to applying to misrepresentations and omission, also requires the investment advisor to act in the best interests of its clients. *See e.g., SEC v. Capital Gains Bureau*, 375 U.S. at 195, 84 S.Ct. at 284-85 ('Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes.') …."

[118] A more elaborate explanation of the difference between the "sole interests" standard and "best interests" standard can be found in Professor John Langbein's article: "The sole interest rule prohibits the trustee from "plac[ing] himself in a position where his personal interest . . . conflicts or possibly may conflict with" the interests of the beneficiary. The rule applies not only to cases in which a trustee misappropriates trust property, but also to cases in which no such thing has happened—that is, to cases in which the trust "incurred no loss" or in which "actual benefit accrued to the trust" from a transaction with a conflicted trustee. The conclusive presumption of invalidity under the sole interest rule has acquired a distinctive name: the "no further inquiry" rule. What that label emphasizes, as the official comment to the Uniform Trust Code of 2000 explains, is that "transactions involving trust property entered into by a trustee for the trustee's own personal account [are] voidable without further proof." Courts invalidate a conflicted transaction without regard to its merits—"not because there is fraud, but because there may be fraud." "[E]quity deems it better to . . . strike down all disloyal acts, rather than to attempt to separate the harmless and the harmful by permitting the trustee to justify his representation of two interests … I compare the trust law duty of loyalty with the law of corporations, which originally shared the trust law sole interest rule but abandoned it in favor of a regime that undertakes to regulate rather than prohibit conflicts … I recommend (in Section II.C) reformulating the trust law duty of loyalty in light of these developments. I would generalize the principle now embodied in the exclusions and exceptions, which is that the trustee must act in the beneficiary's best interest, but not necessarily in the beneficiary's sole interest. Overlaps of interest that are consistent with the best interest of the beneficiary should be allowed. What is needed to cure the overbreadth of the sole interest rule is actually quite a modest fix: reducing from conclusive to rebuttable the force of the presumption of invalidity that now attaches to a conflicted transaction." Langbein, John H., Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?. Yale Law Journal, Vol. 114, p. 929 (2005), available at SSRN: http://ssrn.com/abstract=696801

INVESTMENT ADVISER STANDARDS OF PROFESSIONAL CONDUCT

THE TRI-PARTE FIDUCIARY STANDARD, GENERALLY

We can derive from the case law and reported administrative decisions applicable to investment advisers and financial planners, and decisions arising under ERISA, as well as general principles of fiduciary law, a listing of some of the specific principles or duties arising from the fiduciary standard of conduct. As a point of beginning, the broad fiduciary standard of conduct is commonly broken down (in the United States) among a triad of broad fiduciary duties – due care, loyalty, and utmost good faith.[119]

While useful as a clear and succinct statement of the law, these tri-parte general duties or principles still often fail to provide adequate guidance to investment and financial advisors and those who regulate them. However, the following elicitation of more specific principles arising under these broad fiduciary duties of due care, loyalty, and utmost good faith can assist those providing investment and financial advice to better fulfill their fiduciary obligations.

"INVESTMENT ADVISER STANDARDS OF PROFESSIONAL CONDUCT" - OVERVIEW

The specific principles present under fiduciary law, as discerned from current statutes, regulations, decisions, and agency staff interpretations, is set forth in the form of "Standards of Professional Conduct" in the pages which follow. A legal duty is defined as an obligation under the law "to conform to a particular standard of conduct towards another."[120]

While these "Standards of Professional Conduct" have not been adopted by any regulatory authority, nor any industry organization, as SEC Staff recently opined "all investors deserve the same protections regardless of where they choose to obtain investment advice." Investment advisers who desire to be proactive might choose to incorporate some or all of these professional standards of conduct within their own Code of Ethics.

Presentation in this format is intended to assist the reader in understanding, and thereafter observing, his or her fiduciary obligations. These standards are formulated as *baseline* standards; additional specific rules or obligations may be applicable. Accordingly, these standards are not intended to provide a "safe harbor."

The obligations set forth herein are specific to those providing investment advice, and are not intended to address the broader array of issues and situations which investment advisers may face (outside of the provision of investment advice).

The term "investment adviser" is utilized to describe broadly those providing investment advice to whom broad fiduciary duties of due care, loyalty, and utmost good faith may attach, whether arising under ERISA, the federal Investment Advisers Act of 1940, state common law, or any other means (including

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[119] U.S. courts have in large part adopted the view of fiduciary obligations as resting upon "the triads of their fiduciary duty—good faith, loyalty or due care." *See In re Alh Holdings LLC*, 675 F.Supp.2d 462, 477 (D. Del., 2009).

[120] *Guin v. Brazos Higher Educ. Serv. Corp., Inc.,* No. Civ. 05-668 (RHK/JSM), 2006 WL 288483, at *3 (D.Minn. Feb. 7, 2006), available at http://www.steptoe.com/assets/attachments/1942.pdf.

potential adoption of a "uniform fiduciary standard" for investment advisers and broker-dealers pursuant to SEC rule-making under Section 913 of the Dodd-Frank Act[121]).

In each section a "principle" ("Rule") is set forth, followed by "Commentary" to assist in understanding the principle. This is followed by further discussion through "Annotations" – recitations to specific statutes, rules, case decisions, administrative decisions, no-action letters, and other sources which may serve to further illustrate the application of these principles.

Regardless of the form of future SEC, DOL, or banking rules, any efforts by regulators, self-regulatory organizations, professional organizations or private firms to further define fiduciary standards of conduct will likely better the foundations for the emerging investment advisory and/or financial planning professions. These "Standards of Professional Conduct" for "investment advisers" are presented in hope of facilitating such future endeavors.

SECTION 1. TERMINOLOGY.

1.1 "Client" denotes a person, persons, or entity who engages an investment adviser and for whom professional services are rendered for compensation. Where the services of the investment adviser are provided to an entity (corporation, trust, partnership, estate, etc.), the client is the entity, which entity then acts through its legally authorized representative.

1.2 "Investment adviser" refers to any person providing investment advice pursuant to an "investment advisory engagement," and may refer to an individual, the individual's firm (i.e., employer), or both, as the context requires.

The term is *not* limited to the definition of "investment adviser" found in the advisers act, but is intended to be construed far more broadly for purposes of these standards of professional conduct.

"Firm" denotes an individual investment adviser's employer (whether it is a broker-dealer firm, insurance agency or insurance broker or insurance company, registered investment

[121] On Jan. 21, 2011, SEC Staff recommended "that the Commission exercise its rulemaking authority under Dodd-Frank Act Section 913(g), which permits the Commission to promulgate rules to provide that … the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." SEC Study, pp.108-9. This "uniform fiduciary standard" would apply only to registered investment advisers and broker-dealers, and not to ERISA fiduciaries or financial institutions such as banks and trust companies. "The Staff also contemplates that the uniform fiduciary standard would be an overlay on top of the existing investment adviser and broker-dealer regimes and would supplement them, and not supplant them. SEC Staff Study, p. 109. "The Staff interprets the uniform fiduciary standard to include at a minimum, the duties of loyalty and care as interpreted and developed under Sections Advisers Act Section 206(1) and 206(2)." SEC Staff Study, pp.110-111. "In addition, the Staff believes that rulemaking and/or interpretive guidance regarding the uniform fiduciary standard would be useful to both investment advisers and broker-dealers." SEC Staff Study, p.111.

adviser, bank, trust company, or other form of business or non-profit organization), and also includes situations in which the individual investment adviser (as defined herein) is an independent contractor.

1.3 “Reasonable" or "reasonably" when used in relation to conduct by an investment adviser denotes the conduct of a reasonably prudent and competent investment adviser.

SECTION 2 PROFESSIONALISM.

RULE 2.1 REQUIRED KNOWLEDGE OF APPLICABLE LAWS, REGULATIONS, AND STANDARDS OF CONDUCT. INVESTMENT ADVISERS MUST UNDERSTAND AND COMPLY WITH ALL APPLICABLE LAWS, REGULATIONS, AND STANDARDS OF CONDUCT (INCLUDING BUT NOT LIMITED TO THESE INVESTMENT ADVISER STANDARDS OF PROFESSIONAL CONDUCT) OF ANY GOVERNMENT, GOVERNMENT AGENCY, REGULATORY ORGANIZATION, LICENSING AGENCY, OR PROFESSIONAL ASSOCIATION GOVERNING THEIR PROFESSIONAL ACTIVITIES.

IN THE EVENT OF CONFLICT, INVESTMENT ADVISERS MUST COMPLY WITH THE MORE STRICT LAW, REGULATION, OR STANDARD OF CONDUCT, PROVIDED THAT IN ALL EVENTS INVESTMENT ADVISERS SHALL NOT VIOLATE ANY LAW. INVESTMENT ADVISERS MUST NOT KNOWINGLY PARTICIPATE OR ASSIST IN AND MUST DISSOCIATE FROM ANY VIOLATION OF SUCH LAWS, RULES, OR STANDARDS OF CONDUCT.

Commentary.

Investment advisers should understand the entire scope and nature of their broad fiduciary duties of due care, loyalty, and utmost good faith. In addition, investment advisers should consult, where and as applicable, the laws and regulations falling within the purview of the U.S. Securities and Exchange Commission (SEC), the U.S. Department of Labor (DOL/EBSA) the laws and regulations promulgated by various state or territorial securities administrators, the regulations promulgated by FINRA and other self-regulatory organizations and exchanges, any other governmental agency or organization which may regulate the investment adviser and her or his actions, and the ethical standards of other professional organizations to which the investment adviser may belong. Additional laws may apply to the activities of investment advisers, such as Regulation S-P (privacy requirements) and anti-money laundering requirements.

Standard of conduct are collectively to the rules the laws, government regulations, professional association ethical rules and internal principles of a firm that guide the structure, systems, procedures, and day-to-day decisions of the Investment adviser. They also include the rights and entitlements of individuals established by contract or the assumption of a certain status under the law. Hence, these Investment Adviser Rules of Professional Conduct are but one part of a larger puzzle each Investment adviser must apply to his or her conduct.

The provision of investment advice is a profession and should be regulated as such. The purpose of these Investment Adviser Rules of Professional Conduct is to promote the practice by investment advisers as a profession, and an essential aspect of professionalism is the application of positive duties to those who seek to practice in the profession. As stated by John G. Bruhn , Gary Zajac , Ali A. Al-Kazemi , Loren D. Prescott Jr., in their paper "Moral positions and academic conduct: Parameters of tolerance for ethics failure" (Journal of Higher Education, Vol. 73, 2002):

> A profession is defined as an occupation that regulates itself through systematic, required training and collegial discipline; that has a base in technical, specialized knowledge; and that has a service rather than profit orientation, enshrined in a code of ethics (Reader, 1966). Wilson (1942) has suggested six criteria as the framework for a profession: (1) prolonged and specialized training, (2) rigorous standards of licensure, (3) competency tests cannot be simply deduced, (4) absence of contractual terms of work (5) limitation upon the self-interest of the practitioner and an insulation from extraneous matters, (6) positive obligations to the profession and its clientele.

Annotations.

1. *The Investment Adviser as a Professional, Generally.* Generally, the investment adviser is a professional, and as such accepts restraint on his, her or its conduct as a result of acceding to fiduciary status. As stated early on by Adam Smith, the founder of modern capitalism: "Our continual observations upon the conduct of others insensibly lead us to form to ourselves certain general rules concerning what is fit and proper either to be done or to be avoided."[122] The domain of the investment counselor has previously been described as the "investment advisory profession[123] … Clients trust in investment advisers, if not for the protection of life and liberty, at least for the safekeeping and accumulation of property. Bad investment advice may be a cover for stock-market manipulations designed to bilk the client for the benefit of the adviser; worse, it may lead to ruinous losses for the client. To protect investors, the [SEC] insists, it may require that investment advisers, like lawyers, evince the qualities of truth-speaking, honor, discretion, and fiduciary responsibility[124] Early on, Douglas T. Johnston, Vice President of the Investment Counsel Association of America, stated in part: 'The definition of 'investment adviser' … include[s] those firms which operate on a *professional basis* and which have come to be recognized as investment counsel."[125] [*Emphasis added.*] Moreover, the U.S. Securities and Commission's report which led to the adoption of the Advisers Act "stressed the need to improve the *professionalism* of the industry, both by eliminating tipsters and other scam artists and by emphasizing the importance of unbiased advice, which spokespersons for investment counsel saw as distinguishing their profession from investment bankers and brokers."[126] [*Emphasis added.*]

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[122] Adam Smith, THE THEORY OF MORAL SENTIMENTS 109 (1759).

[123] *Lowe v. SEC,* 472 U.S. 181, 229 (1985) (White, J., dissenting opinion).

[124] *Id.*

[125] *Lowe v. SEC,* 472 U.S. 181 (1985), fn. 38.

[126] SEC Staff, "Study on Investment Advisers and Broker Dealers" (Jan. 21, 2011), *citing* Investment Trusts and Investment Companies: Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 477 at 27-30 (1939). [*Emphasis added.*]

2. *Knowledge of Laws and Regulations: Requirements Imposed Upon SEC-Registered Investment Advisers by the Advisers Act.* Various different laws may apply to the conduct of investment advisers. Following is an overview of various requirements; however, this listing is not designed to be all-inclusive. Robert Plaze, Asst. Director of the SEC's Division of Investment Management, notes that "[t]he law governing SEC-registered advisers imposes five types of requirements on an adviser: (i) a fiduciary duty to clients; (ii) substantive prohibitions and requirements; (iii) contractual requirements; (iv) recordkeeping requirements; and (v) administrative oversight by the SEC, primarily by inspection." See Plaze, Robert E., "The Regulation of Investment Advisers by The Securities and Exchange Commission" (2006), at p. 13. Some of the specific requirements imposed upon registered investment advisers include:

   a. *Maintain Books and Records.* Advisers Act Rule 204-2 requires an adviser to maintain business accounting records as well as various specified records that relate to its advisory business. For example, advisers must maintain, among other things, the following:

      (1) General and auxiliary ledgers reflecting asset, liability, reserve, capital, income and expense accounts;

      (2) A memorandum of any order given and instructions received by the adviser from clients for the purchase, sale, delivery or receipt of securities (including terms and conditions of any order, who recommended and placed the order, the account and date of entry and who executed the order);

      (3) Trial balances, financial statements, any internal audit papers relating to adviser's business;

      (4) Original or copies of certain communications sent to or received by the adviser (including responses to requests for detailed investment advice, placement or execution of securities orders, receipt or delivery of securities or funds);

      (5) A list of and documents relating to the adviser's discretionary client accounts (including powers of attorney or grants of authority);

      (6) Copies of publications and recommendations the adviser distributed to 10 or more persons and a record of the factual basis and reasons for the recommendation;

      (7) A record of certain securities transactions in which the adviser or advisory representatives have a direct or indirect beneficial ownership interest.

      (8) Additional records if an investment adviser has custody of client assets;

      (9) Additional records if an investment adviser exercises proxy voting authority with respect to client securities; and

      (10) Additional records if an investment adviser uses a different method for computing "assets under management" in Form ADV Part 2A than that found in Part 1.

   b. *Adopt Safeguards Relating to Custody.* Advisers Act Rule 206(4)-2 regulates the custody practices of investment advisers registered or required to be registered under the Advisers Act. Rule 206(4)-2 requires advisers that have custody of client funds or securities to implement controls designed to protect those client assets from being lost, misused, misappropriated or subject to the advisers' financial reverses, such as insolvency. Generally, the adviser must maintain client funds and securities with "qualified custodians," such as a bank or a broker-dealer, and make due inquiry to ensure that the qualified custodian sends account statements directly to the clients. The adviser must promptly notify its clients as to where and how the funds or securities will be maintained, when the account is opened and following any changes to this information. Generally, all advisers with custody of client assets must undergo an annual surprise examination by an independent public accountant to verify client assets. In addition, if the adviser itself maintains, or if it has custody because a related person maintains, client assets as a qualified custodian, it must obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board.

c. *Possess a Chief Compliance Officer; Fulfill Supervision Requirements; Conduct Annual Reviews.*

(1) Advisers Act Rule 206(4)-7 requires each registered investment adviser to designate a chief compliance officer ("CCO"). The CCO should be knowledgeable about the Advisers Act and have the authority to develop and enforce appropriate compliance policies and procedures for the adviser. *See* Compliance Programs of Investment Advisers and Investment Companies; Investment Advisers Act Release No. 2204 (Dec. 17, 2003) ("Release 2204") (adopting Advisers Act Rule 206(4)-7).

(2) Generally, an investment adviser and its associated persons may be subject to liability for failure reasonably to supervise persons subject to its supervision, with a view to preventing violations of the federal securities laws and their rules and regulations. An adviser will not be deemed to have failed reasonably to supervise if (i) the adviser had established procedures, and a system for applying such procedures, reasonably designed to prevent and detect such violations insofar as practicable, and (ii) the adviser reasonably discharged its supervisory duties and obligations, and had no reasonable cause to believe that the procedures and system were not being complied with.

(3) The SEC requires each adviser to review the effectiveness of the investment adviser's policies and procedures at least annually pursuant to Rule 206(4)-7 "to determine their adequacy and the effectiveness of their implementation. The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures."[127] While the SEC does not specify the activities required as part of the annual review, the process is generally believed to include a comprehensive risk assessment and a conflicts of interest assessment.[128]

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[127] SEC Rel. IA-2204 (2003). "Although the rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments."

[128] "To implement a compliance program reasonably designed to prevent violations of the Advisers Act and rules thereunder, each adviser should identify the risks and conflicts of interest that are relevant to its business. The identification process should be repeatable and firm-wide … Regardless of the process used by an adviser to identify its risks, the end result of the firm's risk assessment process should be an inventory of potential risks that reflects the current environment of the firm. Such an inventory of risks should not be static. In addition to gathering and analyzing information about an adviser's risk assessment process, examiners review the firm's inventory of risks and determine whether it is current and sufficiently comprehensive." SEC Staff, The Evolving Compliance Environment: Examination Focus Areas (April 2009), located at http://sec.gov/info/iaiccco/iaiccco-focusareas.pdf.

d. *IA Policies and Procedures Adoption.* Advisers Act Rule 206(4)-7 requires each registered investment adviser to also adopt and implement written policies and procedures reasonably designed to prevent the adviser and its personnel from violating the Advisers Act. The Commission has stated that an adviser's policies and procedures, at a minimum, should address the following issues to the extent relevant to that adviser:

(1) Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions;

(2) Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients;

(3) Proprietary trading of the adviser and personal trading activities of supervised persons;

(4) The accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements;

(5) Safeguarding of client assets from conversion or inappropriate use by advisory personnel;

(6) The accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;

(7) Marketing advisory services, including the use of solicitors;

(8) Processes to value client holdings and assess fees based on those valuations;

(9) Safeguards for the privacy protection of client records and information; and

(10) Business continuity plans.

e. *Code of Ethics Adoption, Content Requirements.* Each investment adviser that is registered with the Commission or required to be registered with the Commission must also adopt a written code of ethics.[129] At a minimum, the adviser's code of ethics must address the following areas:

(1) *Standards of Conduct*. Set forth a minimum standard of conduct for all supervised persons, which must reflect the adviser's and its supervised persons' fiduciary obligations;[130]

(2) *Compliance with Federal Securities Laws*. Require supervised persons to comply with federal securities laws;

(3) *Personal Securities Transactions*. Require each access person to report his or her securities holdings at the time that the person becomes an access person and at least once annually thereafter and to make a report at least once quarterly of all personal securities transactions in reportable securities to the adviser's CCO or other designated person;

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[129] Advisers Act Section 204A, and Advisers Act Rule 204A-1. *See* SEC Release IA-2256 (July 2, 2004), "Investment Adviser Code of Ethics."

[130] Many investment advisers' Codes of Ethics contain only general language describing the duties of due care, loyalty, and utmost good faith. It is hoped that these suggested Investment Adviser Standards of Professional Conduct may provide the impetus for investment advisers to revise and expand their discussion of fiduciary obligations, for the benefit and education of their investment adviser representatives.

(4) *Pre-approval of Certain Securities Transactions*. Require the CCO or other designated person(s) to pre-approve investments by the access persons in IPOs or limited offerings;

(5) *Reporting Violations*. Require all supervised persons to promptly report any violations of the code to the adviser's CCO or other designated person(s); and

(6) *Distribution and Acknowledgment*. Require the adviser to provide each supervised person with a copy of the code, and any amendments, and to obtain a written acknowledgment from each supervised person of his or her receipt of a copy of the code.

f. *Filings and Disclosures under Form ADV, Parts 1 and 2A and 2B, Generally.* Generally, a registered investment adviser is required to undertake certain filings and disclosures, and to deliver Form ADV, Parts 2A and 2B to clients. See further discussion of this requirement, *infra*.

g. *General Prohibition on Advisory Contract Assignments without Client Consent*. "Any advisory contract entered into by an adviser that is registered or required to be registered with the Commission must provide in substance that it may not be assigned without consent of the client. An assignment generally includes any direct or indirect transfer of an advisory contract by an adviser or any transfer of a controlling block of an adviser's outstanding voting securities. SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.42-4 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf) (citations omitted).

h. *Duties If Voting Proxies.* The Commission adopted Advisers Act Rule 206(4)-6 to address the adviser's fiduciary duties to its clients when the adviser has authority to vote their proxies. In adopting the rule, the Commission stated: "Under the Advisers Act, an adviser, as a fiduciary, owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies." SEC Release IA-2106. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interests of its client and must not subordinate client interests to its own. Additional specific requirements are set forth in Rule 206(3)-6.

2. *Knowledge of Laws and Regulations: State-Registered Investment Advisers.* While state-registered investment advisers are always subject to the broad anti-fraud requirements found in Section 206 of the (federal) Investment Advisers Act of 1940, some state securities regulators vary the specific requirements imposed on state-registered investment advisers and/or impose additional requirements, such as those (in some states) pertaining to bonding (if discretion exists, or if custody exists), net capital requirements, and additional disclosures in Form ADV Parts 2A and 2B. In addition, investment adviser representatives are registered at the state level and generally must pass the Series 65 examination, although certain designations may be accepted by some states in lieu of meeting the exam requirement.

3. *Knowledge of Laws and Regulations: Broker-Dealer / Registered Representative Specific Duties and Obligations.* Broker-dealers possess a large number of rules prohibiting certain conduct, requiring certain determinations, or mandating certain disclosures. In addition to rules pertaining to conflicts of interest, suitability, and others discussed in other sections of these Investment Adviser Rules of Professional Conduct, additional rules exist (this list is not intended to be comprehensive) pertaining to: books and records; financial responsibility (including "net capital" requirements); supervision of

registered representatives and the maintenance of a supervisory system including supervisory control policies and procedures; designation of a chief compliance officer; supervision of outside business activities and private securities transactions; employee competency standards (including certain continuing education requirements); and disclosures of disciplinary information. For a general summary of these requirements, *see* SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), at pages 72-80 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

4. *Knowledge of Laws: ERISA Fiduciaries, Generally.* The requirements of ERISA apply to investment advisers who deal with certain employee benefit plans. ERISA is generally shorthand for the fiduciary rules that apply to private employee benefit plans and certain tax-qualified retirement/savings accounts. In other words, ERISA can refer to either the fiduciary provisions under Title I of ERISA or the prohibited transaction rules under the Code. Certain standards of conduct may be prescribed by ERISA which are beyond those summarized in these Investment Adviser Rules of Professional Conduct (plan document, bonding, co-fiduciary responsibility, trust requirement, indicia of ownership, prohibited transaction rules, etc.). The Department of Labor recently proposed a rule under ERISA that would broadly define the circumstances under which a person is considered to be a "fiduciary" for ERISA purposes by reason of giving investment advice to an employee benefit plan or a plan's participants. Under this proposed rule, which is anticipated to be acted upon by the end of 2011, IRAs and Keoughs *might* be treated as employee benefit plans and subject to ERISA requirements, with certain exceptions and/or grandfathering permitted. As a very general overview of the fiduciary duties arising under ERISA: "[A]n ERISA fiduciary must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a reasonably prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. ERISA requires, among other things, that a fiduciary must diversify a plan's investments so as minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. ERISA also prohibits a number of transactions, particular those involving conflicts of interest between the plan and certain parties in interest." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.88 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) *See* sections following for a discussion of many of the specific obligations of ERISA fiduciaries, although the information contained herein is not designed to be all-inclusive with respect to ERISA's fiduciary requirements.

5. *Knowledge of Laws: Investment Advisers Found Within Banks and Trust Companies.* Those providing investment advisory services (including but not limited to service by the bank or trust company as trustee) are subject to specific duties and obligations arising from bank regulation and/or state common law. SEC Staff recently observed that there may be "differences" in the "standards of care" applicable to the investment advisory activities of banks. SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.89 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.).

6. *Knowledge of Laws: Regulation S-P; Privacy Requirements.* On June 22, 2000, the Securities and Exchange Commission ("SEC") issued its Final Rule regarding the obligation of broker-dealers, investment companies and SEC-registered investment advisers to protect the financial privacy of their consumers. The rule, Regulation S-P, implements the privacy requirements of the Gramm-Leach-

Bliley Act. Regulation S-P is identical in virtually all essential respects to the privacy rules adopted by the federal banking regulators and the Federal Trade Commission ("FTC"). The FTC privacy rule also applies to state-registered investment advisers. All references to the "privacy rule" in this overview apply to both the SEC and FTC rules on privacy. The rule embodies two core principles – notice and the right to opt out. All investment advisers and broker-dealers, among others, must deliver initial and annual privacy notices that describe in general terms the firm's information sharing and collecting practices. Firms that share nonpublic personal information about consumers with nonaffiliated third parties, unless covered by one of the rule's exceptions, must also provide consumers with an opt out notice and a reasonable period of time for the consumer to opt out (30 days). Specific state statutes or regulations (e.g., Massachusetts) may impose additional obligations upon investment advisers with respect to the confidentiality of client information or actions required in the event of breach.

7. *Knowledge of Laws: Patriot Act; Anti-Money Laundering.* The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA PATRIOT ACT") extended the regulations applying the anti-money laundering provisions of the Bank Secrecy Act ("BSA") beyond banks and certain other institutions that offer bank-like services or that regularly deal in cash to financial institutions, such as registered and unregistered investment companies. Money laundering has been defined as a criminal activity that occurs when money from illegal activity is moved through the financial system to make it appear that the funds come from legitimate sources. Money laundering also supports terrorism and terrorist organizations. Money laundering involves three stages: 1. placement – placing funds/cash into the financial system; 2. layering – distancing the illegal funds from their criminal source through complex layers of financial transactions; and 3. integration – illegal funds appear as derived from a legitimate source. In the US anti-money laundering legislation came into existence in 1970 with the Bank Secrecy Act, strengthened in 1986 with the Money Laundering Control Act and brought center stage with the USA PATRIOT ACT after 9/11/2001. In the current climate, not making basic anti-money laundering efforts can expose a business to significant risk to reputation regardless of whether anti-money laundering rules are technically applicable.

RULE 2.2 TRUTHFULNESS. INVESTMENT ADVISERS MUST NOT KNOWINGLY MAKE ANY MISREPRESENTATIONS RELATING TO INVESTMENT ANALYSIS, RECOMMENDATIONS, ACTIONS, OR OTHER PROFESSIONAL ACTIVITIES.

Commentary.

All oral and written statements made by investment advisers, including those made to clients, prospective clients, their representatives, other advisors of the client, other third parties, or the media, must be professional, accurate, balanced, and not misleading in any way.

Annotations.

1. *Advertising Restrictions under Advisers Act Rule 206(4)-1.* "Rule 206(4)-1 generally prohibits any investment adviser that is registered or required to be registered under the Advisers Act from using any advertisement that contains any untrue statement of a material fact or is otherwise false or misleading. As the Commission stated in adopting Advisers Act Rule 206(4)-1, 'when considering the provisions of the rule it should be borne in mind that investment advisers are professionals and should adhere to a stricter standard of conduct than that applicable to merchants, securities are "intricate merchandise,' and clients or prospective clients of investment advisers are frequently unskilled and

unsophisticated in investment matters.' While investment advisers are prohibited under Advisers Act Sections 206(1) and (2) from making any communications to clients that are misleading, the prohibitions in Rule 206(4)-1 apply only to 'advertisements' by advisers, which the Commission defines generally as written (including electronic) or broadcast communications to more than one person that offer advisory services." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.30 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

Advisers Act Rule 206(4)-1(b) defines advertisement for purposes of the rule as "[a]ny notice circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities." A communication covered by the rule may be made to new clients or to existing clients where the purpose is to induce them to renew their advisory contract or subscription. *See Spear & Staff*, 42 S.E.C. 549 (1965). Specific restrictions or rules exist as to performance advertising, the use of testimonials in advertising, representations that charts or formulas or other devices can be used to determine which securities to buy or sell without disclosing the limitations thereof, and referrals to any report or service as free unless it is actually free and without condition of obligation. *See* SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.30-1 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

2. *Broker Dealer Advertising Restrictions.* "Broker-dealers must ensure that their communications with the public are not misleading under the antifraud provisions of the federal securities laws. In addition, FINRA has detailed rules that address broker-dealers' communications with the public and specifically requires broker-dealer communications to be based on principles of fair dealing and good faith and to be fair and balanced. For example, pursuant to FINRA rules, communications with the public must include material facts and qualifications, must not exaggerate or include false or misleading statements, must not predict or project performance, imply that past performance will recur, or make exaggerated or unwarranted claims, opinions or forecasts. FINRA rules also establish disclosure requirements for advertisements and sales literature." *See* SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.70-1 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) (Citations omitted.)

   "In certain circumstances, FINRA rules require that communications with the public be approved by a registered principal of the broker-dealer before distribution to the public. Generally, a registered principal must approve each advertisement, item of sales literature and independently prepared reprint prior to the earlier of its use or filing with FINRA. Moreover, FINRA rules require that certain broker-dealer communications with the public must be filed with FINRA for approval. Broker-dealers are generally required to obtain FINRA pre-approval for advertisements for their first year of advertising. Additionally, FINRA must preapprove certain broker-dealer communications with the public if they relate to: (1) registered investment companies (including mutual funds, variable contracts, continuously offered closed-end funds and unit investment trusts) that include or incorporate performance rankings or performance comparisons; (2) collateralized mortgage obligations; (3) security futures; or (4) bond mutual funds that include bond mutual fund volatility ratings. Further, if after reviewing a member's advertising or sales literature FINRA determines that the member has departed from the standards of Rule 2210, FINRA may require the member to file all, or a portion of its, advertising or sales literature with FINRA for a period of time to be determined by FINRA. Other communications, while not subject to FINRA preapproval, must be filed with FINRA. Specifically, within 10 business days of first use or publication, a broker-dealer generally must file the following with FINRA: (1) advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts, continuously offered closed-end funds, and unit investment trusts); (2) advertisements and sales literature concerning public direct participation programs; (3) advertisements concerning government securities; and (4) any template for written reports produced by, or advertisements and sales literature concerning, an investment analysis tool. Furthermore, FINRA may subject a member's written and electronic communications with the public to a spot-check procedure." *See* SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.71-2 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) (Citations omitted.)

RULE 2.3 SCRUPULOUS HONESTY, AVOIDANCE OF DECEIT, INTEGRITY. INVESTMENT ADVISERS MUST NOT ENGAGE IN ANY PROFESSIONAL CONDUCT INVOLVING DISHONESTY, FRAUD, OR DECEIT OR COMMIT ANY ACT THAT REFLECTS ADVERSELY ON THEIR PROFESSIONAL REPUTATION, INTEGRITY, OR COMPETENCE. IN THE COURSE OF REPRESENTING A CLIENT AN INVESTMENT ADVISER SHALL NOT KNOWINGLY MAKE A FALSE STATEMENT OF MATERIAL FACT OR LAW TO A THIRD PERSON.

INVESTMENT ADVISERS SHOULD DISCLOSE MATERIAL FACTS TO A THIRD PERSON WHEN DISCLOSURE IS NECESSARY IN ORDER TO AVOID ASSISTING A CRIMINAL OR FRAUDULENT ACT BY A CLIENT.

Commentary.

As to clients, investment advisers should not defraud any client in any manner nor at any time. Investment advisers should not mislead any client, whether by affirmative statement or by making a statement that omits material facts. Investment advisers should not engage in any act, practice or course of conduct which operates or would operate as a fraud or deceit upon a client. Investment advisers should not engage in any manipulative practice with respect to a client.

As to third parties, investment advisers should not assist any client in the undertaking of a criminal or fraudulent act or practice. Nor should investment advisers mislead third parties, whether by affirmative statement or by making a statement that omits material facts.

To maintain and broaden public confidence, investment advisers should perform all of their professional responsibilities with the highest sense of integrity. Integrity is an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions.

Integrity requires an investment adviser to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain an advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle. Integrity requires an investment adviser to observe the fiduciary duties of loyalty and of due care owed to all clients.

Because of the difficulties often encountered in suppressing motivations when an economic interest adverse to the client's interest is present, investment advisers should seek, when appropriate, opinions from third parties (such as other investment advisers) to ensure that the decision made by the investment adviser keeps the clients' best interests paramount at all times.

Ethical codes, including these Investment Adviser Rules of Professional Conduct, are limited in nature. These Investment Adviser Rules of Professional Conduct greatly oversimplify the hard questions which may confront the investment adviser. In the mind of the investment adviser, issues of professional responsibility should not be resolved as if they were issues of statutory construction. Rather, integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, an investment adviser should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and the spirit of technical laws, regulations and rules of professional conduct; circumvention of laws, regulations or rules of professional conduct constitutes subordination of judgment.

<u>**Annotations**</u>

1. <u>*The Requirement of Truthfulness Under ERISA.*</u>
   a. "When an ERISA plan administrator speaks in its fiduciary capacity concerning a material aspect of the plan, it must speak truthfully." *McCall v. Burlington N./Santa Fe Co.*, 237 F.3d 506, 510 (5th Cir.2000).
   b. "ERISA requires a "fiduciary" to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries." ERISA § 404(a). To participate knowingly and significantly in deceiving a plan's beneficiaries in order to save the employer money at the beneficiaries' expense, is not to act "solely in the interest of the participants and beneficiaries." As other courts have held, "[l]ying is inconsistent with the duty of loyalty owed by all fiduciaries and codified in section 404(a)(1) of ERISA*," Peoria Union Stock Yards Co. v. Penn Mut. Life Ins. Co.*, 698 F.2d 320, 326 (C.A.7 1983). *See also Central States*, 472 U.S., at 570-571, 105 S.Ct., at 2840-2841 (ERISA fiduciary duty includes common-law duty of loyalty); Bogert & Bogert, Law of Trusts and Trustees § 543, at 218-219 (duty of loyalty requires trustee to deal fairly and honestly with beneficiaries); 2A Scott & Fratcher, Law of Trusts § 170, pp. 311-312 (same); Restatement (Second) of Trusts § 170 (same). Because the breach of this duty is sufficient to uphold the decision below, we need not reach the question of whether ERISA fiduciaries have any fiduciary duty to disclose truthful information on their own initiative, or in response to employee inquiries." *Varity Corp. v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996).

<u>RULE 2.4. NO INSIDER TRADING / PROHIBITIONS DESIGNED TO PROTECT INTEGRITY OF THE CAPITAL MARKETS</u>. INVESTMENT ADVISERS WHO POSSESS MATERIAL NONPUBLIC INFORMATION THAT COULD AFFECT THE VALUE OF AN INVESTMENT MUST NOT ACT OR CAUSE OTHERS TO ACT ON THE INFORMATION. INVESTMENT ADVISERS MUST NOT ENGAGE IN PRACTICES THAT DISTORT PRICES OR ARTIFICIALLY INFLATE TRADING VOLUME WITH THE INTENT TO MISLEAD MARKET PARTICIPANTS.

<u>Commentary.</u>

Investment advisers should not engage in any manipulative practice with respect to securities, including price manipulation or insider trading.

<u>Annotations.</u>

1. In 1997 the U.S. Supreme Court adopted the misappropriation theory of insider trading *in United States v. O'Hagan*, 521 U.S. 642, 655 (1997). O'Hagan was a partner in a law firm representing Grand Metropolitan, while it was considering a tender offer for Pillsbury Co. O'Hagan used this inside information by buying call options on Pillsbury stock, resulting in profits of over $4 million. O'Hagan claimed that neither he nor his firm owed a fiduciary duty to Pillsbury, so that he did not commit fraud by purchasing Pillsbury options. The Court rejected O'Hagan's arguments and upheld his conviction. The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of the information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.
2. In 2000, the SEC enacted Rule 10b5-1, which defined trading "on the basis of" inside information as any time a person trades while aware of material nonpublic information – so that it is no defense for one to say that she would have made the trade anyway. This rule also created an affirmative defense for pre-planned trades.
3. Exchange Act Section 15(f) generally requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the firm or its associated persons from misusing material non-public information (*i.e.*, insider trading).
4. Under Section 204A of the Investment Advisers Act of 1940, a registered investment adviser "... shall establish, maintain and enforce written policies and procedures reasonably designed ... to prevent the misuse ... of material, nonpublic information by such investment adviser or any person associated with such investment adviser."

RULE 2.5 ROLE OF INVESTMENT ADVISER - AS AN ADVISOR. IN REPRESENTING A CLIENT AN INVESTMENT ADVISER SHALL EXERCISE INDEPENDENT PROFESSIONAL JUDGMENT AND RENDER CANDID ADVICE. IN RENDERING SUCH ADVICE AN INVESTMENT ADVISER MAY REFER NOT ONLY TO CORE COMPETENCIES ACHIEVED BY THE INVESTMENT ADVISER BUT TO OTHER CONSIDERATIONS SUCH AS MORAL, HEALTH, ECONOMIC, FAMILIAL, SOCIAL AND POLITICAL FACTORS THAT MAY BE RELEVANT TO THE CLIENT'S SITUATION.

An investment adviser frequently provides advice not just on investment strategies and investment products, but on a broad variety of economic, family, and personal issues affecting the goals, hopes and dreams of clients. Taking into account all of the factors pertinent to a client's situation is not only permitted, but encouraged.

SECTION 3. FIDUCIARY DUTY OF LOYALTY TO CLIENTS.

RULE 3.1. GENERAL DUTY OF LOYALTY TO CLIENTS. AN INVESTMENT ADVISER, WHO IS GIVEN THE HIGHEST DEGREE OF TRUST AND CONFIDENCE BY THE INVESTMENT ADVISER'S CLIENT, IS A FIDUCIARY AND POSSESSES THE DUTY OF UNDIVIDED LOYALTY TO THE CLIENT. AN INVESTMENT ADVISER SHALL AT ALL TIMES ACT IN THE BEST (OR SOLE) INTEREST OF HIS OR HER CLIENTS, OBEDIENTLY, IN UTMOST GOOD FAITH, HONESTLY AND WITHOUT INTIMIDATION.

Commentary.

Fiduciaries have a duty, created by undertaking certain types of acts, to act primarily for the benefit of another in matters connected with such undertaking. We utilize the term "fiduciary" to mark certain relationships where a party with superior knowledge and information acts on behalf of one who usually does not possess such knowledge and information. The provision of investment advice is such a relationship, as learning the personal details of a client's financial affairs, their hopes, dreams, and aspirations cultivates a confidential and intimate relationship. In these relationships the person with the dominant position (the "fiduciary") acts as if the interests of the other party (the “entrustor” or “client”) were the fiduciary's own.

The greater the knowledge, experience and required degree of expertise of the fiduciary, relative to the knowledge and experience of the client, the more significant the fiduciary association becomes as a protector of the client's interest. Clients in receipt of investment advice will nearly always start off, in their discussions with investment advisers, from a position of contractual weakness and, as to the complexities of tax law, financial planning issues, estate planning issues, insurance, risk management issues, and investments, from the position of relative ignorance. Fiduciary status is thereby imposed by the law upon the party with the greater knowledge and expertise, in this instance the investment adviser, in recognition by the law that the client is in need of protection and care.

Each party to a fiduciary relationship possesses the opportunity to consent to the relationship or to terminate the relationship. Fiduciary rules therefore reflect a consensual arrangement covering special situations in which fiduciaries promise to perform services for clients and receive substantial power to effectuate the performance of the services in circumstances in which the clients cannot efficiently monitor the fiduciaries' performance.

The duty of loyalty is a duty imposed upon an investment adviser, as the investment adviser possesses a fiduciary relationship to his or her client. Investment advisers must take only those actions that are within the best interests of the client. The fiduciary should not act in the fiduciary's own interest. Engaging in self-dealing, misappropriating a client's assets or opportunities, having material conflicts of interest, or otherwise profiting in a transaction that is not substantively or "entirely fair" to the client may give rise breaches of the duty of loyalty. High standards of conduct are required when advising on other people's money.

Traditionally, the duty of utmost good faith has been closely related to the concept of loyalty. However, reckless, irresponsible or irrational conduct – but not necessarily self-dealing conduct – will implicate concepts of good faith and cause an investment adviser to be in breach of this Rule. Utmost good faith has also been utilized to refer to the requirement of the investment adviser to be completely candid and forthright with his or her client.

Honesty is fundamental to the role of the fiduciary. It means that the investment adviser must act bona fide in the (sole or best) interests of the client. In exercising the investment adviser's discretion, the investment adviser should act only to promote and advance the (sole or best) interests of the client.

Investment advisers shall not engage in heavy-handed sales pressure or intimidation with either clients or prospective clients who seek investment advice.

Annotations.

1. *The Duty of "Utmost Good Faith."*

   a. An investment adviser possesses a duty of utmost good faith. *SEC vs. Capital Gains Research Bureau*, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963) ("Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." *Id.* at 194.)

   b. "Duty to Act in Good Faith: An adviser must –

      Act honestly toward clients with candor and utmost good faith.

      Examples of this might include –

      - being truthful and accurate in all communications and disclosures
      - being forthright about issues, mistakes and conflicts of interest
      - providing fund directors with all information in the adviser's possession that reasonably bears on a board decision, particularly where the adviser has a personal interest in the outcome or similar conflict of interest

      Treat clients fairly.

      Examples of this might include –

      - avoiding favoritism of one client or group of clients over another in handling investment opportunities and trade allocations
      - adopting investment opportunity and trade allocation procedures and applying them consistently over time so that no client or group of clients is systematically disadvantaged
      - allocating shared costs across accounts using a rational methodology applied consistently over time

- seeking a fair and prompt resolution of all legitimate client complaints"

Lorna A. Schnase, An Investment Adviser's Fiduciary Duty (Aug. 1, 2010), at p.5, available at http://www.40actlawyer.com/Articles/Link3-Adviser-Fiduciary-Duty-Paper.pdf.

2. *The "Duty of Obedience."*

   a. "Conventional theory holds that the fiduciary relationship comprises two fundamental duties, care and loyalty. This paper argues that a third duty, obedience, is more basic, the foundation on which the duties of care and loyalty ultimately rest. In place of the prevailing dualistic theory of fiduciary duty, it offers a trinitarian alternative. As the trinitarian metaphor implies, the claim here is that, properly understood, three identifiably different elements are functionally distinct yet essentially one … The duty of obedience is often overlooked or reduced to one of the other two fundamental fiduciary duties, precisely because it is so basic as to be almost invisible. To see why this is so, we need to examine the very foundation of fiduciary duty. The irreducible root of the fiduciary relationship is one person's acting for another. The duty of obedience derives directly from – indeed, is virtually synonymous with – that basic principle." Rob Atkinson, Rediscovering the Duty of Obedience: Toward a Trinitarian Theory of Fiduciary Law (2008).

   b. "A comprehensive list of an adviser's fiduciary duties is not found in either the common law or the Advisers Act. However, duties of care and loyalty are among the basic fiduciary duties advisers are generally held to owe their clients, at a minimum. Some authorities also list a duty of obedience. Still others refer to a duty to act in good faith, and a duty of disclosure. … See, for example, "Will the Investment Company and Investment Advisory Industry Win an Academy Award?" remarks of Kathryn B. McGrath, Director of the SEC Division of Investment Management, at the 1987 Mutual Funds and Investment Management Conference ("McGrath Remarks"), citing Scott, The Fiduciary Principle, 37 Calif. L. Rev. 539, 544 (1949), at p.7: "The words 'fiduciary duty' refer to the duties, of first, obedience to the terms of one's trust, second, diligence and care in the carrying out of one's fiduciary functions, and third, undivided loyalty to the beneficiaries of one's trust." Other authorities do not list the duty of obedience separately, but rather consider it within the framework of the other basic duties of care and loyalty." Lorna A. Schnase, An Investment Adviser's Fiduciary Duty (Aug. 1, 2010), at p.5, available at http://www.40actlawyer.com/Articles/Link3-Adviser-Fiduciary-Duty-Paper.pdf. Ms. Schnase illustrates, as an example of adherence to the duty of obedience, that an investment adviser must "Follow any instructions or guidelines provided by the client … Examples of this might include – adhering to instructions from clients concerning impermissible investments (such as socially-screened investments), managing their accounts (such as approved brokers or directed brokerage) and handling transactions in their accounts (such as account transfers, liquidations, added assets, tax lot considerations, etc.)." *Id.* at p.11.

3. *The "Best Interests" Standard Found under the Advisers Act, Generally.*

   a. The U.S. Securities and Exchange Commission's early comments regarding the necessity for imposition of fiduciary duties on those who provide investment advice upon learning the details of a client's financial affairs should not go unnoticed: "The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice 'in almost every instance.' This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients." *In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948). Note that Ms. Hughes was dually registered as both a broker and an investment adviser under the federal securities laws.

b. "An essential feature and consequence of a fiduciary relationship is that the fiduciary becomes bound to act in the interests of her beneficiary and not of herself." *In re Prudential Ins. Co. of America Sales Prac.*, 975 F.Supp. 584, 616 (D.N.J., 1996).

c. "The duty of loyalty requires an adviser to serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.22 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.), *citing* Transamerica Mortgage Advisors, Inc., 444 U.S. 11, 17 (1979).

4. *The (Modified) Sole Interests Standard Applicable under ERISA.* In contrast to the "best interests" standard traditionally imposed upon investment advisers and financial planners under the Investment Advisers Act of 1940 and state common law, ERISA generally imposes a "sole interests" loyalty obligation.

   a. Section 404(a) of ERISA, which sets out the primary duties of fiduciaries, provides, in relevant part: "[A]fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying the reasonable expenses of administering the plan …." *See also Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818 (C.D. Ill., 2004) ("Under the section 404(a) duty of loyalty, ERISA fiduciaries must act 'solely in the interest of plan participants and beneficiaries' … for the 'exclusive purpose' of providing benefits to them."). *Id.* at 863.

   b. However, ERISA recognizes that a plan administrator may wear "two hats," albeit not at the same time. See discussion under Rule 3.2, Annotations, #6, *infra*.

5. *Conflicts of Interest and the Modern Large Financial Services Firm.* "The standard of conduct required of the fiduciary is not diminished by reason of its organizational structure." Tuch, Andrew, "The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife with Conflicts of Interest" (January 2008) (Australia) (noting "When an investment bank performs one of its traditional functions – underwriting securities offerings or providing financial advisory services to clients involved in mergers, acquisitions and other strategic transactions – it may under general law be a fiduciary of its client and thereby be required to avoid positions of conflict without its client's informed consent. Yet the conglomerate structure of the firm may make conflicts of interest an inescapable feature of its doing business."

6. *The Problem of Wearing "Two Hats" at the Same Time.* The difficulties of reconciling fiduciary duties when dual interests are to be served has not gone unnoticed by commentators and jurists over the many years in which fiduciary principles have been applied.

   a. "I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults 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.'" Harlan Stone (future Chief Justice of the U.S. Supreme Court), The Public Influence of the Bar (1934) 48 Harv. L.Rev. 1, 8-9.

   b. In *Bayer v. Beran*, 49 N.Y.S.2d 2, Mr. Justice Shientag said: "The fiduciary has two paramount obligations: responsibility and loyalty. * * * They lie at the very foundation of our whole system of free private enterprise and are as fresh and significant today as when they were formulated decades ago. * * * While there is a high moral purpose implicit in this transcendent fiduciary principle of undivided loyalty, it has back of it a profound understanding of human nature and of its frailties. It actually accomplishes a practical, beneficent purpose. It tends to prevent a clouded conception of fidelity that blurs the vision. It preserves the free exercise of judgment uncontaminated by the dross of divided allegiance or self-interest. It prevents the operation of an influence that may be indirect but that is all the more potent for that reason."

RULE 3.2. REASONABLE AVOIDANCE OF CONFLICTS OF INTEREST. INVESTMENT ADVISERS MUST USE REASONABLE CARE AND JUDGMENT TO ACHIEVE AND MAINTAIN INDEPENDENCE AND OBJECTIVITY IN THEIR PROFESSIONAL ACTIVITIES.

INVESTMENT ADVISERS MUST REASONABLY ACT TO AVOID CONFLICTS OF INTEREST; WHEN OPERATING UNDER ERISA INVESTMENT ADVISERS MUST AVOID CERTAIN CONFLICTS OF INTEREST.

INVESTMENT ADVISERS MUST NOT OFFER, SOLICIT, OR ACCEPT ANY GIFT, BENEFIT, COMPENSATION, OR CONSIDERATION THAT REASONABLY COULD BE EXPECTED TO COMPROMISE THE INVESTMENT ADVISER'S OWN OR ANOTHER'S INDEPENDENCE AND OBJECTIVITY.

Commentary.

"A fiduciary cannot serve two masters." The fundamental truth of this statement cannot be ignored. Yet, conflicts of interest can and do exist in financial services. Where they arise or might arise, conflicts of interest are addressed through one of four means[131]:

[131] In its recent Study, the SEC Staff recommended that the "Commission should consider whether rulemaking would be appropriate to prohibit certain conflicts, to require firms to mitigate conflicts through specific action, or to impose specific disclosure and consent requirements." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.118 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) Of course, the non-imposition of any requirements effects the "fourth option" described in this commentary.

1. First, an express prohibition of the conflict of interest;

   In various contexts, certain conflicts of interest are prohibited by application of the "sole interests" standard under ERISA, by ERISA's "prohibited transaction rules," by SEC rules or decisions, or judicial precedent.

   However, SEC Staff recently noted, in its "Staff Study on Investment Advisers and Broker-Dealers" (Jan. 21, 2011), that in its view there are no particular conflicts of interest which are prohibited. SEC Staff wrote: "While the duty of loyalty requires a firm to eliminate or disclose material conflicts of interest, it does not mandate the absolute elimination of any particular conflicts, absent another requirement to do so." SEC Staff Study, p. 113. Prohibiting certain conflicts of interest is now restricted, to a degree, by federal statute. The SEC Staff observes: "Dodd-Frank Act Section 913(g) expressly provides that the receipt of commission-based compensation, or other standard compensation, for the sale of securities does not, in and of itself, violate the uniform fiduciary standard as applied to a broker-dealer. It also provides that the uniform fiduciary standard shall not require broker-dealers to have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice. Moreover, as discussed below, while the uniform fiduciary standard would affect certain aspects of principal trading, it would not in itself impose the principal trade provisions of Advisers Act Section 206(3) on broker-dealers. In addition, Dodd-Frank Act Section 913 provides that offering only proprietary products by a broker-dealer shall not, in and of itself, violate the uniform fiduciary standard, but may be subject to disclosure and consent requirements." *Id.*

   It is difficult to reconcile the SEC Staff's general statement that no "particular conflicts" must be prohibited, when existing rules or decisions under the Advisers Act effect just such a result, such as the prohibition on performance fees being utilized for most retail clients. Additionally, the SEC Staff later notes that "the Commission could consider whether rulemaking would be appropriate to prohibit certain conflicts." SEC Staff Study, p.117.

2. By the requirement to mitigate or "properly manage" the conflict of interest, usually coupled with a disclosure requirement.

3. By undertaking disclosure requirements arising to the level required by general fiduciary principles;

   As discussed by SEC Staff in its Jan. 21, 2011 Study: "Dodd-Frank Act Section 913(g) recognizes the importance of such disclosure, and directs the Commission to 'facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest … the Staff recommends that the Commission explore the utility and feasibility of a summary disclosure document that would describe in clear, summary form, a firm's services (including the extent to which its advice is limited in time or is continuous and ongoing), charges, and conflicts of interest.'" SEC Staff Study, p.116.

   The SEC Staff also observes: "Another important issue to consider is the timing of customer disclosure. The Staff believes that retail customers would benefit from receiving certain disclosures, such as information about the firm's conflicts of interest, fees, scope of services, and disciplinary information, before or at the time of entering into a customer relationship, with annual updating disclosures thereafter (as is the case with Form ADV Part 2A). Other disclosures about a product, risks, compensation or any specific conflicts could be more effective at the point when personalized investment advice is given." SEC Staff Study, pp.116-7.

4. By not imposing any additional obligation – disclosure or otherwise - at all, or by mandating only "casual disclosures" (such as "I may possess a conflict of interest" or "my interests may not be the same as yours").

While the "best interests" fiduciary standard often permits disclosure of a conflict of interest followed by the informed consent of the client, it should be noted that the existence of conflicts of interest, even when they are fully disclosed, can serve to undermine the fiduciary relationship and the relationship of trust and confidence with the client. The existence of substantial or numerous conflicts of interest, which otherwise could have been reasonably avoided by the investment adviser, could lead to not only an erosion of the investment adviser's relationship with the client, but also an erosion of the reputation of the investment advisory profession. Hence, investment advisers shall reasonably act to avoid conflicts of interest.

Investment advisers should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering investment advice.

Many types of compensation are permissible under these Investment Adviser Rules of Professional Conduct, including commissions, a percentage of assets under management, a flat or retainer fee, hourly fees, or some combination thereof. However, the term "independence" requires that the investment adviser's decision is based on the best interests of the client rather than upon extraneous considerations or influences that would convert an otherwise valid decision into a faithless act. An investment adviser would not be independent if the investment adviser is dominated or beholden to or affiliated with an individual or entity interested in the transaction at issue and is so under their influence that the investment adviser's discretion and judgment would be sterilized. Compensation arrangements which vary the investment adviser's compensation depending upon the investment strategy or products recommended by the investment adviser to the client creates such a severe conflict of interest that investment advisers should act to reasonably avoid such arrangements.

A conflict of interest occurs when the personal interests of the investment adviser or the investment adviser's firm interferes or could potentially interfere with the investment adviser's responsibilities to his, her or its clients. Hence, investment advisers should not accept inappropriate gifts, favors, entertainment, special accommodations, or other things of material value that could influence their decision-making or make them feel beholden to a person or firm. Similarly, investment advisers should not offer gifts, favors, entertainment or other things of value that could be viewed as overly generous or aimed at influencing decision-making, or making a client feel beholden to the firm. *De minimis* gifts are excluded, as they would not materially affect the relationship with the client or third parties.

<u>**Annotations.**</u>

1. <u>*Investment Advisers' Inherent Difficulties in Managing Conflicts of Interest.*</u> There is both early authority and very recent academic research indicating that investment advisers should, to truly act in the best interests of their client, avoid conflicts of interest to the extent reasonable to do so.

a. "The temptation of self interest is too powerful and insinuating to be trusted. Man cannot serve two masters; he will foresake the one and cleave to the other. Between two conflicting interests, it is easy to foresee, and all experience has shown, whose interests will be neglected and sacrificed. The temptation to neglect the interest of those thus confided must be removed by taking away the right to hold, however fair the purchase, or full the consideration paid; for it would be impossible, in many cases, to ferret out the secret knowledge of facts and advantages of the purchaser, known to the trustee or others acting in the like character. The best and only safe antidote is in the extraction of the sting; by denying the right to hold, the temptation and power to do wrong is destroyed." *Thorp v. McCullum,* 1 Gilman (6 Ill.) 614, 626 (1844).

b. "Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are honestly disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse." Cain, Daylian M., Loewenstein, George, and Moore, Don A., "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest"(2003).

2. *The "No Conflict" and "No Profit" Rules under the Common Law; These Rules Also Exist Within The Advisers Act.* The rules applicable to fiduciaries under the common law include the "no conflict rule," which prevents a fiduciary placing himself or herself in a position where his or her own interests conflict or may conflict with those of the client. The "sole interests" standard generally requires avoidance of conflicts of interest, while the "best interests" standard permits some conflicts of interest provided they are properly managed.

The common law rules applicable to fiduciaries also include the "no profit rule," which requires a fiduciary not to profit from his position at the expense of his or her client. At times the no profit rule has been strictly enforced, even to the point of overturning transactions between fiduciaries and their clients where no extra profit was derived by the fiduciary above that which other market participants would have derived.

a. "[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." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-2 (1963).

b. "The IAA arose from a consensus between industry and the SEC 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.'" *Financial Planning Association v. Securities and Exchange Commission*, No. 04-1242 (D.C. Cir. 3/30/2007) (D.C. Cir., 2007*), citing SEC vs. Capital Gains* at 187.

3. *Securities Laws and FINRA Prohibit Certain Conflicts of Interest.* "The federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present

particularly acute potential conflicts of interest. For example, FINRA rules generally prohibit a member with certain 'conflicts of interest' from participating in a public offering, unless certain requirements are met. FINRA members also may not provide gifts or gratuities to an employee of another person to influence the award of the employer's securities business. FINRA rules also generally prohibit a member's registered representatives from borrowing money from or lending money to any customer, unless the firm has written procedures allowing such borrowing or lending arrangements and certain other conditions are met. Moreover, the Commission's Regulation M generally precludes persons having an interest in an offering (such as an underwriter or broker-dealer and other distribution participants) from engaging in specified market activities during a securities distribution. These rules are intended to prevent such persons from artificially influencing or manipulating the market price for the offered security in order to facilitate a distribution." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.58-9 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) (Citations omitted.) "FINRA rules also establish restrictions on the use of non-cash compensation in connection with the sale and distribution of mutual funds, variable annuities, direct participation program securities, public offerings of debt and equity securities, and real estate investment trust programs. These rules generally limit the manner in which members can pay for or accept non-cash compensation and detail the types of non-cash compensation that are permissible." *Id.* at p.68.

4. *Advisers Act's Prohibition against Registered Investment Adviser "Performance Fees" and "Contingent Fees."* In recognition of the extreme conflicts of interest present, and the potential for abuse, the SEC generally prohibits "performance fees" being charged by registered investment advisers. "Generally, investment advisers that are registered or required to be registered with the Commission are prohibited by Advisers Act Section 205(a)(1) from entering into a contract with any client that provides for compensation based on a share of the capital gains or appreciation of a client's funds, i.e., a performance fee. Section 205(a)(1) is designed, among other things, to eliminate 'profit sharing contracts [that] are nothing more than 'heads I win, tails you lose' arrangements,' and that 'encourage advisers to take undue risks with the funds of clients,' to speculate, or to overtrade. There are several exceptions to the prohibition, mostly applicable to advisory contracts with institutions and high net worth clients." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.41-2 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

5. *Duties Arising under ERISA When a Conflict of Interest Exists.*

    a. "When a conflict exists for fiduciaries of a retirement plan that is governed by ERISA, two distinct sets of ERISA requirements are implicated: (1) the rules governing breaches of fiduciary duty found in ERISA §404(a) and (2) the prohibited transaction rules in ERISA §§406(a) and (b) … Fiduciaries are obligated under ERISA's fiduciary responsibility rules to (1) identify conflicts (or potential conflicts) that may impact the management of a plan; (2) evaluate those conflicts and the impact they may have on the plan and its participants; (3) determine whether the conflicts will adversely impact the plan; (4) consider protections that would protect the plan and participants from any potential adverse affect of the conflict (for instance, appointing an independent fiduciary to evaluate the investment or proposed service provider) and; (5) if the conflict adversely impacts the plan and its participants, change service providers, investments or other circumstances related to the conflict.

Although a conflict of interest may exist in connection with a proposed transaction, entering into the transaction may or may not be a breach of fiduciary duty – the determining factors are whether the fiduciary prudently evaluates the conflict, and acts solely in the interest of the participants and for the exclusive purpose of providing benefits. If material adverse impact on the participants cannot be avoided or properly mitigated, entering into the transaction would not be prudent and would trigger a fiduciary breach.

Furthermore, if a conflict of interest is precluded under ERISA's prohibited transaction rules, the fiduciaries cannot, as a matter of law, allow the plan to become a party to the transaction – even if the action were otherwise reasonable or profitable to the plan." C. Frederick Reish And Joseph C. Faucher, The Fiduciary Duty to Avoid Conflicts of Interest in Selecting Plan Service Providers (April 2009), available at http://www.reish.com/publications/pdf/whitepprmar09.pdf.

6. *ERISA Permits Certain Conflicts of Interest to Exist.*

a. *Certain Adverse Financial Interests Permitted, Generally.* "Comparing a traditional trustee to an ERISA fiduciary, the [U.S. Supreme Court in *Pegram v. Herdrich*, 530 U.S. 211, 120 S.Ct. 2143, 2151, 147 L.Ed.2d 164 (2000)] explained that while a traditional fiduciary "is not permitted to place himself in a position where it would be for his own benefit to violate his duty to the beneficiaries ... [u]nder ERISA ... a fiduciary may have financial interests adverse to beneficiaries." *Pegram*, 120 S.Ct. at 2152 (citing 2A A. Scott & W. Fratcher, Trusts § 170, p. 311 (4th ed.1987))." *In re Dynegy, Inc. Erisa Litigation*, 309 F.Supp.2d 861 (S.D. Tex., 2004).

b. *ERISA's Two Hats Doctrine.* "Comparing a traditional trustee to an ERISA fiduciary, the *Pegram* Court explained that while a traditional fiduciary "is not permitted to place himself in a position where it would be for his own benefit to violate his duty to the beneficiaries ... [u]nder ERISA ... a fiduciary may have financial interests adverse to beneficiaries." *Pegram*, 120 S.Ct. at 2152 (citing 2A A. Scott & W. Fratcher, Trusts § 170, p. 311 (4th ed.1987)). See also Bussian, 223 F.3d at 294-295; Martinez, 338 F.3d at 412-413. "Employers, for example, can be ERISA fiduciaries and still take actions that disadvantage employee beneficiaries when they act as employers (e.g., firing a beneficiary for reasons unrelated to the ERISA plan), or even as plan sponsors (e.g., modifying the terms of a plan as allowed by ERISA to provide less generous benefits)." *Id. See also Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 115 S.Ct. 1223, 1228, 131 L.Ed.2d 94 (1995) (recognizing that a plan sponsor may function in a dual capacity as a business employer (i.e., settlor or plan sponsor) whose activity is not regulated by ERISA, and as a fiduciary of its own established ERISA plan whose activity is regulated by ERISA). *Pegram* and other courts recognize that [t]he law does not require employers to establish employee benefit plans. Congress sought to encourage employers to set up plans voluntarily by offering tax incentives, methods to limit fiduciary liability, means to contain administrative costs, and giving employers flexibility and control over matters such as whether or when to establish an employee benefit plan, how to design a plan, how to amend a plan, when to terminate a plan, all of which are generally viewed as business decisions of a settlor, not of a fiduciary, and thus not subject to fiduciary obligations. *In re Enron Corporation Securities, Derivative & "ERISA" Litigation*, 284 F.Supp.2d 511, 551 (S.D.Tex.2003) (*citing Pegram*, 120 S.Ct. at 2153). In *Pegram* the Court also recognized that there exists no "apparent reason in the ERISA provisions to conclude ... that this tension is permissible only for the employer or plan sponsor, to the exclusion of persons who provide services to an ERISA plan." 120 S.Ct. at 2152." *In re Dynegy, Inc. Erisa Litigation*, 309 F.Supp.2d 861, 873-4 (S.D. Tex., 2004)

c. *But – Wear Only One Hat at a Time.* "ERISA does require, however, that a fiduciary with two hats wear only one at a time, and wear the fiduciary hat when making fiduciary decisions." [*Pegram*, 120 S.Ct. at 2152] (*citing Hughes*, 119 S.Ct. at 763, and *Varity Corp. v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996)). Thus, ERISA does not define "fiduciaries simply as administrators of the plan, or managers or advisers... [i]nstead, it defines an administrator, for example, as a fiduciary only `to the extent' that he acts in such a capacity in relation to a plan." *Id.* (citing 29 U.S.C. § 1002(21)(A)). *See also Martinez*, 338 F.3d at 412-413. In every case charging breach of ERISA fiduciary duty, then, the threshold question is not whether the actions of some person employed to provide services under a plan adversely affected a plan beneficiary's interest, but whether that person was acting as a fiduciary (that is, was performing a fiduciary function) when taking the action subject to complaint. *Pegram*, 120 S.Ct. at 2152-2153. *In re Dynegy, Inc. Erisa Litigation*, 309 F.Supp.2d 861, 874-5 (S.D. Tex., 2004).

RULE 3.3 DISCLOSURE OF MATERIAL FACTS, AND PROPER MANAGEMENT OF NON-AVOIDED CONFLICTS OF INTEREST.

(A) INVESTMENT ADVISERS SHALL DISCLOSE ALL MATERIAL FACTS TO THEIR CLIENTS WHEN REQUIRED TO DO SO.

(B) INVESTMENT ADVISERS SHALL DISCLOSE TO CLIENTS ALL MATERIAL CONFLICTS OF INTEREST WHICH REMAIN FOLLOWING THE INVESTMENT ADVISER'S REASONABLE EFFORTS UNDERTAKEN TO AVOID CONFLICTS OF INTEREST. HOWEVER, DISCLOSURE OF CONFLICTS OF INTEREST DOES NOT DEFEAT THE CONTINUING DUTY TO ACT IN THE BEST INTERESTS OF THE CLIENT.

(C) ACCORDINGLY, INVESTMENT ADVISERS SHALL ADOPT AND ADHERE TO REASONABLE POLICIES AND PROCEDURES FOR THE MANAGEMENT OF REMAINING CONFLICTS OF INTEREST IN ORDER THAT THE INVESTMENT ADVISER CONTINUES TO ACT IN THE BEST INTERESTS OF THE CLIENT. THESE INCLUDE, BUT IS NOT LIMITED TO, THE ADOPTION AND PERIODIC REVISION OF A CODE OF ETHICS, APPROPRIATE COMPLIANCE POLICIES AND PROCEDURES, AND SOUND CLIENT ENGAGEMENT PRACTICES.

Commentary.

Does there exist, under the common law applying fiduciary principles, a general duty "to disclose" material facts? Generally, no. Rather, the disclosure of material facts is seen as an element of the defense of the fiduciary when a conflict of interest exists. In other words, where a conflict of interest exists, a duty of disclosure of that conflict of interest arises, along with other duties – including the need to undertake such disclosure thoroughly and affirmatively, and the necessity of obtaining the client's informed consent.

However, as set forth in the annotations, the SEC has implemented a wide variety of specific disclosure obligations, even in situations where no conflict of interest exists.

Despite the best efforts of an investment adviser to eliminate material conflicts of interest, all investment advisers will still likely possess one or more material conflicts of interest in relation to the recommendations which may be made to their clients. Investment advisers must address these remaining conflicts of interest by:

> First, undertaking full and complete written disclosure of material conflicts of interest to the client; and
>
> Second, continuing to act in the best interests of the client by properly managing the conflict of interest and by not permitting the client's best interests to become subservient to the interests of the Investment advisers. (It is emphasized that disclosure of a conflict of interest does not defeat the continuing duty of the investment adviser to act in the best interests of the client.)

In the presence of a conflict of interest, fiduciary law protects the client by obligating the fiduciary to: (1) *affirmatively disclose all material facts* to the client; (2) ensure *client understanding* of the transaction, the conflict of interest which exists, and their ramifications; (3) obtain an *intelligent, independent and informed consent* from the client; and (4) ensure that the proposed transaction, even with client consent, remains *a substantively fair arrangement* for the client.

Annotations.

1. *Does a Duty to Disclose Exist Under the Common Law?*

   a. *No Fiduciary Duty of Disclosure Exists, Per Se (Australia).* "In Australian law, there is no distinct and freestanding fiduciary obligation requiring a fiduciary to disclose information to their principal … Despite the fact that fiduciaries, qua fiduciaries, owe no obligation of disclosure, questions of disclosure are often central in cases entailing fiduciary relationships … Given the significance of questions of disclosure in fiduciary cases, it is important to be clear about the role that disclosure plays in fiduciary law. The editors of *Meagher, Gummow and Lehane's Equity Doctrines and Remedies* describe that role in the following terms:

   > If a person occupying a fiduciary position wishes to enter into a transaction which would otherwise amount to a breach of duty, he must, if he is to avoid liability, make full disclosure to the person to whom the duty is owed of all relevant facts known to the fiduciary, and that person must consent to the fiduciary's proposal.

   In other words, a breach of fiduciary obligation — either the obligation not to be in a position of conflict of interest and duty or the obligation not to make unauthorised profits—may be averted or cured by the consent of the principal to whom the obligation is owed, and the principal's consent will be effective only if the fiduciary has first disclosed to the principal any relevant material information. Rather than constituting the discharge of a fiduciary obligation, disclosure which leads to informed consent confers on a fiduciary immunity from liability for the consequences of actions that would ordinarily amount to breaches of fiduciary obligation. And the immunity-conferring function of disclosure and informed consent provides a complete explanation of the role of disclosure in fiduciary law." Matthew Harding, Two Fiduciary Fallacies (2007).

2. *Advisers Act: Disclosure is Required of Material Facts, Generally.* When a material conflict of interest exist, the investment adviser possesses a duty to disclose the conflict of interest and all material facts

pertaining thereto. But when a conflict of interest is not present, to what extent must material facts be disclosed?

a. "[T]he duty of full disclosure was imposed as a matter of general common law long before the passage of the Securities Exchange Act." *In the Matter of Arleen W. Hughes*, SEC Release No. 4048 (February 18, 1948) (a case involving a conflict of interest arising out of principal trading).

b. Disclosures of many material facts are required under SEC regulations, even when a conflict of interest is not present.

   (1) "Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship." General Instructions for Part 2 of Form ADV, #3. In fact, the SEC requires registered investment advisers to undertake a broad variety of affirmative disclosures, well beyond disclosures of conflicts of interest, and many of these disclosures are required to be found in Form ADV, Parts 1 and 2A and 2B. Part 2A requires information about the adviser's range of fees, methods of analysis, investment strategies and risk of loss, brokerage (including trade aggregation policies and directed brokerage practices, as well as use of soft dollars), review of accounts, client referrals and other compensation, disciplinary history, and financial information, among other matters. A full listing and discussion of the extent of these disclosures is beyond the scope of these materials.

   (2) SEC Staff recently noted that under the "antifraud provisions of the Advisers Act, an investment adviser must disclose material facts to its clients and prospective clients whenever the failure to do so would defraud or operate as a fraud or deceit upon any such person. The adviser's fiduciary duty of disclosure is a broad one, and delivery of the adviser's brochure alone may not fully satisfy the adviser's disclosure obligations." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.23 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

3. *What is a "Material Fact"?*

a. "When a stock broker or financial advisor is providing financial or investment advice, he or she … is required to disclose facts that are material to the client's decision-making." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

b. A material fact is "anything which might affect the (client's) decision whether or how to act." *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 227 Va. 441 (Va., 1984). A fact is considered material if there is a substantial likelihood that a reasonable investor would consider the information to be important in making an investment decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Basic, Inc. v. Levinson*, 485 U.S. 224, 233 (1988).

c. A material conflict of interest is always a material fact requiring disclosure. The existence of a conflict of interest is a material fact that an investment adviser must disclose to its clients because it "might incline an investment adviser -- consciously or unconsciously -- to render advice that was not disinterested." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. at 191-192.

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

4. *Advisers Act: Disclosures of Material Facts Must Be Timely Given.* "[D]isclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the *client will know all the facts at the time that he is asked to give his consent." In the Matter of Arleeen W. Hughes*, SEC Release No. 4048 (February 17, 1948), *affirmed* 174 F.2d 969 (D.C. Cir. 1949).

5. *Advisers Act: Disclosure Must Be Affirmatively Undertaken.* The duty to disclose is an affirmative one and rests with the advisor alone. Clients do not generally possess a duty of inquiry.

   a. "The [SEC} Staff believes that it is the firm's responsibility—not the customers'—to reasonably ensure that any material conflicts of interest are fully, fairly and clearly disclosed so that investors may fully understand them." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.117 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

   b. The fiduciary is required to ensure that the disclosure is received by the client; the "access equals delivery" approach adopted by the SEC in connection with the delivery of a full prospectus to a consumer[132] would not likely qualify as an appropriate disclosure by a fiduciary investment adviser to her or his client of material facts.

   c. As stated in an early case applying the Advisers Act: "It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge material facts to the ones whose interests she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure. The statutes and rules discussed above make it unlawful to omit to state material facts irrespective of alleged (or proven) willingness or readiness to supply that which has been omitted." *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir., 1949).

6. *Advisers Act: Disclosure Must Be Sufficient to Obtain Client "Understanding."* As stated in an early decision by the U.S. Securities and Exchange Commission: "[We] may point out that no hard and fast rule can be set down as to an appropriate method for registrant to disclose the fact

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[132] *See* SEC Release No. 33-8998, "Enhanced Disclosure And New Prospectus Delivery Option For Registered Open-End Management Investment Companies," (Jan. 13, 2009) ("The Commission is also adopting rule amendments that permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site.")

that she proposes to deal on her own account. The method and extent of disclosure depends upon the particular client involved. The investor who is not familiar with the practices of the securities business requires a more extensive explanation than the informed investor. The explanation must be such, however, that *the particular client is clearly advised and understands* before the completion of each transaction that registrant proposes to sell her own securities." [*Emphasis added.*] *In re the Matter of Arleen Hughes*, SEC Release No. 4048 (1948).

7. *Conflicts of Interest Are Common with Respect to the Delivery of Investment Advice.* "Compensation is inherent in any commercial transaction; it is simultaneously a source of conflicts of interests and a possible means of reducing these conflicts by creating the proper incentives."[133]

    a. A conflict of interest is inherent in the relationship between the client and the investment adviser when the investment adviser is compensated by commissions on the sale of financial products. In such circumstances, the investment advisers must affirmatively disclose to the client, in writing and prior to the purchase of the product by the client, the amount of all compensation paid in association with the sale of the product and the placement of the product to the investment advisers or the investment adviser's firm, including but not limited to commissions, payment for shelf space, commissions paid upon securities transactions within a mutual fund by the investment adviser of that fund to the firm, expense allowances, and bonuses.

    b. However, just because an investment adviser works on a fee-only basis (as opposed to commission-based compensation) does not mean that he or she has no potential conflicts of interest. Nearly every fiduciary has one conflict of interest - negotiating with the client the amount to be paid to the fiduciary for the fiduciary's services. Normally negotiations as to the investment adviser's compensation should occur prior to the client's engagement of the adviser; this is because once a relationship of trust and confidence is formed, the investment adviser could seek to abuse that trust by seeking to convince the client to pay higher compensation than that originally agreed. Investment advisers should seek to ensure that each new and existing client will receive significant value from the services and advice provided by the investment advisers, commensurate with the amount of fees and costs paid or incurred by the client. Investment advisers who charge fees based upon a percentage of the assets upon which advice is provided may possess a conflict of interest when a client seeks advice on gifts (to charity or family), major expenditures, paying down debt, etc.

    c. Where conflicts of interest are permitted to exist, the conflict of interest must be properly managed to keep the best interests of the client paramount. In other words, the client's interests must not be harmed, for clients rarely (if ever) undertake gratuitous transfers to their investment advisers.

8. *Disclosures of Conflicts of Interest Must "Lay Bare the Truth … in All Its Stark Significance."* As stated by Justice Cardoza: "If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity of reservation, in all its stark significance …." *Wendt v. Fischer*, 243 N.Y. 439, 154 N.E. 303 (1926).

[133] Bahar, Rashid and Thévenoz, Luc, "Conflicts of Interest: Disclosure, Incentives, and the Market," *Conflicts Of Interest: Corporate Governance & Financial Markets*, Luc Thévenoz and Rashid Bahar, eds., Kluwer Law International and Schulthess, 2007, at p.2.

a. The extent of the disclosure required is made clear by cases applying the fiduciary standard of conduct in related advisory contexts. "The fact that the client knows of a conflict is not enough to satisfy the attorney's duty of full disclosure." *In re Src Holding Corp.*, 364 B.R. 1 (D. Minn., 2007). "Consent can only come after consultation — which the rule contemplates as full disclosure.... [I]t is not sufficient that both parties be informed of the fact that the lawyer is undertaking to represent both of them, but he must explain to them the nature of the conflict of interest in such detail so that they can understand the reasons why it may be desirable for each to [withhold consent].") *Florida Ins. Guar. Ass'n Inc. v. Carey Canada, Inc.*, 749 F.Supp. 255, 259 (S.D.Fla.1990) (*quoting Unified Sewerage Agency, Etc. v. Jeko, Inc.*, 646 F.2d 1339, 1345-46 (9th Cir.1981)); *see also British Airways, PLC v. Port Authority of N.Y. and N.J.*, 862 F.Supp. 889, 900 (E.D.N.Y.1994) (stating that the burden is on the client's attorney to fully inform and obtain consent from the client); *Kabi Pharmacia AB v. Alcon Surgical, Inc.*, 803 F.Supp. 957, 963 (D.Del.1992) (stating that evidence of the client's constructive knowledge of a conflict would not be sufficient to satisfy the attorney's consultation duty); *Manoir-Electroalloys Corp. v. Amalloy Corp.*, 711 F.Supp. 188, 195 (D.N.J.1989) ("Constructive notice of the pertinent facts is not sufficient."). A client of a fiduciary is not responsible for recognizing the conflict and stating his or her lack of consent in order to avoid waiver. *Manoir-Electroalloys*, 711 F.Supp. at 195. Rather, "[t]he lawyer bears the duty to recognize the legal significance of his or her actions in entering a conflicted situation and fully share that legal significance with clients." *In re Src Holding Corp.*, 364 B.R. 1, 48 (D. Minn., 2007).

9. *Disclosure Alone Is Insufficient to Meet One's Fiduciary Obligations; Disclosure's Inherent Limitations as a Means of Consumer Protection.* It is important to emphasize that while a critical and important aspect of compliance with the fiduciary duty of loyalty is adequate disclosure of a conflict of interest, disclosure remains but one of the elements of compliance with the investment adviser's fiduciary duty.

   a. Disclosure, in and of itself, does not negate a fiduciary's duties to his or her client. As stated in an SEC No-Action Letter: "We do not agree that an investment adviser may have interests in a transaction and that his fiduciary obligation toward his client is discharged so long as the adviser makes complete disclosure of the nature and extent of his interest. While section 206(3) of the [Advisers Act] requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent." *Rocky Mountain Financial Planning, Inc.* (pub. avail. March 28,1983). [Emphasis added.]

   b. Various regulators, including the SEC, have relied upon disclosure extensively. However, the ineffectiveness of disclosure as a means of providing consumer protection has long been known, and has recently been confirmed by academic research. "Disclosure forms the central focus of most of the federal securities laws … From a behavioral perspective, however, disclosure risks confusing investors already suffering from bounded rationality, availability and hindsight." Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC (2003), at pp.69-70. *See also* Daylian M. Cain, George Loewenstein, and Dona A. Moore, The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest (1993) ("Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are honestly disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse.") As Professor Cain has more recently stated in a public appearance, "It does not appear that sunlight is the best disinfectant, after all." (Fiduciary Forum, Washington, D.C., Sept. 2010).

c. More generally, it is submitted that while the presence of a conflict of interest requires the fiduciary to disclose the conflict of interest, disclosure is only a precondition to the gaining of the informed consent of the client. Only with such informed consent, in a transaction which remains substantively fair to the client, is the investment adviser's fiduciary obligation met.

10. *The Doctrine of Informed Consent.* The consent of the client must be "intelligent, independent and informed." Generally, "fiduciary law protects the [client] by obligating the fiduciary to disclose all material facts, requiring an *intelligent, independent consent* from the [client], a substantively fair arrangement, or both." Frankel, Tamar, Fiduciary Law, 71 Calif. L. Rev. 795 (1983). [*Emphasis added.*].

11. *Even with Informed Consent, the Proposed Transaction Must Be Fair and Reasonable to the Client.* "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." [Emphasis added.] *Birnbaum v. Birnbaum*, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986).

12. *General Requirements of the Advisers Act.* Section 206(2) of the Advisers Act makes it unlawful for an adviser to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client.

a. An adviser violates Section 206(2) if it makes material misstatements or omissions to clients. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 200 (1963). If the misstatement or omission of a material fact is negligent, then Section 206(2) is violated; if the misstatement or omission is made with scienter, then Section 206(1) is violated. *Steadman v. SEC*, 603 F.2d 1126, 1134-1135 (5th Cir. 1979).

b. "[We] think the better reading of section 206 is that it prohibits failures to disclose material information, not just affirmative frauds. This reading is consistent with the fiduciary status of investment advisers in relation to their clients ... and it is also more likely to fulfill Congress's general policy of promoting 'full disclosure' in the securities industry." *S.E.C. v. Washington Inv. Network*, 475 F.3d 392 (D.C. Cir., 2007), *citing SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 at 191-2, and at 186, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

c. The fiduciary duty to avoid conflicts of interest, and the necessity to obtain the informed consent of the client as to conflicts of interest not avoided, were well known in the early history of the Advisers Act. In an address entitled "The SEC and the Broker-Dealer" by Louis Loss, Chief

Counsel, Trading and Exchange Division, U.S. Securities and Exchange Commission on March 16, 1948, before the Stock Brokers' Associates of Chicago, the fiduciary duties arising under the Advisers Act, as applied in the *Arleen Hughes* release, were elaborated upon:

> The doctrine of that case, in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to *make a scrupulously full disclosure of every element of its adverse interest in the transaction*.
>
> In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. *He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses*. This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law 'acts not on the possibility, that, in some cases the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.' Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine 'has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.''
>
> *This time-honored dogma applies equally to any person who is in a fiduciary relation toward another*, whether he be a trustee, an executor or administrator of an estate, a lawyer acting on behalf of a client, an employee acting on behalf of an employer, an officer or director acting on behalf of a corporation, *an investment adviser* or any sort of business adviser for that matter, or a broker. The law has always looked with such suspicion upon a fiduciary's dealing for his own account with his client or beneficiary that it permits the client or beneficiary at any time to set aside the transaction without proving any actual abuse or damage. What the recent Hughes case does is to say that such conduct, in addition 'to laying the basis for a private lawsuit, amounts to a violation of the fraud provisions under the securities laws: This proposition, as a matter of fact, is found in a number of earlier Commission opinions. *The significance of the recent Hughes opinion in this respect is that it elaborates the doctrine and spells, out in detail exactly what disclosure is required when a dealer who has put himself in a fiduciary position chooses to sell his own securities to a client or buys the client's securities in his own name …*
>
> *The nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases use of the term 'principal' itself may suffice. In others, a more detailed explanation will be required. In all cases, however, the burden is on the*

firm which acts as fiduciary to make certain that the client understands …. [*Emphasis added.*]

d. SEC Staff has placed a great deal of emphasis in recent years on full and complete disclosure of conflicts of interest.

(1) "The duty to disclose material facts applies to conflicts of interest—or potential conflicts of interest—that arise during an adviser's relationship with a client. Therefore, the type of required disclosure will depend on the facts and circumstances. As a general matter, an adviser must disclose all material facts regarding the conflict so that the client can make an informed decision whether to enter into or continue an advisory relationship with the adviser. For example, if an adviser selects or recommends other advisers for clients, it must disclose any compensation arrangements or other business relationships between the advisory firms, along with the conflicts created, and explain how it addresses these conflicts." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.23 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

(2) SEC Staff also stated: "Fundamental to the Advisers Act is an adviser's fiduciary obligation to act in the best interests of its clients and to place its clients' interests before its own. As part of its fiduciary duty to clients, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to clients. Advisers are required to disclose any facts that might cause the adviser to render advice that is not disinterested. When an adviser fails to disclose information regarding potential conflicts of interest, clients are unable to make informed decisions about entering into or continuing the advisory relationship." ["Letter From the Office of Compliance Inspections and Examinations: To Registered Investment Advisers, on Areas Reviewed and Violations Found During Inspections," dated May 1, 2000.]

(3) *See also* General Instruction 3 to Part 2 of Form ADV: "Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them. To satisfy this obligation, you therefore may have to disclose to clients information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require. You may disclose this additional information to clients in your brochure or by some other means."

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

f. Investment advisers should not rely upon disclosure documents fashioned pursuant to issuer or broker-dealer obligations arising under the '33 or '34 Securities Acts to fulfill their obligation of disclosure. For example, providing a Summary Prospectus or Prospectus does not necessarily mean that all material facts have been effectively and affirmatively communicated to the client. "[W]e decline to find that providing a client with a prospectus is a complete defense, as a matter of law, to state claims that the stock broker or investment advisor misrepresented facts or failed to disclose facts material to his or her client's investment decisions." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

13. *Principal Trading by Dual Registrants.* "Advisers are restricted by Advisers Act Section 206(3) when entering into principal and agency-cross trades with their clients. Advisers Act Section 206(3) is intended to address the potential for self-dealing that could arise when an investment adviser acts as principal in transactions with clients, such as through price manipulation or the dumping of unwanted securities into client accounts. Section 206(3) makes it unlawful for an adviser, acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to the transaction. The Commission staff has taken the position that the adviser must disclose not only the capacity in which the adviser is acting, but also any compensation that the adviser receives for its role in such transaction … While the disclosure must be in writing, Section 206(3) does not require that the client's consent be in writing. Written disclosure must be provided and consent must be obtained separately for each transaction, *i.e.*, a blanket consent for transactions is not sufficient ... Compliance with the disclosure and consent provisions of Advisers Act Section 206(3) provision alone does not satisfy an adviser's fiduciary obligations with respect to a principal trade. The Commission has stated that Section 206(3) must be read together with Advisers Act Sections 206(1) and (2) to require that the adviser disclose additional facts necessary to alert the client to the adviser's potential conflict of interest in the principal trade." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.24-6. (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

14. *Advisers Act: Use by Investment Advisers of Affiliated Brokers.* "The Advisers Act does not prohibit advisers from using an affiliated broker to execute client trades or from directing brokerage to certain brokers. However, the adviser's use of such an affiliate involves a conflict of interest that must be disclosed to the adviser's client. To this end, Item 12 of Part 2A of Form ADV also requires an adviser to describe any relationship with a broker-dealer to which the brokerage may be directed that creates a material conflict of interest." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.28 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

15. *Disclosure Obligations Arising under State Common Law.* "When a stock broker or financial advisor is providing financial or investment advice, he or she … is required to disclose facts that are material

to the client's decision-making." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

16. *Fee Rebates vs. Disclosure: Bank Trustees and Proprietary Trust Funds.* The FDIC notes the conflict of interest due to the "lucrative array of fees available under a mutual fund arrangement" and suggests that it must be "resolved in the favor of trust beneficiaries." FDIC Trust Examination Manual, Section 7 "Compliance–Pooled Investment Vehicles," at Section A.1 (3/21/2009), stating: "One of the incentives for converting a [common investment fund] CIF to a proprietary mutual fund is purely financial. There is a lucrative array of fees available under a mutual fund arrangement that is not available from bank sponsored CIF's. However, the desire for increased revenue must not take precedence over the fiduciary responsibility of the bank. Such a conflict must be resolved in favor of the account beneficiaries. If the desire for financial reward is dominant, the conflict could become abusive."

    Some of the states, in enacting authority for banks to use proprietary or affiliated mutual funds, have prohibited their use unless the bank or trust company rebates its management fees, while others just require that certain disclosures be made to trust beneficiaries and/or that total compensation be "reasonable." *See, e.g.,* Wisconsin Statutes Sect. 881.01(4) (1989), stating in part: "A bank or trust company may invest in these securities notwithstanding that the bank or trust company, or an affiliate of' the bank or trust company, provides investment services to the investment company or investment trust if the bank or trust company waives its fee as fiduciary for the assets that it invests in these securities or if the bank , trust company or affiliate waives its fees for providing investment services to the investment company or investment trust." However, Wisconsin no longer effectively mandates fee waivers of offsets in this situation, and like most other states only requires disclosure in writing of the compensation received for providing services to the mutual fund, etc.. *See* Wisconsin Statutes Sect. 881.015 (1007-8). Investment advisers operating in a bank environment should consult the state law applicable to their relationship with the client and/or the account(s).

17. *Disclosure Obligations Under ERISA.*

    a. *General Duty of Disclosure; Duty to Inform.*

        (1) "[T]rust principles impose a duty of disclosure upon an ERISA fiduciary when there are "`material facts affecting the interest of the beneficiary which [the fiduciary] knows the beneficiary does not know'" but "`needs to know for his protection ….'"" *Martinez v. Schlumberger, Ltd.,* 338 F.3d 407, 412 (5th Cir., 2003), *citing* Edward E. Bintz, Fiduciary Responsibility Under ERISA: Is There Ever a Fiduciary Duty to Disclose?, 54 U. PITT. L. REV. 979, 985 (1993) (quoting RESTATEMENT (SECOND) OF TRUSTS § 173 cmt. d (1959)).

        (2) "A fiduciary has an obligation to convey complete and accurate information to its beneficiaries." *In Re Regions Morgan Keegan Erisa Litigation*, 692 F. Supp.2d 944, 955 (W.D. Tenn., 2010). ""The duty to inform is a constant thread in the relationship between beneficiary and trustee; it entails not only a negative duty not to misinform, but also an affirmative duty to inform when the trustee knows that silence might be harmful." *Id.*

    b. *Duty to Provide Information with Respect to Participant-Directed Retirement Accounts.* In the past ERISA class action fee litigation resulted in many adverse rulings to participants who alleged a failure to disclose certain fee information, and/or certain fee-sharing information, by a plan sponsor. Commencing Jan. 1, 2012, plan sponsors can no longer rely upon such decisions, due to a recently adopted interim final rule mandating additional disclosures. "Paragraph (a) of § 2550.404a–5 sets forth the general principle that, where documents and instruments governing an individual account plan provide for the allocation of investment responsibilities to participants and beneficiaries, a plan fiduciary, consistent with ERISA section 404(a)(1)(A) and (B), must take steps to ensure that such participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan, including plan fees and expenses, and regarding the designated investment alternatives available under the plan, including fees and expenses attendant thereto, to make informed decisions with regard to the management of their individual accounts … [T]he Department [of Labor] believes, as an interpretive matter, that ERISA section 404(a)(1)(A) and (B) impose on fiduciaries of all participant-directed individual account plans a duty to furnish participants and beneficiaries information necessary to carry out their account management and investment responsibilities in an informed manner …." DOL, EBSA, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule (Oct. 20, 2010). The following summarizes just a few of the new major disclosure items required under the new regulation.

(1) *Fee and Expense Information Disclosures / Investment Alternatives.* "Paragraph (d)(1)(iv) of the proposal required disclosure of fee and expense information for designated investment alternatives … such as commissions, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees … If the fee or expense is charged directly against participant's or beneficiary's individual investment or account, as is typically the case with sales loads, account fees, and the other items delineated in the parenthetical, then the fee or expense is to be disclosed as a shareholder-type fee. If, on the other hand, the fee or expense is paid from the operating expenses of a designated investment alternative, then the fee or expense is to be included in the total annual operating expenses of a designated investment alternative …." DOL, EBSA, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule (Oct. 20, 2010).

(2) *Disclosure of Portfolio Turnover Rates.* The Department of Labor's recent rule noted the effect of trading costs, by requiring express disclosure of portfolio turnover. "An investment alternative's portfolio turnover indicates the frequency with which the investment alternative is buying and selling securities. An investment that is frequently buying and selling securities may be generating higher trading costs. Trading costs are not included in an alternative's expense ratio, yet the cost of trading on a portfolio level does have an effect, in some cases a large effect, on the alternative's rate of return. The Department, therefore, believes that such information may be helpful to participants and beneficiaries in assessing the appropriateness of their investment options … must include the investment's portfolio turnover rate in a manner consistent with Securities and Exchange Commission Form N–1A or N–3, as appropriate." DOL, EBSA, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule (Oct. 20, 2010).

(3) *Benchmarking of Returns of Investment Options Required.* "Paragraph (d)(1)(iii) of the proposal required, for each designated investment alternative with respect to which the return is not fixed, the disclosure of "the name and returns of an appropriate broad-based securities market index over the 1-year, 5-year, and 10-year periods * * *" for which

performance data must be disclosed. [The final rule retains the proposed requirement that a benchmark must be a broad-based securities market index and it may not be administered by an affiliate of the investment issuer, its investment adviser, or a principal underwriter, unless the index is widely recognized and used. The Department, however, notes that paragraph (d)(2)(ii) of the final regulation permits the disclosure of information that is in addition to that which is required by this final regulation, so long as the additional information is not inaccurate or misleading. Thus, in the case of designated investment alternatives that have a mix of equity and fixed income exposure (e.g., balanced funds or target date funds), a plan administrator may, pursuant to paragraph (d)(2)(ii) of the final rule, blend the returns of more than one appropriate broad-based index and present the blended returns along with the returns of the required benchmark, provided that the blended returns proportionally reflect the actual equity and fixed-income holdings of the designated investment alternative." DOL, EBSA, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule (Oct. 20, 2010).

c. *Reliance upon Plan Service Providers and Issuer Disclosure Information.* "[A] plan administrator will not be liable for the completeness and accuracy of information used to satisfy these disclosure requirements when the plan administrator reasonably and in good faith relies on information received from or provided by a plan service provider or the issuer of a designated investment alternative." DOL, EBSA, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule (Oct. 20, 2010).

(1) *But – Knowledge of Misleading Information Dictates Greater Disclosures.* "[I]t should be noted that there may be extraordinary situations when fiduciaries will have a disclosure obligation beyond those addressed by this regulation. For example, if a plan fiduciary knew that, due to a fraud, information contained in a public financial report would mislead investors concerning the value of a designated investment alternative, the fiduciary would have an obligation to take appropriate steps to protect the plan's participants, such as disclosing the information or preventing additional investments in that alternative by plan participants until the relevant information is made public." DOL/EBSA, Proposed Rule, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans (July 23, 2008).

d. *Disclosure of Compensation Arrangements.* Generally, the new 408(b)(2) interim final regulation requires, effective January 1, 2012 (as per 2/11/2011 announcement), certain plan service providers to disclose detailed information to fiduciaries regarding services, including direct and indirect compensation, as a precondition to avoiding liability under 406(a)(1)(C). Generally, the rule applies to services provided as a fiduciary, including investment advisory services, accounting/auditing services; brokerage services, and recordkeeping services. Generally the rule requires disclosure regardless of whether the compensation is directly or indirectly received.

e. *No Disclosure Required of Plan Sponsor Considering Amendment to Benefit Plan.* "[W]hether an employer has a fiduciary duty to affirmatively disclose whether it is considering amending its benefit plan, we conclude that no such duty exists. Those circuits which have recognized the existence of such a duty have not presented persuasive reasons, and instead we find that the practicalities of the business world weigh against it." *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407, 428 (5th Cir., 2003). "[A]n employer has no affirmative duty to disclose the status of its internal deliberations on future plan changes even if it is seriously considering such changes, but if it chooses in its discretion to speak it must do so truthfully." *Beach v. Commonwealth Edison Co.*, 382 F.3d 656, 666 (7th Cir., 2004)

f. *No Disclosure Required of Negative Information Regarding Employer Stock.* "The Court cannot glean a broad requirement that ERISA fiduciaries disclose to plan participants any information about an employer that could have a negative effect on the value of the employer's stock when the participants hold said stock under an ERISA plan. Furthermore, such a duty would place too high a burden on employers to continually update plan participants and the public12 about myriad situations within the company which could negatively affect the value of the employer's stock. *See Herrington v. Household Int'l, Inc.*, 2004 WL 719355, at *8 (N.D.Ill. Mar. 31, 2004) (noting that such a disclosure standard "would require defendants to continuously gather and disclose nonpublic information bearing some relation to the plan sponsor's financial condition")." *Powell v. Dallas Morning News Lp*, 610 F.Supp.2d 569 (N.D. Tex., 2009).

18. *The Disclosure Obligations of Broker-Dealers are Generally Insufficient to Meet the Fiduciary Standard's Requirements.*

a. "In practice, with broker-dealers, required disclosures of conflicts have been more limited than with advisers and apply at different points in the customer relationship." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.106 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.). Often disclosures are not affirmatively made, such as when clients are directed to a web site to view disclosures. At other times "casual disclosure" is all that is required, such as "we may have conflicts of interest" or "our interests may not be the same as yours."

b. However, recently "FINRA requested comment on a concept proposal to require the provision of a disclosure statement for retail investors at or before commencing a business relationship that would include many items of information analogous to what is required in Form ADV Part 2. FINRA, Regulatory Notice 10-54, 'Disclosure of Services, Conflicts and Duties' (Oct. 2010). Specifically, the proposal would require member firms to provide to a retail customer, at or prior to commencing a business relationship, a written statement describing, among other things: the types of accounts and services it provides; the scope of services provided and products offered to retail customers and the fees associated with each brokerage account and service offered; the conflicts associated with such services (e.g., financial or other incentives that the firm or its registered representatives have to recommend certain products, investment strategies or services) and conflicts that may arise and how the firm manages such conflicts; and any limitations on the duties otherwise owed to retail customers (e.g., not assuring the ongoing suitability of an investment or a portfolio of investments nor the propriety of unsolicited orders, and may execute transactions on a principal basis (absent instructions to act only in an agency capacity))." SEC Staff Study, p. 114, fn. 518.

RULE 3.4. ADDRESSING CONFLICTS OF INTEREST ARISING FROM DUTIES OWED TO MULTIPLE DISTINCT CLIENTS. INVESTMENT ADVISERS SHALL REASONABLY SEEK TO NOT FAVOR THE INTERESTS OF ANY ONE CLIENT OVER THE INTEREST OF ANOTHER CLIENT. SINCE SITUATIONS MAY ARISE IN WHICH THE INVESTMENT ADVISER'S ABILITY TO TREAT ALL OF THE INVESTMENT ADVISER'S CLIENTS WITH EQUAL FAIRNESS IS COMPROMISED, OR WHERE IT MAY APPEAR THAT THE INTEREST OF ONE CLIENT IS FAVORED OVER THE INTEREST OF ANOTHER CLIENT, INVESTMENT ADVISERS SHALL INFORM CLIENTS IN WRITING AND IN ADVANCE OF THE LIMITATIONS WHICH INVESTMENT ADVISERS POSSESSES AND HOW THE INVESTMENT ADVISERS WILL ADDRESS THE SITUATION.

Commentary.

Most fiduciaries (agents) act for more than one client (principal). Conflicts of interest may arise where the investment adviser has reason to favor the interests of one client over another client (e.g., larger accounts over smaller accounts, accounts compensated by performance fees over accounts not so compensated, accounts in which employees have made material personal investments, accounts of close friends or relatives of supervised persons).

While favoritism of one client over another client should be avoided wherever possible, as such would constitute a breach of fiduciary duty, situations arise (such as a sudden major stock market value decline) in which the investment adviser may find that the investment adviser is unable to serve all of the investment adviser's clients equally well due to scarce resources. Investment advisers should therefore, in advance of such situations, inform clients of investment adviser's limitations and the policies which the Investment adviser has adopted to treat clients as fairly as possible.

RULE 3.5. RELATIONSHIPS WITH CLIENTS POSSESSING DIMINISHED CAPACITY.

(A) WHEN A CLIENT'S CAPACITY TO MAKE ADEQUATELY CONSIDERED DECISIONS IN CONNECTION WITH A REPRESENTATION IS DIMINISHED, WHETHER BECAUSE OF MINORITY, MENTAL IMPAIRMENT OR FOR SOME OTHER REASON, THE INVESTMENT ADVISER SHALL, AS FAR AS REASONABLY POSSIBLE, MAINTAIN A NORMAL INVESTMENT ADVISER - CLIENT RELATIONSHIP WITH THE CLIENT. HOWEVER, UNDER SUCH CIRCUMSTANCES NEARLY ALL CONFLICTS OF INTEREST MUST BE AVOIDED BY THE INVESTMENT ADVISER, GIVEN THE PRACTICAL INABILITY OF THE INVESTMENT ADVISER TO ENSURE THE CLIENT'S UNDERSTANDING OF THE CONFLICT OF INTEREST AND SECURE THE CLIENT'S INFORMED CONSENT.

(B) WHEN THE INVESTMENT ADVISER REASONABLY BELIEVES THAT THE CLIENT HAS DIMINISHED CAPACITY, IS AT RISK OF SUBSTANTIAL PHYSICAL, FINANCIAL OR OTHER HARM UNLESS ACTION IS TAKEN AND CANNOT ADEQUATELY ACT IN THE CLIENT'S OWN INTEREST, THE INVESTMENT ADVISER MAY TAKE REASONABLY NECESSARY PROTECTIVE ACTION, INCLUDING CONSULTING WITH INDIVIDUALS OR ENTITIES THAT HAVE THE ABILITY TO TAKE ACTION TO PROTECT THE CLIENT.

(C) INFORMATION RELATING TO THE REPRESENTATION OF A CLIENT WITH DIMINISHED CAPACITY IS PROTECTED BY THE GENERAL RULE GOVERNING CLIENT CONFIDENTIALITY. NOTWITHSTANDING THIS GENERAL RULE, WHEN TAKING PROTECTIVE ACTION PURSUANT TO PARAGRAPH (B) ABOVE, THE INVESTMENT ADVISER IS IMPLIEDLY AUTHORIZED UNDER RULE TO REVEAL INFORMATION ABOUT THE CLIENT, BUT ONLY TO THE EXTENT REASONABLY NECESSARY TO PROTECT THE CLIENT'S BEST INTERESTS OR TO FULFILL THE DUTIES OWED BY THE INVESTMENT ADVISER TO THE CLIENT.

SECTION 4. FIDUCIARY DUTY OF DUE CARE TO CLIENTS.

RULE 4.1 STANDARD OF DUE CARE. AN INVESTMENT ADVISER SHALL, IN THE PERFORMANCE OF SERVICES FOR A CLIENT, ACT WITH THE DUE CARE EXPECTED OF INVESTMENT ADVISERS IN LIKE SITUATIONS, APPLYING THE REQUISITE KNOWLEDGE, EXPERIENCE AND ATTENTION TO THE ENGAGEMENT.

Commentary.

The quest for excellence is the essence of due care. Due care requires a member to discharge professional responsibilities with competence and diligence. It imposes the obligation to perform professional services to the best of an investment adviser’s ability with concern for the best interest of those for whom the services are performed and consistent with the profession's responsibility to the public.

The duty of due care has been considered to involve both process and substance. That is, in reviewing the conduct of an investment adviser in adherence to the investment adviser’s fiduciary duty of due care, a court would likely review whether the decision made by the investment adviser was informed (procedural due care) as well as the substance of the transaction or advice given (substantive due care). Procedural due care is often met through the application of an appropriate decision-making process, and judged under the standard, not (necessarily) by the end result. Substantive due care pertains to the standard of care and the standard of culpability for the imposition of liability for a breach of the duty of care.

Substantive Due Care. Under the Investment Advisers Act of 1940, the duty of due care is measured by the ordinary negligence standard, and it is anticipated that the duty of due care imposed by this Rule would likewise be measured by the same ordinary negligence standard. However, the standard of prudence is relational, and it follows that the standard of care for investment advisers is the standard of a prudent investment adviser. By way of explanation, the standard of care for professionals is that of prudent professionals; for amateurs, it is the standard of prudent amateurs. For example, Restatement of Trusts 2d § 174 (1959) provides: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing itself to be expert or professional. *See* Annot., “Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill”, 91 A.L.R. 3d 904 (1979) & 1992 Supp. at 48-49.

Note, however, that the courts recognize that it is simply not possible for a fiduciary to be aware of every piece of relevant information before making a decision on behalf of the principal, and a fiduciary cannot guarantee that a correct judgment will be made in all cases. Due to the difficulty of evaluating the behavior of fiduciaries, most often courts turn to an analysis not of the advice that was given but rather to the process by which the advice was derived. Nevertheless, while adherence to a proper process is also necessary, at each step along the process the Investment adviser is required to act prudently with the care of the prudent investment adviser. In other words, the investment adviser must at all times exercise good judgment, applying his or her education, skills, and expertise to the financial planning issue before the investment adviser. Simply following a prudent process is not enough if prudent good judgment (and the investment adviser's requisite knowledge, expertise and experience) is not applied as well.

Procedural Due Care. One must evaluate the duty of care, unlike the duty of loyalty, by the process the fiduciary undertakes in performing his functions and not the outcome achieved. The very word "care" connotes a process. One associates caring with a condition, state of mind, manner of mental attention, a feeling, regard, or liking for something. How else may one determine whether an investment adviser who regularly achieves below average returns, or an attorney who loses most cases, has performed his duty of care? It is only through evaluating the steps the fiduciary took while doing his job, and not whether they resulted in success, that one may judge whether the fiduciary has breached his duty.

Annotations.

1. *Expert Testimony Is Normally Required to Establish the Investment Adviser's Standard of Care* . "Persons engaged in the practice of a profession or trade are held to the standard of "'the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities.'" *Mcgraw v. Wachovia Sec.*, No. C 08-2064-MWB (N.D. Iowa, 2010) (memorandum opinion), *citing Kastler v. Iowa Methodist Hosp.*, 193 N.W.2d 98, 101 (Iowa 1971) (quoting RESTATEMENT (SECOND) OF TORTS § 283 (1965)). The burden rests upon the plaintiff to prove the professional's breach of this standard of care. *Mcgraw; also see Devine v. Wilson*, 373 N.W.2d 155, 157 (Iowa App. 1985). "Unless a professional's lack of care is so obvious as to be within the comprehension of a layperson, the standard of care and its breach must ordinarily be established through expert testimony." *Mcgraw, citing Perin v. Hayne*, 210 N.W.2d 609, 613 (Iowa 1973); *also citing Devine*, 373 N.W.2d at 157.

2. *Registered Investment Advisers Must Possess Reasonable Basis for Investment Recommendations.* Under the Advisers Act, the SEC Staff recently interpreted the fiduciary duty of care to require the investment adviser to "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.22 and p.27(available at http://sec.gov/news/studies/2011/913studyfinal.pdf.), *citing*, *see*, Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052 (July 14, 2010) ("Release 3052") at 119.

3. *However … Rule-Making is Anticipated Under Dodd-Frank for Registered Investment Advisers and Broker-Dealers.* "The [SEC] Staff believes that the Commission, through rulemaking, guidance, or both, should specify the minimum professional obligations of investment advisers and broker-dealers under the duty of care. In evaluating the regulation of investment advisers and broker-dealers, the Staff believes that it could be useful to develop rules or guidance on the minimum requirements that are fundamental to a duty of care under the uniform fiduciary standard." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.122 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) "Professional standards under the duty of care

could be developed regarding the nature and level of review and analysis that broker-dealers and investment advisers should undertake when making recommendations or otherwise providing advice to retail customers. The Commission could articulate and harmonize any such standards, by referring to and expanding upon, as appropriate, the explicit minimum standards of conduct relating to the duty of care currently applicable to broker-dealers (e.g., suitability (including product-specific suitability), best execution, and fair pricing and compensation requirements) under Commission and SRO rules." *Id.* "Any such rules or guidance could take into account long-held Advisers Act fiduciary principles, such as the duty to provide suitable investment advice (e.g., with respect to specific recommendations and the client's portfolio as a whole) and to seek best execution. Detailed guidance in this area has not been a traditional focus of the investment adviser regulatory regime." *Id.* at 123.

4. *ERISA's "Prudent Man" Due Care Standard.* Section 401(a) of ERISA, which sets out the primary duties of ERISA fiduciaries, in essence adopts the "prudent man rule" as the standard of due care, as it provides in relevant part: "[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries… with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims…." Unlike the Advisers Act, "under ERISA, the fiduciary standard and the prudent man rule are included in the statute." Fred Reish and Bruce Ashton, "Brokers as Fiduciaries: The Reality and the Issues," Reish & Reicher Bulletin (Dec. 17, 2009).

   a. *Prudent Man Standard, Generally.* ERISA requires fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B . "A fiduciary must discharge his duties with the care, skill, prudence and diligence under the circumstances then prevailing of "the traditional 'prudent man'." *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.1982). "ERISA's fiduciary duty was meant to hold plan administrators to a duty of loyalty akin to that of a common-law trustee." *Ameritech Benefit Plan Comm. v. Comm. Workers of America*, 220 F.3d 814, 825 (7th Cir.2000). Accordingly, "[t]he fiduciary must act as though [he] were a reasonably prudent businessperson with the interests of all the beneficiaries at heart." *Id.* "The duty of prudence imposes an unwavering duty to act both as a prudent person would act in a similar situation and with single-minded devotion to plan participants and beneficiaries." *In Re Regions Morgan Keegan Erisa Litigation*, 692 F. Supp.2d 944 (W.D. Tenn., 2010).

   b. *DOL Regulations Assist in Defining Scope of the Obligation of Prudence.* "Regulations under Section 404(a)(1)(B) of ERISA provide that with regard to an investment or investment course of action taken by a fiduciary of a plan pursuant to his investment duties, the requirements of Section 404(a)(1)(B) of ERISA are satisfied if the fiduciary (A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (B) has acted accordingly. 29 C.F.R. § 2550.404(a)-1(b)." *Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818, 850 (C.D. Ill., 2004).

   c. *The Process and/or Methods Followed by Fiduciary Are Examined, Not the Success of Investments.* "ERISA requires fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B). The Fifth Circuit has stated:

> In determining compliance with ERISA's prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions. "[ERISA's] test of prudence ... is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed." Thus, the appropriate inquiry is whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment. *Laborers National*, 173 F.3d at 317 (citations omitted).

… Because the "prudent man" standard focuses on whether the fiduciary utilized appropriate methods to investigate and evaluate the merits of a particular investment, the appropriate methods in a particular case depend "on the `character' and `aim' of the particular plan and decision at issue and the `circumstances prevailing' at the time a particular course of action must be investigated and undertaken." *Bussian*, 223 F.3d at 299." *In re Dynegy, Inc. Erisa Litigation*, 309 F.Supp.2d 861 (S.D. Tex., 2004). *See also In Re Regions Morgan Keegan Erisa Litigation*, 692 F. Supp.2d 944 (W.D. Tenn., 2010) ("The test for the duty of prudence is whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.")

d. *Prudence is Tested under Modern Portfolio Theory, Rather than the (Old) Trust Standard.* "Regulations promulgated by the Department of Labor (DOL) generally reflect that a fiduciary with investment duties must act as a prudent investment manager under the modern portfolio theory rather than under the common law of trusts standard, which examined each investment with an eye toward its individual riskiness. *Id.* at 317-318 (citing 29 C.F.R. § 2550.404a-1)." *In re Dynegy, Inc. Erisa Litigation*, 309 F.Supp.2d 861, 875 (S.D. Tex., 2004).

e. *Prudence is Measured by Objective, Not Subjective, Standards; Hence, The "Good Faith" of the Fiduciary is Not Pertinent.* "Prudence is thus measured according to the objective 'prudent person' standard developed in the common law of trusts." *Donovan v. Mazzola*, 716 F.2d 1226, 1231 (9th Cir.1983). Subjective good-faith simply does not come into play. *Leigh v. Engle*, 727 F.2d 113, 124 (7th Cir.1984). "[T]he prudent man standard is an objective standard, and good faith is not a defense to a claim of imprudence." *In re Dynegy, Inc. Erisa Litigation*, 309 F.Supp.2d 861, 875 (S.D. Tex., 2004). *See also Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir.1983), *cert. denied*, 467 U.S. 1251, 104 S.Ct. 3533, 82 L.Ed.2d 839 (1984) ("this is not a search for subjective good faith - a pure heart and an empty head are not enough")."

f. *An Independent Investigation of Merits of the Investment by the Fiduciary is Required.* "The focus of the inquiry under the prudent man rule is on the fiduciaries' independent investigation of the merits of a particular investment rather than an evaluation of the merits alone. The test of prudence focuses on whether the fiduciaries, at the time they engage in a transaction, have employed the appropriate methods to investigate the merits of the investment and to structure the investment." *Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818, 850 (C.D. Ill., 2004) (Citations omitted.) *See also Harley v. Minnesota Mining & Mfg. Co.*, 42 F.Supp.2d 898, 906 (D. Minn. 1999) (The "prudent person" standard articulated in § 1104(a)(1)(B) is objective, focusing on the fiduciary's conduct preceding or at the time of the challenged conduct. *See [Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 917-18 (8th Cir. 1994)]*. Under this standard, a fiduciary is obligated to undertake an independent investigation of the merits of an investment and to use appropriate, prudent methods in conducting the investigation. *See, e.g., In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 435(3d Cir.) ("[T]he most basic of ERISA's investment fiduciary duties [is] the duty to conduct an independent investigation into the merits of a particular investment."), *cert. denied*, 519 U.S. 810, 117 S.Ct. 56, 136 L.Ed.2d 19 (1996); *Liss v. Smith*, 991 F.Supp. 278, 297 (S.D.N.Y.1998) (stating that the failure to make an independent investigation and evaluation has "repeatedly been held to constitute a breach of fiduciary obligations") (citing cases); *Whitfield v. Cohen*, 682 F.Supp. 188, 194 (S.D.N.Y.1988) (stating that the "test of prudence focuses on the trustee's conduct in investigating, evaluating and making the investment," and indicating that the trustee's failure to make an independent investigation is a breach of fiduciary duty) (*citing Fink v. National Sav. and Trust Co.*, 772 F.2d 951, 957 (D.C.Cir.1985))." *Harley* at 906-7.

g. *Neither Prescience Nor Omniscence Required.* "ERISA imposes the highest standard of conduct known to law on fiduciaries of employee pension plans … However, this is not equivalent to a standard of absolute liability, as ERISA fiduciaries are only required to exercise prudence, not prescience or omniscience …." *Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818, 863 (C.D. Ill., 2004). "The ultimate outcome of an investment is not proof that a fiduciary acted imprudently. *Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan*, 507 F.Supp. 378, 384 (D.Haw.1980). "[T]he appropriateness of an investment is to be determined from the perspective of the time the investment was made, not from hindsight." *Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818, 867 (C.D. Ill., 2004).

5. *Best Execution.*

a. *For Broker-Dealers.* "Under the antifraud provisions of the federal securities laws and SRO rules, broker-dealers also have a legal duty to seek to obtain best execution of customer orders. The duty of best execution requires broker-dealers to seek to execute customers' trades at the most favorable terms reasonably available under the circumstances. Traditionally, price has been the predominant factor in determining whether a broker-dealer satisfied its best execution obligations. The Commission has stated that broker-dealers should also consider at least six additional factors: (1) the size of the order; (2) the speed of execution available on competing markets; (3) the trading characteristics of the security; (4) the availability of accurate information comparing markets and the technology to process the data; (5) the availability of access to competing markets; and (6) the cost of such access." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.69 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf) (Citations omitted).

b. *For Registered Representatives.* "Investment advisers have an obligation to seek best execution of clients' securities transactions where they have the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts). In meeting this obligation, an adviser must seek to obtain the execution of transactions for each of its clients in such a manner that the client's total cost or proceeds in each transaction are the most favorable under the circumstances. When seeking best execution, an adviser should consider the full range and quality of a broker's services when selecting broker-dealers to execute client trades including, among other things, the broker's execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided. An investment adviser should 'periodically and systematically' evaluate the execution it is receiving for clients." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.28-9 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf) (Citations omitted).

RULE 4.2 ACHIEVING AND MAINTAINING PROFESSIONAL COMPETENCE. AN INVESTMENT ADVISER SHALL PROVIDE SERVICES TO CLIENTS COMPETENTLY. AN INVESTMENT ADVISER IS COMPETENT ONLY WHEN HE OR SHE HAS ATTAINED AND HAS MAINTAINED AN ADEQUATE LEVEL OF KNOWLEDGE, SKILL AND EXPERIENCE, AND IS ABLE TO APPLY THAT KNOWLEDGE SKILL AND EXPERIENCE EFFECTIVELY IN PROVIDING SERVICES TO CLIENTS.

Commentary.

Competence is derived from a synthesis of knowledge, skill and experience. Due to ever-changing laws, regulations, and the development of new strategies, services, and products, the maintenance of competence requires a commitment to learning and professional improvement that must continue throughout an investment adviser's professional life. Maintaining competency is an investment adviser's individual responsibility. In all engagements and in all responsibilities, each Investment adviser should undertake to achieve a level of competence that will assure that the quality of the Investment adviser's services meets the high level of professionalism required by these principles.

RULE 4.3. WHEN CONSULTATION REQUIRED WITH OTHER PROFESSIONALS. CONSULTATION OR REFERRAL BY THE INVESTMENT ADVISER WITH OTHER PROFESSIONALS SHALL BE REQUIRED WHEN A PROFESSIONAL ENGAGEMENT EXCEEDS THE PERSONAL COMPETENCE OF THE INVESTMENT ADVISER AND THE COMPETENCIES OF OTHERS WHO MIGHT SUPPORT THE INVESTMENT ADVISER FROM WITHIN THE INVESTMENT ADVISER'S FIRM.

Commentary.

Competence represents the attainment and maintenance of a level of understanding and knowledge that enables an investment adviser to render services with facility and acumen. It also establishes the limitations of a member's capabilities by dictating that consultation or referral may be required. Each investment adviser is responsible for assessing his or her own competence – of evaluating whether education, experience, and judgment are adequate for the responsibility to be assumed.

The fiduciary duty of due care requires the investment adviser to possess knowledge, utilize care, and act diligently. Knowledge requires that the investment adviser possess the necessary education and skills to discharge the Investment adviser's duties owed to the client. While investment advisers cannot be experts in all aspects of the complex tax laws, financial, estate and risk management issues, and financial markets that exist, they should not try to represent themselves as such. However, investment advisers should strive to expand their expertise in areas which will best serve their clients.

A lack of knowledge or expertise is, in itself, not a violation of the Rule. However, advising a client in areas where such knowledge is required, or not consulting with others in those areas, would be a violation of the Rule. The Rule requires investment advisers to provide advice only in areas in which they fully and reasonably understand the technical implications.

Annotations.

1. *When Client is a Fiduciary – Duty to Delegate.* Where the client is a fiduciary himself, herself, or itself (e.g., acting as a trustee, attorney-in-fact, guardian, etc.), the client may possess a duty to consult with an investment adviser when the client lacks the requisite knowledge to navigate the world of investments. Similarly, under ERISA, in those circumstances where plan sponsors "lack the requisite knowledge, experience and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors." *Liss v. Smith*, 991 F.Supp. 278, 387 (S.D.N.Y. 1998).

2. *Reasonable Prudence in Selecting and Monitoring When Delegation Occurs.* "In order to exercise reasonable prudence in seeking expert advice, a fiduciary must (1) investigate the expert's qualifications, (2) provide the expert with complete and accurate information, and (3) make certain that reliance on the expert's advice is reasonably justified under the circumstances. As such, the fiduciary's duty is to ensure that the expert is qualified and reliable, not to investigate the accuracy of the expert's advice." *Barboza v. Cal. Ass'n Of Prof'l Firefighters* (E.D. Cal., 2011) (applying ERISA to decisions of a plan sponsor).

RULE 4.4. DILIGENCE IN THE DELIVERY OF SERVICES. INVESTMENT ADVISERS SHALL BE DILIGENT IN DISCHARGING RESPONSIBILITIES TO CLIENTS, EMPLOYERS, AND THE PUBLIC. DILIGENCE IMPOSES THE RESPONSIBILITY UPON INVESTMENT ADVISERS TO RENDER SERVICES REASONABLY PROMPTLY AND CAREFULLY AND WITH A REASONABLE LEVEL OF THOROUGHNESS.

Commentary.

Diligence is the provision of services in a reasonably prompt and thorough manner. Diligence also includes proper planning for, and supervision of, the rendering of professional services.

Diligence requires investment advisers to discharge their duties in a timely manner and to maintain full records of decisions and actions. Timeliness is necessary so that opportunities will not be lost due to inaction. Violations of ethical behavior can be caused by inaction when action would have been required, or by lack of thoroughness in evaluating the investment issue confronting the client.

Various other aspects of "diligence" are discussed in the "suitability" and "due diligence" rules set forth below.

RULE 4.5. SUITABILITY AS TO RECOMMENDATIONS OF INVESTMENT PRODUCTS. IN RECOMMENDING SECURITIES OR INVESTMENT PRODUCTS TO CLIENTS THE INVESTMENT ADVISER MUST DETERMINE THAT THE SECURITY OR INVESTMENT PRODUCT IS SUITABLE FOR THAT CUSTOMER IN LIGHT OF THE CUSTOMER'S FINANCIAL STATUS AND INVESTMENT OBJECTIVES.

Commentary.

The duty of suitability in the making of investment product recommendations is a minimal, but important duty. The fiduciary duty of due care requires greater effort and even more sound judgment to be applied, however, as illustrated by the Investment Adviser Rules of Professional Conduct 4.6, 4.7 and 4.8.

Annotations.

1. *The Three Major Aspects of "Suitability," Generally.* In general, three approaches to suitability have developed under the case law, including FINRA and Commission enforcement actions – "reasonable basis" suitability, "customer-specific" suitability, and "quantitative" suitability.

2. *Applicability of Suitability Obligations to Registered Investment Advisers.* Investment advisers owe their clients the duty to provide only suitable investment advice. *See* SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.27-8 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.), *quoting* Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994) (proposing a rule under the Advisers Act Section 206(4)'s antifraud provisions that would expressly require advisers to give clients only suitable advice; the rule would have codified existing suitability obligations of advisers).

   a. *Reasonable Basis Suitability – Investment Strategies and/or Products.* Under reasonable basis suitability, a broker-dealer has an affirmative duty to have an "adequate and reasonable basis" for any security or strategy recommendation that it makes. *See* Exchange Act Release No. 27535 (Dec. 13, 1989) (finding that the broker's recommendations violated suitability requirements because the broker did not have a reasonable basis for the strategy he recommended, wholly apart from any considerations relating to the particular customer's portfolio). *See also Hanly*, 415 F.2d at 597, *supra* note 271; *In the Matters of Walston & Co.,* Exchange Act Release No. 8165 (Sept. 22, 1967) (settled order); *Michael F. Siegel*, 2007 NASD Discip. LEXIS 20 (2007). A broker-dealer, therefore, has the obligation to investigate and have adequate information about the security or strategy it is recommending. "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 Funds*, 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).

   b. *See also* Regulatory Notice 09-25, "Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations" (and FINRA Rule 2111.05 (effective Oct. 7, 2011) ("The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.")

3. *Customer-Specific Suitability.* Under customer-specific suitability, a broker-dealer must make recommendations based on a customer's financial situation and needs as well as other security holdings, to the extent known. *See In the Matters of Richard N. Cea, et al.*, Exchange Act Release No. 8662 at 18 (Aug. 6, 1969) ("Release 8662") (involving excessive trading and recommendations of speculative securities without a reasonable basis); *F.J. Kaufman and Co.*, Exchange Act Release No. 27535 (Dec. 13, 1989); NASD Rule 2310 (requiring that members "have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs"); Regulatory Notice 09-25, "Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations"; FINRA Rule 2111.05 (effective Oct. 7, 2011) (noting that "the customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile.").

   a. This customer-specific suitability requirement is construed to impose a duty of inquiry on broker-dealers and registered investment advisers to obtain relevant information from customers relating to their financial situations.

      (1) "To fulfill the obligation, [a registered investment] adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.22 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

      (2) As to broker-dealers, *see* NASD Rule 2310: "Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer." *See also* Regulatory Notice 09-25, "Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations;" FINRA Rule 2111(a) (effective Oct. 7, 2011). ("A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."). *See also* In the Matter of the Application of Gerald

M. Greenberg, et al., Exchange Act Release 6320 (July 21, 1960) (holding that a broker cannot avoid the duty to make suitable recommendations simply by avoiding knowledge of the customer's financial situation entirely). However, note that under the FINRA rules, a broker-dealer's suitability obligations are different for institutional customers than for non-institutional customers. NASD IM-2310-3[FINRA Rule 2111(b)] (effective Oct. 7, 2011) sets out factors that are relevant to the scope of a broker-dealer's suitability obligations in making recommendations to an institutional customer.

b. The requirement of customer-specific suitability is also construed to impose a duty of inquiry on broker-dealers and registered investment advisers keep such information current.

(1) Exchange Act Rule 17a-3(a)(17)(i) requires, subject to certain exceptions, broker-dealers to update customer records, including investment objectives, at least every 36 months from the last recommendation.

4. *Quantitative Suitability (No Excessive Trading, Churning, or Switching).* "Under quantitative suitability, a broker-dealer that has actual or de facto control over a customer account must have a reasonable basis for believing that the number of recommended transactions within a certain period, even if suitable when viewed in isolation, is not excessive and unsuitable for the customer when taken together in light of the customer's investment profile. Activities such as excessive trading, churning, and switching have been found to violate the quantitative suitability obligation under the SRO suitability rules and federal antifraud provisions." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.64-5 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

a. *See In the Matter of the Application of Clyde J. Bruff*, Exchange Act Release No. 40583 (Oct. 21, 1998) (excessive trading is itself a form of unsuitability).

b. "Churning" occurs when a broker-dealer buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions. *See, e.g. In the Matter of the Application of Donald A. Roche*, Exchange Act Release No. 38742 (June 17, 1997) ((excessive trading is a type of violation of "broad" suitability rules promulgated by SROs) (*quoting Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981).

c. "Switching" involves transactions in which shares of a particular security are redeemed and all or part of the proceeds are used to purchase shares of another security with the primary effect of benefiting the broker rather than the customer. *See, e.g., In the Matter of the Application of Scott Epstein*, Exchange Act Release No. 59328 (Jan. 30, 2009), *aff'd Epstein v. S.E.C.*, 2010 WL 4739749 (3rd Cir. 2010) (finding that a registered representative violated NASD Rules 2310(a), 2310(b), IM-2310-2, and 2110 because he did not have reasonable grounds for recommending mutual fund switches and put his own interests ahead of the interests of his customers).

5. *Other SEC/FINRA Rules Pertaining to Suitability.* "Specific disclosure, due diligence, and suitability requirements apply to certain securities products, including penny stocks, options, mutual fund share classes, debt securities and bond funds, municipal securities, hedge funds, direct participation programs, variable insurance products, and non-traditional products, such as structured products and

leveraged and inverse exchange-traded funds. Moreover, considerations related to suitability may be raised with regard to specific types of accounts such as discretionary, day trading, or margin accounts." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.65-6 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

RULE 4.6. DUE DILIGENCE IN INVESTMENT STRATEGY AND INVESTMENT PRODUCT SELECTION. IN ADDITION TO MEETING THE SUITABILITY REQUIREMENTS, THE INVESTMENT ADVISER MUST EXERCISE DUE DILIGENCE AS TO:
- THE INVESTMENT STRATEGY TO BE EMPLOYED; AND
- THE INVESTMENT PRODUCTS RECOMMENDED TO THE CLIENT;
SEEKING TO SELECT THE INVESTMENT STRATEGY(IES) AND PRODUCT(S) WHICH BEST MEET THE CLIENT'S NEEDS.

WHEN ENGAGED TO DO SO OR REQUIRED BY LAW, THE INVESTMENT ADVISER MUST MONITOR THE INVESTMENTS CHOSEN.

Commentary.

Consistent with the nature and scope of the engagement, the investment adviser shall undertake a reasonable investigation regarding the investment strategy, as well as the specific investment products, recommended to clients. Such an investigation may be made by the investment adviser or by others provided the investment adviser acts reasonably in relying upon such investigation.

Factors the investment adviser should address in such an investigation include, but are not limited to: (1) the historical and expected returns of the investment product and its asset class; (2) the risks posed by the product as to price volatility, terminal value, or otherwise; (3) the effect of the addition of the product to the investment portfolio of the client and its expected risks and returns; (4) the fees and costs associated with the acquisition, holding, or potential sale of the product; (5) the tax attributes of the product in light of the client's situation (both as to tax benefits and tax detriments); and (6) whether any guarantees offered by the product will likely provide a meaningful benefit to the client in light of their costs.

Annotations.

1. *Investment Strategy Due Diligence, Generally.*
   a. *Under ERISA.* "We think it is entirely appropriate for a fiduciary to consider the time horizon over which the plan will be required to pay out benefits in evaluating the risk of large loss from an *investment strategy*." *Metzler v. Graham*, 112 F.3d 207, 210 (5th Cir.1997) [*Emphasis added.*]
2. *Diversification Requirement, Generally.* Unless the fiduciary and the client otherwise agree, it should be assumed by the fiduciary that the prudent man rule applies to the design and implementation of the client's investment portfolio.
   a. *ERISA's Diversification Requirement, Generally.* "ERISA requires fiduciaries to diversify "the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." 29 U.S.C. § 1104(a)(1)(C). The Fifth Circuit has stated: 'The degree of investment concentration that would violate this requirement to diversify cannot be stated as a fixed percentage, because a fiduciary must consider the facts and circumstances of each case. The factors to be considered include (1) the purposes of the plan; (2) the amount of the plan

assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; (7) dates of maturity.' *Metzler v. Graham*, 112 F.3d 207, 209 (5th Cir.1997) (citing H.R.Rep. No. 1280, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5084-85 (Conf. Rpt. at 304)).. Moreover, the court admonished lower courts that "[i]t is clearly imprudent to evaluate diversification solely in hindsight-plan fiduciaries can make honest mistakes that do not detract from a conclusion that their decisions were prudent at the time." *Id.* at 209. [Generally, there are four principle fiduciary duties under ERISA §404(a): duty of loyalty; duty of prudence; duty to diversify; and duty to follow plan documents.]

3. *Investment Product Due Diligence, Generally.*

   a. *Due Diligence Arising under ERISA, as to Investment Selection and Monitoring.* "An ERISA investment adviser possesses the general duty to prudently select and monitor any service provider or designated investment alternative offered under the plan." 29 C.F.R. Part 2550 (Oct. 14, 2010), at 132; § 2550.404c-1(d)(2)(iv). "It is by now black-letter ERISA law that 'the most basic of ERISA's investment fiduciary duties [is] the duty to conduct an independent investigation into the merits of a particular investment.' *In Re Unisys Savings Plan Litig.*, 74 F.3d 420, 435 (3d Cir.), cert. denied, ___ U.S. ___, 117 S.Ct. 56, 136 L.Ed.2d 19 (1996). 'The failure to make any independent investigation and evaluation of a potential plan investment' has repeatedly been held to constitute a breach of fiduciary obligations. *Whitfield v. Cohen*, 682 F.Supp. 188, 195 (S.D.N.Y.1988)." *Liss v. Smith*, 991 F.Supp. 278 (S.D.N.Y., 1998). ERISA regulations defines the "appropriate consideration" which must be given to "those facts and circumstances that ... the fiduciary knows are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties": "[A]ppropriate consideration" shall include ... [a] determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio ... to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and [c]onsideration of ... (A) [t]he composition of the portfolio ... (B) [t]he liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and (C) [t]he projected return of the portfolio relative to the funding objectives of the plan." 29 C.F.R. § 2550.404a-1(b).

4. *Investment Policy Statements- Required?*

   a. *Under ERISA – As a Practical Matter, "Yes".* "ERISA does not contain a specific requirement that a written investment policy be maintained by the trustees. I find, at least in this instance, that such a policy is necessary to insure that the plan investments are performing adequately and meeting the actuarial, liquidity and other needs of the Funds. Support for this proposition is found in Department of Labor regulations … The maintenance by an employee benefit plan of a statement of investment policy designed to further the purposes of the plan and its funding policy is consistent with the fiduciary obligations set forth in ERISA § 404(a)(1)(A) and (B).... For purposes of this document, the term `statement of investment policy' means a written statement that provides the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories of investment management decisions .... A statement of investment policy is distinguished from directions as to the purchase or sale of a specific investment at a specific time .... 29 C.F.R. § 2509.94-2(2). While this regulation states only that a written investment plan is "consistent" with ERISA's fiduciary duty requirements, in the circumstances here, absence of any plan constitutes a breach of fiduciary duty." *Liss v. Smith*, 991 F.Supp. 278 (S.D.N.Y., 1998).

5. *Duty to Monitor Investments Under ERISA.*

   a. "While ERISA does not expressly state a 'duty to monitor', courts have recognized a duty to monitor and many of the fiduciary duties outlined above may be fully or partially fulfilled through a regular monitoring process … The duty to monitor investment performance is applicable even with respect to retirement plans that rely on the so-called "404(c) safe harbor" to insulate plan fiduciaries from liability to plan participants for losses sustained in the participants' individual accounts based on investment losses stemming from participant-directed investments." Alison Wright, Howard Rice Nemerovski, Caady Falk & Rabkin, P.C., ERISA Fiduciary Duty and the Duty to Monitor (Bloomberg Law Reports / Employee Benefits, 2010), available at http://www.furrandassociates.com/files/13875/Bloomburg%20Law%20Report_ERISA%20Fiduciary%20Duty%20and%20Duty%20to%20Monitor.pdf.

   b. *See Lingis v. Motorola, Inc.*, 649 F.Supp.2d 861 (N.D. Ill., 2009) ("The duty to monitor is thus a natural extension of the duty to appoint and remove plan fiduciaries … The Department of Labor regulation cited above stated that fiduciaries can comply with the duty to monitor by reviewing the fiduciaries' performance "at reasonable intervals." 29 C.F.R. § 2509.75-8 (FR-17)." *Id.*

   c. *See Harley v. Minnesota Mining and Mfg. Co.*, 42 F.Supp.2d 898 (D. Minn., 1999) ["Once the investment is made, a fiduciary has an ongoing duty to monitor investments with reasonable diligence and remove plan assets from an investment that is improper. *See, e.g., Liss*, 991 F.Supp. at 299 (noting, in finding a breach of fiduciary duty, that the fiduciaries had failed to monitor the performance of the fund's broker); *Hunt v. Magnell*, 758 F.Supp. 1292, 1299 (D.Minn.1991) ("ERISA fiduciaries must monitor investments with reasonable diligence and dispose of investments which are improper to keep."); *Whitfield*, 682 F.Supp. at 196. Typically, whether a fiduciary acted prudently — or in other words, as a reasonably prudent fiduciary — is a question of fact. *See, e.g., Roth*, 16 F.3d at 919 (finding that whether the fiduciaries acted reasonably in the circumstances presented involved a question of fact precluding summary judgment)."] *Harley* at 906-7.

6. *Prudence, Not Prescience, is Required.* While the duty of due diligence is a high one, it is not without boundaries. For example, "ERISA imposes the highest standard of conduct known to law on fiduciaries of employee pension plans." *Reich v. Valley National Bank of Arizona*, 837 F.Supp. 1259, 1273 (S.D.N.Y.1993), *quoting Donovan v. Bierwirth*, 680 F.2d 263 (2nd Cir.1982); Kuper v. Iovenko, 66 F.3d 1447, 1453 (6th Cir.1988). However, this is not equivalent to a standard of absolute liability, as ERISA fiduciaries are only required to exercise prudence, not prescience or omniscience. *Frahm v. Equitable Life Assurance Society of the United States*, 137 F.3d 955, 960 (7th Cir.1998); *DeBruyne v. Equitable Life Assurance Society of the United States*, 920 F.2d 457, 465 (7th Cir.1990)." *Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818, 863 (C.D. Ill., 2004).

7. *Investigation of Accuracy of Offering Circulars, Reports Generally Not Required, Unless Facts Give Rise to Suspicions, or Unless Duty Assumed to So Investigate.* Another case "addressed, in the context of determining liability under federal securities laws, whether an investment advisor has a duty to investigate the accuracy of statements made in an offering memorandum not prepared by itself and which its client relies upon in making an investment. The court declined to impose such a duty "when

there is nothing that is obviously suspicious about those statements." *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385, 413 (S.D.N.Y., 2005), *citing Gabriel Capital, L.P. v. Natwest Finance, Incorporated*, 137 F.Supp.2d 251, 262 (S.D.N.Y.2000). ("An investment advisor is retained to suggest appropriate investments for its clients, but is not required to assume the role of accountant or private investigator and conduct a thorough investigation of the accuracy of the facts contained in the documents that it analyzes for the purpose of recommending an investment."). *Id.* at 263. However, if a representation is made that the accuracy of documents will be verified, then such a duty of due diligence, voluntarily assumed by the investment adviser, will likely exist. *See Fraternity Fund* at p.415 ("Here, however, Asset Alliance allegedly represented to Sanpaolo that it 'ensure[d] that the portfolios' marks are consistent with market values.' By making this representation, Asset Alliance took on a duty to review and check Beacon Hill's prices.").

8. *ERISA's Requirements.* Under ERISA, a fiduciary is obligated to undertake an independent investigation of the merits of a particular investment and to use appropriate and prudent methods in conducting that investigation. *Harley v. Minnesota Mining & Mfg. Co.*, 42 F.Supp.2d 898, 906 (D. Minn. 1999*), citing In re Unisys Savings Plan Litigation*, 74 F.3d 420, 435 (3rd Cir. 1996). In determining compliance with ERISA's prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions.

9. *Hedge Fund Due Diligence.* "Where an investment advisor recommends a hedge fund without conducting sufficient due diligence, an investor's breach of fiduciary duty claim "arises in the securities context" (*Bayou Hedge Fund Litigation*, 534 F. Supp.2d 405, 422, SDNY 2007, *aff'd sub nom., South Cherry St. v Hennessee Group*, 573 F.2d 98, 2d Cir., 2009)." *Hecht v. Andover Assoc. Mgt. Corp.*, 2010 NY Slip Op 50528(U) (N.Y. Sup. Ct. 3/12/2010).

RULE 4.7. ENSURING THE REASONABLENESS OF THE TOTAL FEES AND COSTS BORNE BY A CLIENT. AN INVESTMENT ADVISER SHALL REASONABLY ENSURE THAT THE TOTAL FEES AND COSTS BORNE BY THE CLIENT IN CONNECTION WITH THE INVESTMENT ADVISER'S SERVICES AND RECOMMENDATIONS ARE REASONABLE IN LIGHT OF THE SERVICES PROVIDED.

Commentary.

The Reasonablenesss of Fees, Generally. Fees charged or incurred by clients should not be excessive in light of the extent and nature of the services provided, the skill and expertise required of the investment adviser, the risks assumed by the investment adviser in connection with the advice and services provided, and the benefits obtained by the client.

Discussion of Investment Advisor Fee Arrangements, Generally.

AUM Fee Arrangements, Generally. In the *Constellation Financial Management LLC* no-action letter under Investment Advisor Act of 1940 - Section 206, dated January 9, 2003, the SEC Staff discussed charging fees using a percentage of assets under management:

> In recent years, the financial services industry has discovered how profitable asset management fees are, and many registered-representatives of broker-dealer firms have transitioned from transaction-generated commissions to asset management fees (i.e., fees based on a percentage of

assets under management). In general, such fees increase as the size of the client's portfolio increases. While there has been some criticism that fees should not be substantially higher when the time and effort expended are not commensurately higher, there exist at least three major reasons justifying a percentage of assets under management approach. First, there is certainly a greater personal and firm risk (in terms of potential liability) as the amount of managed assets increases. This often directly translates into increased costs, especially as to E&O insurance premiums for the Investment adviser or his or her firm. Second, in terms of benefit to the client, an investment adviser benefits more greatly the client who has a greater level of assets under management. The time that is spent by an investment advisers undertaking investment research and due diligence, and reviewing the academic research promulgated by others, benefits all clients, but perhaps benefits the wealthier client the most. Third, investment advisers may choose to provide services to those who possess lower amounts of managed assets than would otherwise be accepted by the investment advisers, as a means of benefitting the public good. While this justification may be controversial, the higher fees paid by some clients enable Investment advisers to serve those of limited resources but who nevertheless possess financial planning needs. Investment advisers thereby are better equipped to serve the public good, while still permitting the investment advisers to maintain a reasonable level of professional practice income.

Varying AUM Fees, Observations. Percentage fees can be set substantially lower for clients, as a percentage of the investment portfolio, as the size of the client's portfolio grows. This is one way of adjusting the compensation to fit the effort required, while still compensating for the added risk of greater managed assets or the greater benefit to the client. In addition, an investment adviser may choose to voluntarily lower fees for an investor in primarily fixed income investments, in adherence to his or her fiduciary duty, although this, in turn, might create a conflict of interest as to determining the asset allocation to be recommended to the client.

Flat Fee or "Retainer Fee" Arrangements. Charging a "flat fee" to all clients, regardless of the level of managed assets or the client's overall wealth, would remove virtually all remaining potential conflicts of interest. In the fee-only investment community, it is sometimes known as being "pure." It better ensures that the investment advisers does not have a financial incentive to take an inordinate amount of risk with the client's investment portfolio in pursuit of unnecessarily high returns, fails to recommend that the client convert managed financial assets to non-managed or non-financial assets, or pay off debt, even when such is better for the client, and does not advise against spending the clients' money or giving it away as part of the clients' estate planning. However, a pure "flat fee" or retainer does not compensate the advisor for the added risk associated with the management of larger accounts, nor for the added benefits to the client related to larger accounts. Moreover, flat fees may meet resistance from clients, just as any other fee structure would.

Hourly Fee Arrangements, Generally. There are investment advisers and financial planners who firmly believe in hourly fee arrangements. Investment advisers should be encouraged to enter into hourly-based financial planning arrangements when appropriate. However, criticism by hourly-only investment advisers of other compensation structures should be resisted, as an hourly fee only model for the financial planning profession may not be appropriate in all cases, as this commonly repeated story reveals: A woman was strolling along a street in Paris when she spotted Picasso sketching at a sidewalk café. The woman asked Picasso if he might sketch her, and charge accordingly. Picasso obliged. In just minutes, there she was: an original Picasso. "And what do I owe you?" she asked. "Five thousand francs," he answered. "But it only took you three minutes," she politely reminded him. "No," Picasso said. "It took me all my life."

Commissions; Variable Compensation. Commissions, since they are paid by third parties to the investment adviser, pose a serious conflict of interest to the investment adviser. However, the payment of commissions, or other forms of third-party compensation (*e.g.*, principal trading mark-ups and mark-downs) do not constitute a *per se* violation of an investment adviser's fiduciary duties. More problematic is the situation where the investment adviser's compensation is *variable*. Variable compensation, in which the investment adviser may be paid more for recommending one product over another, such as a higher commission (or other forms of third-party compensation, such as payment for shelf space, 12b-1 fees, soft dollar compensation, etc., paid to the investment adviser or an affiliate thereof), presents the investment adviser with the difficult burden to justify the higher compensation – especially when the review of the arrangement is likely to be undertaken by an arbitrator, judge or jury who may be less than inclined to accept the explanation provided. A better practice for an investment adviser utilizing commission-based compensation (or any other form of third-party compensation) would be to agree with the client, in advance, as to the parameters of the investment adviser's compensation, and then to select products within such compensation parameters. A best practice would be the avoidance of third-party material compensation, altogether.

Even with Clients Only Paying Compensation, Conflicts of Interest Relating to Compensation of the Investment Adviser are Likely to Still Exist. Despite the efforts to avoid conflicts of interest, and regardless of the form of compensation, some conflicts of interest will continue to exist. Proper management of remaining conflicts of interest is essential to preserving the investment adviser's ability to act in the best interests of the client.

Close Attention to Fees and Costs is Required. Fiduciary status requires investment advisers to pay close attention to the total fees and costs which a client will bear in connection with the advisory services, including the total fees and costs of recommended investment products. Since an investment adviser has the objective of putting the client's interests first, and since fees and costs borne by the client's will affect the results obtained by the client, it is obvious that any costs passed on to clients must be spent wisely. This does not mean that the least expensive alternative must always be used, but it does mean that a cost-benefit analysis must be considered for each expense.

Annotations.

1. *Prudent Investor Rule: Duty to Reduce Costs.* As stated previously, at least one court has found the Prudent Investor Rule to be the standard applicable to an investment adviser's duty of due care under the state common law (while other courts have declined to follow that holding); in any event, most retail clients believe that the investment adviser will, following his or her duty of due care, recommend to the client a "prudent" investment portfolio. However, even then, an investment adviser and the client may, by mutual agreement, waive the Prudent Investor Rule's application, provided sufficient information regarding the ramifications of such waiver are disclosed and understood by the client.

   If the Prudent Investor Rule is applicable to the investment adviser's relationship with the client, then the Rule goes a large step is discussing the duties of a fiduciary with regard to costs. For example, as adopted in Florida, and as set forth in Section 518.11(1)(f), Florida Statutes (2010): "The circumstances that the fiduciary may consider in making investment decisions include, without limitation ... the general economic conditions, the possible effect of inflation, the expected tax consequences of investment decisions or strategies, the role each investment or course of action plays within the overall portfolio, the expected total return, including both income yield and appreciation of capital, *and the duty to incur only reasonable and appropriate costs*." [*Emphasis added*.] As stated in the commentary to the UPIA, "[I]t is important for trustees to make cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio." In other words, to act prudently a fiduciary must act to reduce costs. Like any investor, a fiduciary should be informed of the total costs of the investment, and should consider alternatives. Higher costs should be incurred only when there is a legitimate reason to do so - such as higher expected returns or the need to engage an investment advisor to assist the fiduciary." [Comment to Section 7, UPIA.]

2. *Investment Advisers's Duty to Understand – and Evaluate - All of the "Total Fees and Costs" of Pooled Investment Vehicles.* The "annual expense ratio" of a mutual fund, unit investment trust, or ETF does not represent all of the fees and costs associated with same. Knowing this, as part of the investment adviser's due diligence efforts in mutual fund selection, investment advisers should undertake a reasonable review of the total costs of the investment product recommended. For a reference article as to how investment advisers might discern, or at least estimate, the "total fees and costs" of U.S. stock mutual funds, see Rhoades, Estimating the Total Fees and Costs of Stock Mutual Funds and ETFs (April 22, 2009), available at http://www.josephcapital.com/EstimatingtheTotalCostsofStockMutualFunds200904.pdf.

3. *Broker-Dealer Rules Which Limit Compensation.* While not meeting the greater obligation of a fiduciary to ensure that all fees and costs are reasonable, "SRO rules generally require broker-dealer prices for securities and compensation for services to be fair and reasonable taking into consideration all relevant circumstances. Generally, this requirement prohibits a member from entering into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission that is not reasonable. Recognizing that what may be "fair" (or reasonable) in one transaction could be "unfair" (or unreasonable) in another, FINRA has provided guidance on what may constitute a "fair" mark-up. Moreover, the courts and the Commission have held that under the antifraud provisions of the federal securities laws, broker-dealers must charge prices reasonably related to the prevailing market price. The Commission has consistently held that undisclosed markups of equities of more than 10% above the prevailing market price are fraudulent. Markups of less than 10% may also be fraudulent in certain circumstances. For example, appropriate markups on debt securities are generally much lower, with the Commission even finding markups below 4 or 5% to be excessive and fraudulent. Broker-dealers are also prohibited under FINRA rules from charging unfair or unreasonable underwriting compensation in connection with the distribution of securities, and must disclose all items of underwriting compensation in the prospectus or similar document. Similarly, under FINRA rules, a broker-dealer's charges and fees for services performed (including miscellaneous services such as collection of moneys due for principal, dividends, or interest; exchange or transfer of securities; appraisals, safekeeping or custody of securities, and other services) must be "reasonable" and "not unfairly discriminatory between customers" … charging an unfair commission would also violate a broker-dealer's obligation to observe just and equitable principles of trade pursuant to FINRA rules." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), pp.66-8 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) (Citations omitted.)

4. *ERISA Requires All Fees Paid Are "Reasonable."*

a. *The Prohibited Transaction Rule and Exception Thereto Permitting "Reasonable" Fees.* ERISA §406 (prohibited transaction rule) prohibits the provision of goods and services between a plan and a party in interest. A party in interest includes persons providing services to such a plan. For example, a registered investment adviser (RIA) or stockbroker providing services to a retirement plan is a party in interest. The ERISA prohibitions preclude the furnishing of services between a plan and a party in interest and the transfer of plan assets to a party in interest. Thus, absent an exemption, the plan could not employ the RIA or stockbroker or use plan assets to pay their fees. Hence, ERISA §408(b)(2) provides an exception to the prohibited transaction rule, which permits the provisions of services between and plan and a party in interest *provided that the fees paid are reasonable*.

b. *The "Facts and Circumstances" Test for Reasonableness.* A plan fiduciary is allowed to receive "any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan." ERISA § 408(c)(2); 29 U.S.C. § 1108(c)(2).

   i. Whether compensation paid to a plan fiduciary for services rendered to a plan is "reasonable" depends on the particular facts and circumstances of each case. 29 C.F.R. § 2550.408c-2(b)(1).

   ii. However, if the fiduciary is already receiving full-time pay from an employer or association of employers or from an employee organization, whose employees or members participate in the plan, the fiduciary may receive only reimbursement of direct expenses. *Id.*

c. *"Reasonable" Not Clearly Defined.* "What constitutes 'reasonable' compensation is not clearly defined in the ERISA statute or regulations. The disclosure and other requirements associated with such compensation have been a source of confusion and controversy among plan sponsors, service providers and participants in recent years ... The meaning of 'reasonable' is not defined by reference to any specific amount or formula. Rather, reasonableness is a concept derived from the process by which a plan fiduciary selects investment options for plans based on disclosures and other information concerning fees and related services. DOL regulations address the meaning of 'reasonableness' and discuss different contexts in which fees may or may not give rise to a violation of ERISA duties. In general, in order to be reasonable, fees must be reasonable in light of the services provided and must not be duplicative or excessive. A fiduciary has an ongoing duty to monitor fees to ensure that they remain reasonable and to provide plan participants with sufficient information concerning fees to enable them to make informed investment decisions." Fein, Melanie L. , The Reasonableness of 401(K) Plan Fees (July 2010). Available at SSRN: http://ssrn.com/abstract=1682074.

d. *Excessive Fee Cases – Use of Retail Funds in 401(k) Plans.* A number of recent cases have examined whether it is a breach of ERISA's fiduciary duties for a plan sponsor to include in a qualified retirement plan lineup retail mutual funds, when the plan sponsor possessed the bargaining power to obtain "institutional shares" or other funds which had lower fees. The federal courts appear to be split in their holdings:

   i. The Seventh Circuit held that a fiduciary is not under a duty to "scour the market to find and offer the cheapest possible fund." *Hecker v. Deere & Co.,* 556 F.3d 575 (7th Cir. 2009) *cert. denied* 130 S.Ct. 1141 (2010) ("As the district court pointed out, there was a wide range of expense ratios among the twenty Fidelity mutual funds and the 2,500 other funds available through BrokerageLink. At the low end, the expense ratio was .07%; at the high end, it was just over 1%. Importantly, all of these funds were also offered to investors in the general public, and so the expense ratios necessarily were set against the backdrop of market competition. The fact that it is possible that some other funds might have had even lower ratios is beside the point; nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund … As for the allegation that Deere improperly limited the investment options to Fidelity mutual funds, we find no statute or regulation prohibiting a fiduciary from selecting funds from one management company. A fiduciary must behave like a prudent investor under similar circumstances; many prudent investors limit themselves to funds offered by one company and diversify within the available investment options. As we have noted several times already, the Plans here directly offered 26 investment options, including 23 retail mutual funds, and offered through BrokerageLink 2,500 non-Fidelity funds. We see nothing in the statute that requires plan fiduciaries to include any particular mix of investment vehicles in their plan …

ii. However, the Eighth Circuit distinguished *Hecker* and held that a plaintiff's complaint that a plan's fiduciary failed to use its bargaining power to negotiate cheaper institutional shares and instead included retail funds with higher costs was sufficient to survive a motion to dismiss. *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585 (8th Cir. 2009) ("The complaint alleges that the Plan comprises a very large pool of assets, that the 401(k) marketplace is highly competitive, and that retirement plans of such size consequently have the ability to obtain institutional class shares of mutual funds. Despite this ability, according to the allegations of the complaint, each of the ten funds included in the Plan offers only retail class shares, which charge significantly higher fees than institutional shares for the same return on investment. [Fn: Compare to Hecker v. Deere & Co., which involved a fiduciary duty claim based on excessive fees where participants had access to over 2,500 mutual funds. 556 F.3d 575, 578 (7th Cir.2009). The district court in Hecker found it "untenable to suggest that all of the more than 2500 publicly available investment options had excessive expense ratios." Id. at 581. The far narrower range of investment options available in this case makes more plausible the claim that this Plan was imprudently managed.] … Braden's allegations are sufficient to state a claim that appellees breached their duty of loyalty by failing to disclose details about the revenue sharing payments. Braden alleges that those payments corrupted the fund selection process — that each fund was selected for inclusion in the Plan because it made payments to the trustee, and not because it was a prudent investment. If true, this information could influence a reasonable participant in evaluating his or her options under the Plan … our construction of the statute is in keeping with traditional principles of trust law, which inform our interpretation of ERISA. Varity Corp., 516 U.S. at 496, 116 S.Ct. 1065. The transactions prohibited by § 1106 tend to be those in which "a fiduciary might be inclined to favor [a party in interest] at the expense of the plan's beneficiaries." *Harris Trust & Sav. Bank*, 530 U.S. at 242, 120 S.Ct. 2180. At common law, the fiduciary bears the burden of justifying such transactions. *See, e.g., Fulton Nat'l Bank v. Tate*, 363 F.2d 562, 571-72 (5th Cir.1966) ("[T]he beneficiary need only show that the fiduciary allowed himself to be placed in a position where his personal interest might conflict with the interest of the beneficiary[, and] the law presumes that the fiduciary acted disloyally.") (emphasis in original); *Matter of Estate of Snapp*, 502 N.W.2d 29, 34 (Iowa 1993); *Peyton v. William C. Peyton Corp.*, 7 A.2d 737, 747 (Del.1939). In short, "prohibited transactions [under § 1106(a)(1)] involve self-dealing [and the] settled law is that in such situations the burden of proof is always on the party to the self-dealing transaction to justify its fairness." *Marshall v. Snyder*, 572 F.2d 894, 900 (2d Cir.1978).”

iii. *Hecker* was also distinguished in *Tibble v. Edison Intern.*, 639 F. Supp. 2d 1074 (C.D. Cal. 2009) (“ERISA details the general duty of loyalty and care owed by a plan fiduciary to its participants. See 29 U.S.C. § 1104. The statute requires a plan fiduciary to discharge his duties solely in the interest of the plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries, and defraying reasonable expenses of administering the plan. Id. § 1104(a)(1)(A). The fiduciary shall use the amount of "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Id. § 1104(a)(1)(B) … Even if the retail mutual funds that were included in the Plan performed more poorly than other mutual funds or had higher expense ratios, these facts alone would not be sufficient to show a breach of the duty of loyalty. Plaintiffs will have to go further and show that the Defendant fiduciaries chose a weaker retail mutual fund over a stronger retail mutual fund, because of the fact that the weaker retail mutual fund offered revenue sharing and the stronger retail mutual fund did not. *See* McKesson, 391 F.Supp.2d at 834 (noting that a breach of the duty of loyalty requires "actual disloyal conduct"). In the Court's view, it is only under such circumstances that a breach of the duty of loyalty would be shown … the Court finds that certain internal communications, when viewed in the light most favorable to Plaintiffs, could be interpreted as revealing that individuals involved in the mutual fund selection process were impermissibly considering revenue sharing when deciding which mutual funds would become investment options for the Plan participants. These emails in combination with the existing structural conflict of interest, whereby SCE directly benefitted from the selection of mutual funds that offered revenue sharing, create a triable issue as to whether certain fiduciaries acted disloyally when choosing certain mutual funds. On the other hand, however, the evidence does not necessarily lead to the conclusion that there was a breach of the duty of loyalty. Indeed, some of this evidence suggests that the fiduciaries were selecting funds for the permissible purpose of benefitting both the Plan participants and SCE. Thus, it will be necessary to receive further evidence and to hear testimony from the relevant fiduciaries in order to determine whether they actually acted disloyally when making investment decisions for the Plan … The Court's decision in this case is consistent with the Seventh Circuit's opinion in Hecker. The Court agrees with the Seventh Circuit that there is nothing inherently wrong with using revenue sharing from mutual funds in order to offset some of the administrative costs that might otherwise be borne by the plan sponsor. The problem occurs only when the relevant fiduciaries make investment decisions not because they are in the best interest of the Plan participants, but in order to maximize the amount of revenue sharing that is generated for the benefit of the plan sponsor. Apparently no such allegation was made in Hecker because the court analyzed the case purely under a failure to disclose theory. This case, however, is not simply about whether a conflict of interest was disclosed or not. Rather, the issue is whether the relevant fiduciaries were actually acting in the best interests of the Plan participants. As discussed above, there is evidence in this case that could reasonably be interpreted as demonstrating that such a breach of the duty of loyalty actually took place. Thus, while this case is consistent with Hecker, at the same time it includes an additional allegation of disloyal conduct (arguably supported by some evidence) that was not addressed in Hecker."

5. *Termination Fees Not Permitted by Registered Investment Advisers.* An investment adviser should not charge a fee for termination of an investment adviser-client financial planning relationship, as such would give rise to a breach of fiduciary duty. The SEC has stated that an advisory client has a right at any time to terminate the advisory relationship, and has previously brought enforcement actions regarding the right of advisory clients to receive a refund of any prepaid advisory fees that the adviser has not yet earned. *See, e.g.*, *In the Matter of J. Baker Tuttle Corp.*, Initial Decision Release No. 13 (Jan. 8, 1990) and *In the Matter of Monitored Assets Corp.*, Investment Advisers Act Release No. 1195 (Aug. 28, 1989) (settled order).
   a. Termination fees for the termination of an investment adviser-client relationship should not be charged, other than reasonable fees normally charged by custodians to all customers of the custodian. *See National Deferred Compensation* (pub. avail. Aug. 31, 1987) ("an adviser may not fulfill its fiduciary obligations if it imposes a fee structure penalizing a client for deciding to terminate the adviser's service or if it imposes an additional fee on a client for choosing to change his investment").
   b. *See also Constellation Financial Management, LLC* (pub. avail. Jan. 9, 2003) ("We have taken the position that certain fees that may have the effect of penalizing a client for ending the advisory relationship, or that may make the client reluctant to terminate an adviser, may be inconsistent with the adviser's fiduciary duty, and may violate Section 206 …" (*citing National Deferred Compensation*).
6. *Must An Investment Adviser Recommend a Lower Cost S&P 500 Index Fund, If Several Choices Exist?* "A fiduciary must always act in the client's best interest (even when it is not in his or her own best interests). Therefore, it may be a breach of fiduciary duty to recommend a S&P 500 mutual fund with a 5% load when you know of a fund with an equivalent track record that is no-load and has low annual expenses." Donald Moine, Are You A Fiduciary?, From the August 13, 2000 MorningstarAdvisor.com, available at http://www.prudentinvestoract.com/Are%20You%20a%20Fiduciary.pdf.

RULE 4.8. PROPER CONSIDERATION OF TAX REDUCTION STRATEGIES. INVESTMENT ADVISERS SHALL REASONABLY CONSIDER AND RECOMMEND TO THE CLIENT SUCH STRATEGIES AND INVESTMENT PRODUCTS WHICH MAY REDUCE THE TAX BURDENS IMPOSED UPON THE CLIENT OVER TIME.

Commentary.

In recommending investments to clients and undertaking financial planning, taxes also play an important role and must be taken into account by the investment adviser. The investment adviser is required to possess a reasonable knowledge of tax reduction strategies. Given the complexity and breadth of tax laws, the investment adviser should seek out tax advice from appropriate tax professionals where appropriate to meet the needs of the Investment adviser's client and as a means of supplementing the Investment adviser's own expertise in financial and tax planning.

An investment adviser is not permitted to disavow the duty to consider taxes in the furnishing of financial planning services to the client; however, an investment adviser may delegate or assign the necessary provision of tax advice to a qualified tax professional, provided a qualified tax professional is actually engaged by the investment adviser or the client in connection with the financial planning or investment advice which is rendered. Additionally, an investment adviser is not obligated to opine on tax matters which are not encountered by most clients.

The duty of due care imposed by the broad fiduciary duty applicable to Investment advisers extends to a consideration of the tax effects of financial planning decisions. Given the importance of tax reduction in financial planning activities, no investment adviser may state that he, she or their firm does not provide tax advice, unless the investment adviser places the investment recommendations provided to the client placed in writing and has them reviewed by a competent tax professional.

Annotations.

How important is this attentiveness to taxation? According to an SEC study, investors in actively managed mutual funds lose an estimated 2.5% a year in annual returns to taxes. Another study by accounting firm KPMG Peat Marwick for the Congressional Joint Economic Committee found that the annual impact of taxes ranged from zero for the most tax-efficient funds to 5.6 percentage points for the least. Combined with actively managed stock mutual fund costs (both "disclosed" and "hidden") that average 2.8% or more per year, taxes and costs can combine to eliminate 50% or more of an investor's expected annual return. On a compounded basis, that 50% loss can equate to an erosion of the vast majority of the returns the capital markets have to offer to individual investors.

SECTION 5. DUTY OF CONFIDENTIALITY.

RULE 5.1. FIDUCIARY DUTY OF CONFIDENTIALITY. INVESTMENT ADVISERS SHALL KEEP ALL INFORMATION ABOUT CLIENTS (INCLUDING PROSPECTIVE CLIENTS AND FORMER CLIENTS) IN STRICT CONFIDENCE, INCLUDING THE CLIENT'S IDENTITY, THE CLIENT'S FINANCIAL CIRCUMSTANCES, THE CLIENT'S SECURITY HOLDINGS, AND ADVICE FURNISHED TO THE CLIENT BY THE FIRM, UNLESS THE CLIENT CONSENTS OTHERWISE.

Commentary.

The fiduciary duty of confidentiality prohibits the investment adviser from using information obtained in confidence from his client or beneficiary other than for the benefit of that client or beneficiary. Other laws and regulations, including Regulation S-P (privacy requirements), and other professional standards of conduct, may impose upon an investment adviser the duty to safeguard each client's confidential and personal information.

An investment adviser shall not disclose any confidential client information without the specific consent of the client. However, this rule shall not be construed to affect in any way an investment adviser's obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit an investment adviser's compliance with applicable laws and government regulations, or prohibit review of an investment adviser's professional practice, or to preclude an investment adviser from initiating a complaint with, or responding to any inquiry made by any regulatory agency.

Investment adviser's employees and third-party-vendors who are provided with access to confidential client information should sign a statement agreeing to adhere to the Investment adviser's privacy policy or otherwise protecting any confidential client information which is received.

In the event of the sale of an investment adviser's practice or portion thereof, an investment adviser must take appropriate precautions (for example, through a written confidentiality agreement) so that the prospective purchaser does not disclose any information obtained in the course of the review, since such information is deemed to be confidential client information. Likewise, investment advisers reviewing a practice in connection with a prospective purchase or merger shall not use to their advantage nor disclose the other investment adviser's confidential client information that comes to their attention.

Best Practices Suggestions.

1. *Privacy Policy.* An investment adviser may desire to consider the following language in its published Privacy Policy:

> We are committed to maintaining the confidentiality, integrity and security of the personal information that is entrusted to us. Federal law requires that we notify you annually of our Privacy Policy, in writing. The categories of nonpublic information that we collect from you may include information about your personal finances, personal taxes, personal estate planning, information about your health to the extent that it is needed for the financial, tax, estate, and asset protection planning process, and information about transactions between you and third parties (such as financial product providers, etc.).
>
> We may disclose limited information to attorneys, accountants, trust officers, mortgage lenders and other advisors or firms with whom you have established a relationship. You may opt out from our sharing information with these non-affiliated third parties by notifying us at any time by telephone, mail, fax, email, or in person. We may also share a limited amount of information about you with your brokerage firm or other custodian in order to assist you in establishing accounts, transferring accounts, facilitating cash or other transfers, executing securities transactions, and voting proxies.
>
> We may also share a limited amount of information about you with our portfolio reporting firm (to be selected) and our account aggregation firm and portfolio reporting firm.
>
> We maintain a secure office to ensure that your information is not placed at unreasonable risk. We employ a firewall barrier and authentication procedures in our computer environment. We do not provide your personal information to mailing list vendors or to solicitors. We require strict confidentiality in our agreements with unaffiliated third parties that require access to your personal information, including auditors, consultants, and other financial services companies. Federal and state regulators (such as the U.S. Securities and Exchange Commission and/or and the State of Florida Department of Financial Services) and professional organizations with whom we affiliate (such as the Certified Financial Planner Board of Standards, Inc.) may review our company records and your personal records as permitted by law; this is for your protection. While we possess a policy of strict confidentiality as to our clients' matters, under certain circumstances we may be required by law to make disclosures to government agencies and to third parties, such as upon receipt of a subpoena.
>
> Personally identifiable information about you will be maintained while you are a client, and for the required period thereafter that records are required to be maintained by federal and state securities laws and regulations. After that time, information may be destroyed. We will notify you in advance if our privacy policy is expected to change.

2. *Obtain Client Signature.* An investment adviser should request that the investment adviser's clients and prospective clients, prior to the initial receipt of substantial confidential information or upon any material change to the investment adviser's disclosure policies, sign a written statement accepting the disclosures which are authorized in the investment adviser's privacy policy, and authorizing disclosures to be undertaken to such third parties as appropriate.
3. *When Investment Adviser is an Attorney.* An investment adviser who is also an attorney admitted to practice before the Bar of any state, or who holds himself or herself out as an attorney, may likewise consider the following addition to the investment adviser's privacy policy: "(Name of investment advisory firm) does not provide legal services and its files are not afforded such protection under the attorney-client privilege."

SECTION 6. EXTENT OF DUTIES; NON-WAIVER OF DUTIES; AND DEFINING THE SCOPE OF THE RELATIONSHIP.

RULE 6.1.

THE DUTY OF AN INVESTMENT ADVISER TO ACT IN THE BEST INTERESTS OF A CLIENT EXTENDS TO THE ENTIRETY OF THE RELATIONSHIP OF THE CLIENT.

THE BROAD DUTIES OF DUE CARE, LOYALTY AND UTMOST GOOD FAITH ARE NOT WAIVABLE BY THE CLIENT.

HOWEVER, WITHIN REASONABLE BOUNDARIES THE SCOPE OF THE CLIENT'S ENGAGEMENT OF THE INVESTMENT ADVISER CAN BE LIMITED BY CLEARLY EXPRESSED TERMS.

Commentary.

Fiduciary status does not result from the negotiations of parties to a proposed contract. While entry into a relationship by the parties is voluntary, these Investment Adviser Rules of Professional Conduct and public policy play a crucial role in the imposition of fiduciary status and the relationships which follow from it. Fiduciary status is imposed by the Rules of Professional Conduct upon the investment adviser-client relationship due to the parties' 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.

Annotations.

1. *Fiduciary Duties of RIAs Extend to the Entirety of the Relationship.* The fiduciary standard arising under the Advisers Act "applies to the investment adviser's entire relationship with its clients and prospective clients …." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.22 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.) *But see* Dodd-Frank Act Section 913(g), providing that "[n]othing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."

2. *Hedge and Indemnification Clauses under the Advisers Act.* "Advisers Act Section 215(a) voids any provision of a contract that purports to waive compliance with any provision of the Advisers Act. The Commission staff has taken the position that an adviser that includes any such provision (such as a provision disclaiming liability for ordinary negligence or a 'hedge clause') in a contract that makes the client believe that he or she has given up legal rights and is foreclosed from a remedy that he or she might otherwise either have at common law or under Commission statutes is void under Advisers Act Section 215(a) and violates Advisers Act Sections 206(1) and (2). The Commission staff has stated that the issue of whether an adviser that uses a hedge clause would violate the Advisers Act turns on 'the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client.' The Commission has brought enforcement actions against advisers alleging that the advisers included hedge clauses that violated Advisers Act Sections 206(1) and (2) in client contracts." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.22 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

3. *Registered Investment Advisers and Arbitration Clauses.* Some state securities regulators prohibit clauses in registered investment adviser – client agreements which mandate arbitration. For SEC-registered investment advisers, however, it appears that pre-dispute arbitration clauses are permitted. *Bakas v. Ameriprise Financial Services, Inc.*, 651 F. Supp. 997 (D. Minn. 2009). However, Advisers Act Section 205(f), added by the Dodd-Frank Act, authorizes the Commission to prohibit or restrict mandatory pre-dispute arbitration provisions in client agreements; the Commission has not proposed or adopted such a rule at the time of this writing (April 10, 2011).

4. *Waivers of the Fiduciary Duty to Make Only Suitable Recommendations Are Not Permitted.* "Obtaining a customer's consent to an unsuitable transaction does not relieve a broker-dealer of his obligation to make only suitable recommendations under the SRO rules." SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.62 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf), *citing* , *see, e.g., In the Matter of the Application of Clinton Hugh Holland, Jr.,* Exchange Act Release No. 36621 at 10 (Dec. 21, 1995) ("Even if we conclude that Bradley understood Holland's recommendations and decided to follow them, that does not relieve Holland of his obligation to make reasonable recommendations."), *aff'd*, 105 F.3d 665 (9th Cir. 1997) (table format); Release 30036, supra note 279 (regardless of whether customer wanted to engage in aggressive and speculative trading, representative was obligated to abstain from making recommendations that were inconsistent with the customer's financial condition); *In the Matter of the Application of Eugene J. Erdos*, Exchange Act Release No. 20376 at 10 (Nov. 16, 1983) (*citing In the Matter of Philips & Company*, Exchange Act Release 5294 at 8 (Apr. 9, 1956) ("[W]hether or not [the customer] considered the transactions in her account suitable is not the test for determining the propriety of [the registered representative's] conduct. The proper test is whether [the representative] 'fulfilled the obligation he assumed when he undertook to counsel [the customer], of making only such recommendations as would be consistent with [the customer's] financial situation and needs.'").

   a. *Why Waivers Not Permitted.* In order to waive the application of the fiduciary standard, a client must be able to undertake, autonomously, an informed waiver. Given the complexity of the financial planning and securities industries and the complexity of the fiduciary concept in general, it is highly unlikely that the typical client will possess the knowledge to make such an informed, intelligent decision.

b. *Why Waivers Not Permitted.* As evidence of the tremendous difficulty consumers of financial services possess in understanding financial planning concepts, and the difficulty in making good decisions even when handed knowledge of investment products, see James J. Choi, David Laibson, Brigitte C. Madrian, Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds. The abstract for this article states: "We report experimental results that shed light on the demand for high-fee mutual funds. Wharton MBA and Harvard College students allocate $10,000 across four S&P 500 index funds. Subjects are randomized among three information conditions: prospectuses only (control), summary statement of fees and prospectuses, or summary statement of returns since inception and prospectuses. Subjects are randomly selected to be paid for their subsequent portfolio performance. Because payments are made by the experimenters, services like financial advice are unbundled from portfolio returns. Despite this unbundling, subjects overwhelmingly fail to minimize index fund fees. In the control group, over 95% of subjects do not minimize fees. When fees are made salient, fees fall, but 85% of subjects still do not minimize fees. When returns since inception (an irrelevant statistic) are made salient, subjects chase these returns. Interestingly, subjects who choose high-cost funds recognize that they may be making a mistake." As this study indicates, every seasoned financial planner knows that the vast majority of consumers of financial planning services lack the knowledge to undertake sound financial and investment decisions.

c. Characterizing a fiduciary's duties of due care and loyalty as "default rules" that can be cast aside by contractual choice too easily equates fiduciary law with contract law. Information asymmetries between an investment adviser and her or his client make it unlikely express waivers incorporated in an engagement contract would reflect the client's judgment that the provision would be value maximizing. Labeling fiduciary duties as "default rules" also threatens to strip fiduciary rules of their moral content. Fiduciary duties are most effective when they function both as legal rules and moral norms. A label that equates the duty of loyalty with, say, a UCC provision allocating risk of loss undermines the duty's normative force. The erosion of the social norm may create significant external costs for all future investment advisers and their clients. [See Melanie B. Leslie, "Trusting Trustees: Fiduciary Duties and the Limits of Default Rules," Benjamin N. Cardozo School of Law, Jacob Burns Institute for Advanced Legal Studies, Working Paper No. 111 (2005). While some academics have argued that certain fiduciary duties should be waivable, even the vast majority of these academics stress that fiduciary duties should not be waivable in situations where fiduciaries are advising on other people's money.

d. The fiduciary duty of loyalty "is not specifically set forth in the Act, established by SEC rules, nor a result of a contract between the adviser and the client (and thus it cannot be negotiated away). Rather, a fiduciary duty is imposed on an adviser by operation of law because of the nature of the relationship between the two parties." [Robert E. Plaze, Associate Director, Division of Investment Management, United States Securities and Exchange Commission, "The Regulation of Investment Advisers by The Securities and Exchange Commission," a white paper presented at the Private Investment Funds Conference, International Bar Association - American Bar Association, February 28, 2005].

5. *Generally, Clients Have No Adequate Means To Monitor The Conduct of Their Fiduciaries*. "[E]ntrustors become dependent on their fiduciaries and may not be able to monitor the quality of

their services because: (1) the skills involved are not easily acquired or understood; (2) the cost to entrustors of monitoring and evaluating such services would undermine the utility of the arrangement; and (3) there exists no other effective alternative monitoring mechanism. In sum, fiduciary rules reflect a consensual arrangement covering special situations in which fiduciaries promise to perform services for entrustors and receive substantial power to effectuate the performance of the services, while entrustors cannot efficiently monitor the fiduciaries' performance." Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, ____ (1995).

6. *When Bargaining On Issues Related To Waiver, Consumers Must Fend For Themselves; Specific Procedures Must Be Followed.* "While bargaining with their fiduciaries on the issue of waiver, entrustors must fend for themselves as independent parties. Their right to rely on their fiduciaries must be eliminated. In fact, during the bargaining, the entire relationship must be terminated. Fiduciary law allows such termination of the relationship with respect to specified transactions only if the parties follow a specific procedure. This procedure is designed to ensure an effective transition from the fiduciary mode in which entrustors rely on their fiduciary, to a contract mode in which parties rely on themselves. That is why fiduciaries must put entrustors on notice that, in connection with the specified transaction, entrustors cannot rely on their fiduciaries. That is why entrustors must be capable of bargaining independently with their fiduciaries and have the capacity to enter into bargains. That is also why, to allow entrustors to make informed decisions, fiduciaries must provide them with information regarding the transaction, especially when the fiduciaries acquired this information in connection with the performance of their services to the entrustors. This procedure is, and should remain, mandatory." Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, 1210-1 (1995).

   a. "In order to transform the fiduciary mode into a contract mode, four conditions must be met: (1) entrustors must receive notice of the proposed change in the mode of the relationship; (2) entrustors must receive full information about the proposed bargain; (3) the entrustors' consent should be clear and the bargain specific; (4) the proposed bargain must be fair and reasonable. Thereafter, two other general bargaining conditions apply. One relates to consenting parties: entrustors must be capable of independent will. The other relates to the subject matter of the bargain: the proposed bargain must not cover non-waivable duties." Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, 1218 (1995).

   b. "Fiduciaries must provide entrustors material information necessary for the entrustors to make an informed decision regarding the waiver. This is necessary because, in contrast to contract law, there is no assumption in fiduciary law that the parties' information about the proposed waiver or bargain is symmetrical. Asymmetrical information among the parties to a fiduciary relationship results both from the nature and from the purpose of the relationship. Fiduciaries possess far more information about their own activities. Entrustors and fiduciaries are not equally equipped to make a cost-benefit analysis of the contemplated change in their relationship. In reality, entrustors can seldom perform such an analysis because they lack accurate information to make it. Therefore, when the fiduciaries possess information in connection with the bargain, and especially if the information has come to them by virtue of their position as fiduciaries, the change of the relationship mode must be accompanied by the fiduciaries' disclosure of this information to the entrustors." Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, 1218 (1995).

7. *Lacking Adequate Consideration, The Validity of Informed Consent Is Highly Suspect, Especially With Respect to Broad Waivers of Rights.* "The entrustors must clearly consent to waive or bargain

around the fiduciaries' duties towards them, and their awareness must be sharper than contract parties' awareness when they waive contract obligations owed to them. That is because, by waiving fiduciary duties, entrustors always give fiduciaries something of value. For example, consent to breach the fiduciary duty of loyalty (misappropriation) can provide a defense for fiduciaries - negating a necessary element of a wrong, and the existence of a wrong. Whether entrustors receive something in return is less clear and depends on their ability to sever the umbilical cord with their fiduciaries, as well as on their bargaining capabilities. The requirement of clarity relates to the condition that the bargain be fair and reasonable. This condition, in turn, is grounded in a rationale, derived from contract law, suggesting that if the bargain is highly unfair and unreasonable, the consent of the disadvantaged party is highly suspect. Experience demonstrates that people rarely agree to terms that are unfair and unreasonable with respect to their interests. Because the bargain or waiver is more likely to be in the fiduciaries' interests, but less likely to be in the entrustors' interests, the consent, by entrustor's action or inaction, must be clear. To ensure clarity, default rules should be as specific and precise as possible. Fiduciary duties of loyalty and care, however, are broad standard rules. Therefore, the bargain around these duties must carve out explicit and specific situations. A number of reasons can be offered for requiring specificity. First, specific rules are efficient for the parties' planning and for bargaining around the rules. Second, specificity is necessary to avoid misunderstandings among the parties. Third, in many cases, a broad waiver of duties is bound to be uninformed and speculative. Waivers of specific claims or level of losses will be more readily upheld. For example, if the fiduciary relationship is an escrow, waiver of particular conditions in advance would likely be upheld because the conditions of the initial relationship are fairly specific, and the waiver will be specific. Fiduciaries may also have better luck enforcing waivers of specific fiduciary duties after violations have occurred. Their chances are improved because the nature and extent of the violation are easily ascertainable, and because the entrustors' bargaining position is stronger. Similarly, waivers of bonding requirements by executors, especially family members or friends of the testator, are likely to be upheld because the testators presumably knew the executors well, and because the waivers are specific and limited to a particular function. A broad waiver of the underlying duties of the executors, however, might not be enforced. Similar reasons apply to waivers of the duty of loyalty in other contexts. Overall, the courts are not likely to uphold bargaining around the broad duties of fiduciaries far in advance when the fiduciaries have substantial discretion over the entrustors' power or property." Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, ____ (1995). "Even if above requirements are met, courts will generally not enforce an unfair or unreasonable bargain, but will require a showing that the transaction is fair and reasonable … A second reason for doubting the voluntariness of an apparent consent to an unfair transaction could be a lingering suspicion that generally, when entrustors consent to waive fiduciary duties (especially if they do not receive value in return) the transformation to a contract mode from a fiduciary mode was not fully achieved. Entrustors, like all people, are not always quick to recognize role changes, and they may continue to rely on their fiduciaries, even if warned not to do so. Lack of fairness may also signal the absence of more or less equal bargaining power by the entrustor …." Frankel, "Fiduciary Duties as Default Rules," 74 Or. L. Rev. 1209, 1218 (1995).

8. *The "Sticky" Aspect of Fiduciary Duties When Applied To Duties Which Protect Both The Client And the Public Interest.* The duties arising from a fiduciary relationship are not easily cast aside. While either party to an investment advisory agreement can terminate the *agreement* governing the provision of investment advisory services, this does not necessarily terminate the fiduciary duties – which can continue to exist. In fact, it is clear that fiduciary duties which are mandatory under the

law, and which benefit the public (such as by encouraging participation by individual investors in the capital markets, and by ensuring that consumers receive trusted advice), are not able to be waived and the relationship of the parties changed as a result to a non-fiduciary one. *See* discussion in NAPFA comment letter on this point. Additionally, as a general rule under the common law (which applies fiduciary duties to investment advisory relationships outside the ambit of federal or state statutes and SEC rules, as mentioned above, except when preempted by ERISA) the fiduciary duty does not terminate merely because the contract for advisory services between the party terminates. For example, in *Western Reserve Life Assurance Company of Ohio v. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007), a dual registrant met twice with a customer, discussing the customer's financial goals and the options for investment of a $2.5m portfolio. The dual registrant recommended a variable annuity to the customer, which investment was entered into. The dual registrant also undertook to monitor the investments in the variable annuity, and acted as the customer's financial advisor. The Texas appellate court, noting that courts do not lightly find fiduciary *relationships* to exist, stated: "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." [*Emphasis added.*] The court further noted that the dual registrant "was much more than a mere order-taker to the Clients—he acted as a financial advisor whom the Clients trusted to monitor the performance of their investments and recommend appropriate financial plans to them. Accordingly, the duty that Hutton owed the Clients went well beyond the 'narrow' duty of executing trade orders." As illustrated by this case, a dual registrant cannot seek to "switch on and off" a fiduciary hat, claiming that some actions are fiduciary in nature and others are not. Once a fiduciary relationship is established, it extends to all of the advice given and transactions recommended to the client. Trust received cannot be cast off and then easily betrayed.

The fact that broad fiduciary duties which benefit the public (such as those imposed by the Advisers Act) cannot be waived, and that fiduciary duties of an investment adviser continue even though his or her contract with the client has been terminated, flows from general principles of fiduciary law and from logic. These rules are required in order to protect the client, by prohibiting the fiduciary from undertaking a simply expedient action of casting off fiduciary duties just prior to consummating an act which would otherwise be in breach of a fiduciary duty.

In a similar fiduciary context, as to the fiduciary duties owed by partners to each other, under the law of most states certain fiduciary duties of partners are not waivable. Moreover, a partner cannot announce his withdrawal from a partnership one day and then commence competing with the partnership the next day. [*See Leff vs. Gunter*, 22 Cal.3d 508 (1983) ("The notion of a continuing fiduciary duty between former partners is not new … in *Donleavey v. Johnston* (1914) 24 Cal.App. 319, 141 P. 229 … [t]he court properly observed: 'The sound rule is, that [a former partner] cannot make any profit to himself from a secret transaction initiated while the relation of trustee and cestui que trust exists, no matter when it springs into actual operation.' … The foregoing principles were echoed in *Fouchek v. Janicek* (1950) 190 Or. 251, 225 P.2d 783, in which the Oregon Supreme Court found a breach of fiduciary duty by one partner who, without using confidential information, preempted a business opportunity after termination of the partnership, having secretly negotiated for the opportunity on his own behalf while the partnership was also engaged in negotiations therefor … [as]the court graphically noted: 'When a partner wrongfully snatches a seed of opportunity from the granary of his firm, he cannot, thereafter, excuse himself from sharing with his copartners the fruits of its planting, even though the harvest occurs after they have terminated their association ….")] [*See also Everest Investors 8 v. McNeil Partners* (2003) 114 Cal.App.4th 411, 424 ("The fiduciary obligations of a general partner with respect to matters fundamentally related to the partnership business cannot be waived or contracted away.")].

SECTION 7. RELATIONSHIPS BETWEEN INVESTMENT ADVISER AND HIS OR HER FIRM.

RULE 7.1. INFORMING EMPLOYER OF MATERIAL EVENTS. AN INVESTMENT ADVISER MUST ADVISE HIS OR HER CURRENT EMPLOYER OF ANY PUBLIC CENSURE OR CERTIFICATION SUSPENSION OR REVOCATION HE OR SHE RECEIVES FROM ANY GOVERNMENTAL BODY OR INDUSTRY ORGANIZATION, AND OF ANY MATERIAL COMPLAINT RECEIVED FROM A CLIENT.

RULE 7.2. AN INVESTMENT ADVISER SHALL REASONABLY RESOLVE ANY CONFLICTS BETWEEN DUTIES OWED TO CLIENTS AND DUTIES OWED TO EMPLOYERS IN FAVOR OF THE CLIENT.

Commentary.

The first and overriding responsibility any investment professional possesses is to the participants of the market – the client. This primary obligation is required in order to maintain the perception and reality that the market is a fair game and thus encourage the widest possible participation in the capital allocation process. The premise of the U.S. capital market is that the widest possible participation in the market will result in the most efficient allocation of financial resources and, therefore, will lead to the best operation of the world-wide economy. Putting the client first actually protects and promotes the best interests of the entire financial community, and, therefore, society as a whole. The concept is operationalized by requiring that financial professionals place the interests of their clients ahead of all other concerns. Responsibilities to employers, colleagues and selves are all placed in a descending order of importance so that the financial markets can be best served. All relevant information must be disclosed to clients and all decisions made with their interests first in mind.

An investment adviser is required to assess, in her or his individual judgments, whether an activity of their employer with respect to the investment adviser's client is consistent with the investment adviser's role as a professional. For example, an employer of an investment adviser may promote the sale of a particular security through a sales contest or other means under which additional compensation would be paid to the investment adviser beyond that provided normally in connection with product sales; the fiduciary duty of loyalty owed to the client by the investment adviser would require that the investment adviser not participate in such a sales contest as it would likely interfere with the independent judgment of the client.

There are circumstances, however, where the client's interests cannot be promoted by the investment adviser over that of his or her employer or prior employer. An example would be prohibitions established by contract between the investment adviser and his or her employer prohibiting the investment adviser from soliciting clients of the firm other employees of the firm to depart the firm, prohibiting competition within a reasonable geographical area and for reasonable period of time, and prohibiting the Investment adviser from seizing trade secrets of the firm.

<u>7.3. RESPONSIBILITIES OF INVESTMENT ADVISER IN CONNECTION WITH DELIVERY OF INVESTMENT ADVISORY SERVICES BY EMPLOYEES.</u> AN INVESTMENT ADVISER IN A FIRM WHO INDIVIDUALLY OR TOGETHER WITH OTHER INVESTMENT ADVISERS POSSESSES COMPARABLE MANAGERIAL AUTHORITY IN A FIRM SHALL MAKE REASONABLE EFFORTS TO ENSURE THAT THE FIRM HAS IN EFFECT MEASURES GIVING REASONABLE ASSURANCE THAT ALL EMPLOYEES ASSISTING THE INVESTMENT ADVISER IN THE DELIVERY OF FINANCIAL PLANNING SERVICES TO THE INVESTMENT ADVISER'S CLIENTS CONFORM TO THE RULES OF PROFESSIONAL CONDUCT AND THAT THE ACTIONS OF THOSE EMPLOYEES IN THE DELIVERY OF FINANCIAL PLANNING SERVICES ARE COMPATIBLE WITH THE OTHER PROFESSIONAL OBLIGATIONS OF THE INVESTMENT ADVISER.

SECTION 8. OBLIGATIONS OF INVESTMENT ADVISER TO THE PROFESSION

<u>RULE 8.1. ADDRESSING VIOLATIONS OF THE INVESTMENT ADVISER RULES OF PROFESSIONAL CONDUCT BY OTHER INVESTMENT ADVISERS.</u> AN INVESTMENT ADVISER WHO KNOWS THAT ANOTHER INVESTMENT ADVISER HAS COMMITTED A VIOLATION OF THE RULES OF PROFESSIONAL CONDUCT THAT RAISES A SUBSTANTIAL QUESTION AS TO THAT OTHER INVESTMENT ADVISER'S HONESTY, TRUSTWORTHINESS OR COMPETENCY:

(A) MAY COUNSEL THE OTHER INVESTMENT ADVISER WHO COMMITTED THE VIOLATION, INCLUDING BUT NOT LIMITED TO ADVICE ON HOW TO EFFECT REMEDIAL ACTION, FURTHER EDUCATION WHICH THE INVESTMENT ADVISER MAY PURSUE; AND

(B) IF THE INVESTMENT ADVISER REASONABLY BELIEVES THAT THE OTHER INVESTMENT ADVISER WILL NOT UNDERTAKE PROPER REMEDIAL ACTION OR MAY IN THE FUTURE CAUSE HARM TO OTHER THE SAME OR OTHER CLIENTS OF THE OTHER INVESTMENT ADVISER OR THE PROFESSION, OR REASONABLY BELIEVES THAT THE OTHER INVESTMENT ADVISER ACTED INTENTIONALLY OR RECKLESSLY, THE INVESTMENT ADVISER SHOULD INFORM THE APPROPRIATE PROFESSIONAL AUTHORITY.

(C) NOTWITHSTANDING THE FOREGOING, THE INVESTMENT ADVISER SHALL REPORT THE OTHER INVESTMENT ADVISER TO THE INVESTMENT ADVISER'S FIRM, AND/OR TO APPROPRIATE REGULATORY AUTHORITIES, WHEN REQUIRED TO DO SO PURSUANT TO SUCH FIRM'S OR SUCH REGULATORY AUTHORITY'S OWN ADOPTED RULES.

Commentary.

There are many approaches to dealing with violations of professional obligations when detected by another member of the profession. In some instances applicable laws or regulations require the reporting of such violations to self-regulatory organizations and/or government agencies. At all times material violations should be reported by an investment adviser to his or her supervisor.

However, in instances where reporting is not required, the investment adviser may possess the option to either report the violation or counsel the individual in order to seek to avoid repeat offenses.

If an investment adviser were obliged to report every violation of these Investment Adviser Rules of Professional Conduct, the failure to report any violation would itself be a violation. Such a requirement is, as a practical matter, unenforceable. This Rule limits the reporting obligation to those offenses that a self-regulating profession must vigorously endeavor to ensure are never repeated. The reporting obligation is designed to either seek to rectify harm already caused to a client of the other investment adviser or to prevent harm to be caused in the future to that other investment adviser's same client or other potential clients. A measure of judgment is, therefore, required in complying with the provisions of this Rule.

A report about misconduct is not required where it would involve violation of the Rule regarding preservation of the reporting investment adviser's client's confidences. However, in such circumstances the reporting investment adviser should encourage a client to consent to disclosure where investigation and prosecution of the report would not substantially impart the interests of the client.

END.