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September 23, 2015

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

Office of Exemption Determinations  
Employee Benefits Security Administration  
U.S. Department of Labor  
Attn: D-11712 and D-11713  
200 Constitution Avenue, NW  
Washington, DC 20210

Re: *Definition of the Term Fiduciary: Conflict of Interest Rule (RIN 1210-AB32);  
Proposed Best Interest Contract Exemption and Principal Transactions in Debt Securities  
Exemption (ZRIN: 1210-ZA25)*

Ladies and Gentlemen:

I write to specifically reply to the comment letter dated July 21, 2015, submitted by Ralph C. Derbyshire, Senior Vice President and Deputy General Counsel, FMR LLC Legal Department, on behalf of Fidelity Investments (hereafter "Fidelity"). I possess significant concerns regarding the statements contained in that letter with regard to its portrayal of some aspects of fiduciary law in the United States. Additionally, I believe the major proposals in that letter, concerning modifications to the proposed exemptions, and in proposing a new "best interests" (non-fiduciary) exemption, would effectively create "the exemptions that swallow the rule." Also, the proposals of Fidelity would fail to meet the requirements imposed by ERISA that any such exemption be in the interests of ERISA plans and plan participants and that plan participants be protected.

While I have the utmost respect for Fidelity as a company, I believe Fidelity's proposals, if adopted, would result in the failure of ERISA's fiduciary protections to be effectively applied to plan sponsors, plan participants, and IRA account owners. Hence, I urge Fidelity's recommendations be rejected.

I submit these comments on my own behalf. My views do not necessarily represent the views of Western Kentucky University, the Gordon Ford College of Business nor its Finance Department. Nor are these comments necessarily reflective of the views of any association or organization with whom I may be, or have been, associated.

### **Executive Summary.**

#### **A. SIFMA's/FINRA's "Best Interest" Proposals, and Related Proposals by Fidelity and Others, Negate the Fiduciary Duty of Loyalty and, Accordingly, Fail to Adhere to the Requirements for the Grant of Exemptive Relief.**

1. The new "Best Interests" standard proposed by SIFMA, and seemingly endorsed by FINRA, Fidelity, and some other broker-dealer firms, is not protective of plan participants and their beneficiaries, and is not in the best interests of plan participants and their beneficiaries as the term "best interests" is commonly understood to mean in judicial opinions, other sources, and by the lay public.
2. The term "Best interests" is commonly known to equate to the fiduciary duty of loyalty. Yet, the new "Best Interests" standard proposed by SIFMA and/or by FINRA does not impose a fiduciary duty of loyalty upon providers of investment and retirement advice.
3. Upon close analysis, the new "Best Interests" standard proposed by SIFMA and/or by FINRA is only a slight modification to the low standard of suitability; the suitability doctrine is inappropriate for the delivery of investment and retirement planning advice under ERISA. Additionally, under the new "Best Interests" standard proposed by SIFMA and/or by FINRA, the customer remains in an arms-length relationship, in which the doctrine of caveat emptor applies, rather than in a fiduciary-entrustor relationship as envisioned by ERISA's detailed statutory prescriptions.
4. The use of the term "Best Interests" to describe SIFMA and/or FINRA's proposed standard, given the established use of that term as equivalent to the fiduciary duty of loyalty, is deceitful. Additionally, it will exacerbate already-widespread consumer confusion.
5. Any proposal to create a prohibited transaction exemption based on these new "best interests" proposals advanced by SIFMA, FINRA, Fidelity or others would fail to meet the requirements for the Secretary of Labor's grant of an exemption under the express provisions of ERISA. The Secretary lacks the authority under ERISA to diminish consumer protections, from those afforded by the fiduciary-entrustor relationship, to those minimal protections afforded in arms-length relationships as would exist under the SIFMA/FINRA proposals.

#### **B. Contracting Out of Fiduciary Relationships is Impermissible and Any Exemptive Relief to Authorize Such a Procedure Would Fail to Meet ERISA's Statutory Requirements for the Grant of Exemptive Relief.**

1. Whether imposed by the express terms of ERISA, by Congress' grant of authority to the U.S. Department of Labor to enact rules on qualified retirement plan and IRA accounts, or by the common law (such as when a relationship of trust and confidence exists), the ability of the

advisor and client to “contract out” of the fiduciary-client relationship, and return to an arms-length (sales-customer) relationship, is negated.

2. In the advisor-client context, core fiduciary duties cannot be waived. Even the “contractualists” academics who argue for a contract theory of fiduciary law (as might be applied in business settings, such as between business partners), accept the proposition that core fiduciary duties cannot be waived.
3. The application of the concepts of estoppel and waiver are limited in the fiduciary realm.
4. The ability to “contract away” the protections afforded by ERISA’s detailed statutory regime is not the basis for an exemption for which relief can be granted, given that contracting away such legal protections is neither protective of the plan beneficiaries nor in the interests of plan beneficiaries.

C. **A Requirement for Demonstration of Actual Reliance by the Entrustor on the Fiduciary’s Advice Is Not Properly a Condition for Imposition of Fiduciary Status; Imposition of Such A Requirement Would Violate ERISA as Well as ERISA’s Established Requirements for the Grant of Exemptive Relief.**

1. While reliance by consumers on the investment and retirement planning advice they receive is commonplace, it is not a pre-condition to the law’s imposition of fiduciary status.
2. Any attempt to establish such a pre-condition to the imposition of fiduciary status would not be in accord with established common law which applies fiduciary status upon those in relationships of trust and confidence with their clients, regardless of whether reliance is proven.
3. Any attempt to establish a “reliance” pre-condition to the imposition of fiduciary status is in accord with ERISA, which does not impose such a precondition.
4. A plethora of sound public policy reasons exist for the imposition of fiduciary status by ERISA, which have nothing to do with reliance.
5. Imposition of a precondition requirement of “reliance” would enable widespread consumer harm.
6. Accordingly, any precondition requirement before fiduciary duties would be imposed would not be in the interests of beneficiaries, nor protective of plan beneficiaries, and hence any exemptive relief which might be granted on the basis of a reliance precondition requirement would exceed the Secretary’s authority, absent some other means of protecting the beneficiary.

D. **Fiduciary Duties Apply During the Formation of the Advisor-Client Relationship.**

- E. Fidelity’s Proposal to Simplify Disclosures of Conflicts of Interest Does Not Meet the Fiduciary Requirement of Affirmative Disclosure.**
- F. Fidelity’s Proposal to Expand the Seller’s Carve-Out to Small Plan Sponsors Would Negate the Essential Protections Small Business Owners Require.**
- G. Fidelity’s Proposal to Expand the Carve-Out for Investment Education to Include Recommendations of Specific Investment Alternatives Impermissibly Creates a Loophole, and Would Not Meet ERISA’s Standards for the Grant of Exemptive Relief.**
1. Advice, whether it is provided to one person, to a small group, or to a large group, is advice.
  2. Given the extension of the definition of “fiduciary” under the DOL’s proposed “Conflicts of Interest” rule, there appears to be no need to any exemption for investment education. Education should be provided by fiduciaries.
  3. Recommendations of specific securities clearly are investment advice. Any ability by a non-fiduciary advisor to undertake specific security recommendations would create a giant loophole, which over time would swallow up ERISA’s important fiduciary protections.
  4. Accordingly, any expansion of the education exemption would not be protective of plan beneficiaries, nor in their interests, and hence would fail to satisfy the requirements for the grant of exemptive relief.

### **INTRODUCTION: The Requirements of ERISA, Generally.**

For purposes of providing a foundation for my discussion of Fidelity’s proposals, and for the education of some (non-attorney) readers of this comment letter, I provide the following summary of key provisions of the Employee Retirement Income Security Act (“ERISA”). As the U.S. Department of Labor (“DOL”) considers finalization of the Conflicts of Interest rule proposals and any class exemption that may be granted, the DOL should at all times refer back to the ERISA’s statutory requirements and afford those statutory requirements a reasonable interpretation in light of the present circumstances of ERISA retirement plan participants and IRA account owners (hereafter collectively referred to as “participants”). As the U.S. Supreme Court has 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).”<sup>1</sup> Plan participants and IRA account owners seek to overcome the challenges of today’s far more complicated modern financial world, with its myriad of investment options and significant number of traps for the unwary, and are in full need of these statutory protections, as well as the protections afforded by the DOL’s proposed Conflicts of Interest Rule.

Fiduciary Standard of Conduct. ERISA section 404(a) sets forth the requirements of fiduciaries, including the “sole interests” and “exclusive purpose” requirements long attributed to the fiduciary duties of loyalty

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<sup>1</sup> *Varity Corp. v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996).

and utmost good faith, as well as the fiduciary duty of due care (including skill, prudence and diligence). The statute provides:

(a) Prudent man standard of care

- (1) Subject to sections 1103 (c) and (d), 1342, and 1344 of this title, 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 reasonable expenses of administering the plan;
  - (B) 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;
  - (C) by diversifying 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; and
  - (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

Sections 404(a)(1)(A) through (D) are sometimes referred to as the four general rules of an ERISA fiduciary: (A) “exclusive benefit rule”; (B) “prudent man rule”; (C) “diversification rule”; and (D) “plan document rule.”

The U.S. Supreme Court recently confirmed the long-standing understanding that ERISA’s fiduciary standards are “derived from the common law of trusts.”<sup>2</sup> The Court also stated: “In determining the contours of an ERISA’s fiduciary duty, courts often must look to the law of trusts.” *Id.*

Prohibited Transactions, Generally. ERISA’s strict “sole interest” fiduciary standard is further augmented by ERISA’s prohibited transaction rules. ERISA section 406(a) prohibits various types of transactions between a plan and parties in interest. ERISA states that a plan fiduciary shall not cause the plan to engage in a transaction if the plan fiduciary knows or should know that such transaction constitutes a direct or indirect—

- Sale or exchange, or leasing, of any property;
- Lending of money or other extension of credit;
- Furnishing of goods, services, or facilities;
- Transfer to, or use by or for the benefit of a party in interest, of any assets of the plan; or
- Acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA section 407.

Under these prohibited transaction rules, a plan fiduciary ordinarily cannot use plan assets to pay for services. For example, Section 406(a)(1)(A) prohibits the “sale or exchange, or leasing of any property between the plan and a party in interest.” This clause implicates the sale of investment products

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<sup>2</sup>*Tibble v. Edison*, 475 U.S. \_\_\_\_ (2015) (slip opinion p.5), citing *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559, 590 (1985).

(including annuities) to the plan and the payment to the broker, consultant, or investment adviser a fee or commission in connection therewith.

Section 406(b) prohibits fiduciaries with direct or indirect access to plan assets from using those assets for their own benefit, or for the benefit of another party.

Section 406(b)(1) provides that a fiduciary shall not deal with the assets of the plan in his or her own interest or for his or her own account. In other words, the fiduciary is prohibited from self-dealing.

Section 406(b)(2) provides that a fiduciary shall not deal in his or her individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. Generally, this is commonly called the “dual loyalty” provision. A fiduciary must be able to represent the plan to its fullest ability in a transaction.

Section 406(b)(3) provides that a fiduciary should not receive any consideration for his or her own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan. This is commonly known as the anti-kickback provision.

It could be said that ERISA generally prohibits payments for services provided to the plan or account or participant, and even many dealings with a plan or account or participant. However, as seen below, ERISA addresses these constraints through several types of exemptions.

Statutory Exemptions and Prohibited Transaction Exemptions, Generally. Certain transactions with parties in interest are exempt from the prohibited transaction rules, either because they are permitted by a statutory exemption in ERISA (of which there are 20), because they are covered under a class exemption issued by the DOL, or because the DOL has granted an individual exemption.

The best known and perhaps most important statutory exemption is found in Section 408(b)(2), allowing the use of plan assets to pay fees for services. However, the exemption applies strictly to a fiduciary’s “contracting or making reasonable arrangements” with the plan’s service provider for “services that are necessary” for plan operation, and only if no more than “reasonable compensation” is paid for them. As often occurs with either statutory or class or individual exemptions, there are often substantial and significant conditions attached to the exemption.

The DOL may grant administrative exemptions to an individual or a class of individuals allowing them to engage in a variety of transactions involving employee benefit plans. DOL administrative exemptions are referred to as Prohibited Transaction Exemptions (PTEs). Class exemptions are administrative “blanket” exemptions that permit a person to engage in a similar transaction or a series of similar transactions with a plan in accordance with the terms and conditions of the class exemption, without requiring the person to obtain an individual exemption from the DOL.

Under the express terms of ERISA, the “Secretary may not grant an exemption under this subsection unless he finds that such exemption is— (1) administratively feasible, (2) *in the interests of the plan and*

*of its participants and beneficiaries, and (3) protective of the rights of participants and beneficiaries of such plan.” 29 U.S.C. §1108(a) (in pertinent part) [Emphasis added.]*

Understanding the Minimal Relaxation of “Sole Interests” When a PTE Exists: The Participants “Best Interests” Must Still Be Respected at All Times. Under ERISA’s legal standard for granting relief by means of a PTE from ERISA’s strict requirements, ERISA’s strict “sole interests” fiduciary standard, as well as its prohibitions on many transactions, is reduced if an exemption is granted to what constitutes, in essence, a requirement that the exemption be in the “best interests” of the participants – as the exemption must be “in the interests of the (participants)” and must be “protective of the rights of” the participants.

By way of further explanation, the “sole interests” standard is frequently applied (with some exceptions, which vary from jurisdiction to jurisdiction) to trustee-beneficiary relationships. This sole interests standard generally prohibits transactions between the trustee and the trust, even if the transaction is mutually beneficial.

In contrast, the “best interests” standard is somewhat more flexible. It permits transactions between a fiduciary and the assets under its, his, or her charge, but only if there is a mutual benefit to the assets managed (or the entrustor – i.e., the person who has entrusted the assets to the fiduciary’s care, or the adviser to the client). At a minimum, the entrustor should not be harmed by any transaction that involves the fiduciary.

In either instance, the fiduciary standard is referred to as the “highest standard under the law.” In fact, the “best interests” standard is *somewhat* more lenient in the sense that *certain* transactions proposed by a fiduciary may be permitted which are otherwise prohibited under the “sole interests” standard. I would note, however, that the “best interests” standard – as applied to trustees (where transactions with the trust are not strictly prohibited), and to advisory relationships such as attorney-client which are quite similar (in terms of the vast disparity of knowledge between fiduciary and entrustor, for example), is not that far removed from the tough “sole interests” standard of conduct.

A more elaborate explanation of the difference between the “sole interests” standard and “best interests” standard can be found in an article penned by Professor John Langbein:

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.<sup>3</sup>

It should be emphasized, again, that the law of trusts informs the DOL as it seeks to apply and interpret ERISA's provisions.

**A. SIFMA's/FINRA's "Best Interest" Proposals, and Related Proposals by Fidelity and Others, Negate the Fiduciary Duty of Loyalty and, Accordingly, Fail to Adhere to the Requirements for the Grant of Exemptive Relief.**

**1. The new "Best Interests" standard proposed by SIFMA, and seemingly endorsed by FINRA, Fidelity, and some other broker-dealer firms, is not protective of plan participants and their beneficiaries, and is not in the best interests of plan participants and their beneficiaries as the term "best interests" is commonly understood to mean in judicial opinions, other sources, and by the lay public.**

The phrase "act in the best interests of the client" is used to explain, in language the lay person would understand, the core aspect of the fiduciary duty of loyalty. It is a phrase used over the centuries to connote the fiduciary duty of loyalty. Yet, despite this widespread acceptance of the current definition of "best interests," Fidelity, SIFMA, FINRA and others opposed to the DOL's imposition of fiduciary status have suggested a new and alternative "Bests Interests Paradigm" (hereafter the "BIP") standard that does not encompass the requirements of the fiduciary duty of loyalty.

Fidelity, along with many others, have proposed this very troubling "Best Interests Paradigm" (BIP). Yet, as explained herein, their collective and apparently coordinated attempts to redefine "best interests" as a new type of suitability standard, and the lack of fiduciary duty of loyalty under such a "best interests" standard, do not meet the requirements for the grant of an exemption by the U.S. Department of Labor.

Fidelity's proposal is closely aligned with other proposals from various broker-dealer lobbying associations and their constituents to abandon and/or negate the fiduciary standard of conduct and to replace it with a nebulous, product-sales friendly standard that fails to provide any meaningful protections for consumers.

Fidelity's Proposal. Fidelity summarized its new "best interests" paradigm in its July 22, 2015 request to testify:

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<sup>3</sup>Langbein, John H., Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest? Yale Law Journal, Vol. 114, p. 929 (2005).

The Department [of Labor] should adopt a new paradigm for application of the best interest standard to investment advice ...:

- (a) engagement of advisor's services and compensation should be non-fiduciary;
- (b) best interest standard should be applied within the scope of the engagement;
- (c) adopt broad principles-based transaction relief requiring only (i) an enforceable best interest commitment, (ii) payment of no more than reasonable compensation, and (iii) disclosure of conflicts of interest, including compensation payable to the advisor.

In its July 21, 2015 comment letter submitted to the DOL, Fidelity set forth the specifics of its proposal (pertinent portion follows):

*Our new best interest paradigm would provide that the establishment of the terms of engagement between the advisor and investor is non-fiduciary in nature by modifying section 2510.3-21(c) of the Proposed Regulation as follows:*

*(c) Scope of fiduciary duty – investment advice.*

*(1) A person who is a fiduciary with respect to an employee benefit plan or IRA by reason of rendering investment advice (as defined in paragraph (a) of this section) for a fee or other compensation, direct or indirect, with respect to any securities or other property of such plan, or having any authority to do so, shall not be deemed to be a fiduciary with respect to:*

***(i) the terms and conditions of the engagement of the person, including the scope of the obligation to provide advice, the products or services with respect to which advice is provided and the compensation payable to such person, provided the plan fiduciary, participant or beneficiary, or IRA owner, has consented to the terms and conditions of the engagement after disclosure of all material aspects of such terms and conditions, including potential conflicts of interest; or***

*(ii) any assets of the plan or IRA with respect to which such person does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control, does not render investment advice (as defined in paragraph (a)(1) of this section) for a fee or other compensation, and does not have any authority or responsibility to render such advice.*

[*Emphasis in original; emphasis added.*]

In contrast, the DOL's proposed section 2510.3-21(c) states in pertinent part:

(c) Scope of fiduciary duty--investment advice. A person who is a fiduciary with respect to an employee benefit plan or IRA by reason of rendering investment advice (as defined in paragraph (a) of this section) for a fee or other compensation, direct or indirect, with respect to any securities or other property of such plan, or having any authority or responsibility to do so, shall not be deemed to be a fiduciary regarding any assets of the plan or IRA with respect to which such person does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control, does not render investment advice (as defined in paragraph (a)(1) of this section) for a fee or other compensation, and does not have any authority or responsibility to render such investment advice ....

Fidelity's "best interest paradigm" (BIP) proposal is closely aligned with proposals which have been advanced by many broker-dealer and asset management firm lobbyists and their constituent members, in

touting support for a form of “best interests” standard that does not amount to the fiduciary duty of loyalty.

SIFMA’S Proposal. In its July 20, 2015 comment letters to the DOL, SIFMA, “representing the broker-dealers, banks and asset managers” (i.e., Wall Street), stated in pertinent part:

FINRA uses a much more common sense test that does not contain a standard that cannot practically be met: it requires that the adviser make suitable recommendations based on the client’s financial circumstances and needs and that the adviser put his client’s interest before his own. We urge the Department to use the FINRA formulation ...

SIFMA members believe that a claim that a relationship is a fiduciary relationship should be “defeated” if the parties do not mutually understand that they both intended a fiduciary relationship ....

As SIFMA has repeatedly stated, it concurs with a best interest standard ...

SIFMA agrees that a person should not be able to agree to act as a fiduciary and then seek to avoid the fiduciary status to which he or she agreed ...

SIFMA believes there are less disruptive and more comprehensive ways to implement a best interest standard for additional protection for individual investors who maintain securities investments. Our members long ago endorsed a best interest or uniform fiduciary standard of care for all retail investors, including the retirement sector, when providing personalized investment advice about securities. SIFMA has encouraged the SEC, which has broad jurisdiction and authority in this space, to take action to establish a uniform fiduciary standard across all retail securities accounts receiving personalized investment advice ...

FINRA, under the supervision and oversight of the SEC, has been increasingly refining its definition of suitability under Rule 2111 and most recently through FINRA Notice 13-45, referenced earlier, to require brokers to put clients’ best interests ahead of their own ...

To further assist the SEC and FINRA and to maintain forward progress towards formalizing a best interest standard across all retail investor securities accounts, SIFMA, on June 3, 2015, proposed a “Best Interests of the Customer Standard for Broker-Dealers”, which is designed to lay the groundwork for an investor-focused, comprehensive regulatory solution that works for investors and broker-dealers alike.

SIFMA believes that an optimal “best interests of the customer” legal standard for broker-dealers should do the following:

1. Apply across all investment recommendations made to individual retail customers in all brokerage accounts (not be limited to just IRA accounts);
2. Serve as a benchmark for, be consistent with, and integrate seamlessly into, the SEC uniform fiduciary standard that ultimately emerges under Dodd-Frank § 913;
3. Provide interim, strong, substantive, “best interests” protections for retail customers; and

4. Follow the traditional securities regulatory approach of establishing a rules-based heightened standard, including robust disclosure, coupled with robust examination, oversight, and enforcement by the SEC, FINRA and state securities regulators, as well as a private right of action for investors, as exists today.

On June 3, 2015, SIFMA provided this mark-up (modification to) FINRA's rules, as part of its proposal:

2111. Suitability The Best Interests of the Customer

a. 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 in the best interests of 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.

i. The best interests standard. A best interests recommendation shall:

1. Reflect the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the customer's investment profile (defined above). The sale of only proprietary or other limited range of products by the member shall not be considered a violation of this standard.

2. Appropriately disclose and manage investment-related fees. See *Manage investment-related fees below*.

3. Avoid, or otherwise appropriately manage, disclose, and obtain consents to, material conflicts of interest, and otherwise ensure that the recommendation is not materially compromised by such material conflicts. See *Manage material conflicts of interest below*.

ii. Manage investment-related fees. A member shall ensure that investment-related fees incurred by the customer from the member are reasonable, fair, and consistent with the customer's best interests. Managing investment-related fees does not require recommending the least expensive alternative, nor should it interfere with making recommendations from among an array of services, securities and other investment products consistent with the customer's investment profile.

iii. Manage material conflicts of interests. A member or associated person shall avoid, if practicable, and/or mitigate material conflicts of interest with the customer. A member or associated person shall disclose material conflicts of interest to the customer in a clear and concise manner

designed to ensure that the customer understands the implications of the conflict. The customer shall be given the choice of whether or not to waive the conflict, and must provide consent, as provided in Rule 2260 (Disclosure). Notwithstanding the disclosure of, and customer consent to, any material conflict, a recommended transaction or investment strategy must nevertheless be in the **best interests** of the customer.

iv. Provide required disclosures. A member or associated person shall provide and/or otherwise make available to the customer, among other things: 1) account opening disclosure, 2) annual disclosure, and 3) webpage disclosure, as provided in Rule 2260 (Disclosure).

b. A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in Rule 4512(c), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decision making authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.

#### 2260. Disclosures

a. Account opening disclosure. A member or associated person shall disclose to the customer, at or prior to the opening of the customer account, or prior to recommending a transaction or investment strategy, if earlier, the following:

- the type of relationships available from the broker-dealer and the standard of conduct that would apply to those relationships;
- the services that would be available as part of the relationships, and information about applicable direct and indirect investment-related, fees;
- material conflicts of interest that apply to these relationships, including material conflicts arising from compensation arrangements, proprietary products, underwritten new issues, types of principal transactions, and customer consents thereto; and
- disclosure about the background of the firm and its associated persons generally, including referring the customer to existing systems, such as FINRA's BrokerCheck database.

b. Annual disclosure. A member shall disclose to the customer annually a good faith summary of investment related fees incurred by the customer from the member or associated person with respect to all products and services provided during the prior year (or such shorter period as applicable).

c. Webpage disclosure. A member's webpage shall provide disclosure that is concise, direct and in plain English, following a layered approach that provides supplemental information to the customer. A member's webpage shall include access to all account opening disclosure. Paper disclosure shall be provided to customers that lack effective Internet access or that otherwise so request.

d. Customer consent. Customer consent to material conflicts of interest or for other purposes as appropriate may be provided at account opening. (FN1) Existing customers with accounts established prior to the effective date of the best interests standard shall be deemed to have consented to the material conflicts of interest, if any, disclosed to the customer, upon continuing to accept or use account services.

e. Disclosure updates. Updates to disclosures, if necessary or appropriate, may be made through an annual notification that provides a website address where specific changes to a member's disclosure are highlighted.

FN1. Customer consent to principal transactions, for example, could be provided at account opening.

FINRA's Proposal. In its July 17, 2015 comment letter to the DOL, FINRA stated in pertinent part:

FINRA has publicly advocated for a fiduciary duty for years and agrees with the Department that all financial intermediaries, including broker-dealers, should be subject to a fiduciary "best interest" standard ...

At a minimum, any best interest standard for intermediaries should meet the following criteria:

- The standard should require financial institutions and their advisers to:
  - act in their customers' best interest;
  - adopt procedures reasonably designed to detect potential conflicts;
  - eliminate those conflicts of interest whenever possible;
  - adopt written supervisory procedures reasonably designed to ensure that any remaining conflicts, such as differential compensation, do not encourage financial advisers to provide any service or recommend any product that is not in the customer's best interest;
  - obtain retail customer consent to any conflict of interest related to recommendations or services provided; and
  - provide retail customers with disclosure in plain English concerning recommendations and services provided, the products offered and all related fees and expenses ...

The federal securities laws and FINRA rules comprehensively regulate all aspects of a broker-dealer's business. Among the many requirements imposed are the principles that broker dealers deal fairly with customers, adhere to just and equitable principles of trade, and ensure that recommendations are suitable for customers. Broker dealers also must establish rigorous systems of compliance and supervision, which are regularly examined by FINRA and the SEC.

Using these existing requirements as the core structure of a best interest standard would reduce the costs of transitioning to a best interest requirement and provide assurance that the core structure will be enforced by the SEC and FINRA ...

The standards for the investment adviser and the broker-dealer businesses must be harmonized to provide consistent investor protection while reflecting the distinctive nature of each business model ....

Financial Services Institute's (FSI's) Proposal. In its July 21, 2015 comment letter, FSI, "an advocacy organization comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms" [this author notes, however, that FSI does not represent many independent registered investment advisers, especially fee-only advisers], stated:

Since 2009, FSI has supported a uniform fiduciary standard of care applicable to all professionals providing personalized investment advice to retail clients. Consistent with the Department's intent, this standard of care would require financial advisors to act in the best interest of their clients ...

FSI believes that a uniform fiduciary standard of care is critical to the protection of retirement plan assets and the stability of the financial markets. Such a definition should explicitly require Financial Institutions and financial advisors to:

- Act in the best interest of their clients;
- Provide advice with skill, care, and diligence based upon information that is known, about the customer's investment objectives, risk tolerance, financial situation, and other needs; and
- Disclose and manage material conflicts of interest, avoid them when possible, and obtain informed customer consent to act when such conflicts cannot be reasonably avoided ....

[W]e have developed an alternate disclosure regime for the Department to consider in lieu of the BICE contract and disclosure requirements. FSI believes that the two-tiered disclosure regime outlined below will serve to inform investors of the information that is most critical to their decision-making ...

The two-tiered disclosures would include:

- First Tier: A short-form disclosure document, provided as part of the account opening process that would focus on the issues that are of greatest importance to investors. The short-form disclosure would also represent an upfront, enforceable commitment on the part of the financial advisor and the Financial Institution to act in the best interest of the client. The information detailed on the short-form disclosure would include:
  - A statement of the best interest standard of care owed by the Financial Institution to the client;
  - The nature and scope of the business relationship between the parties, the services to be provided, and the duration of the engagement;
  - A general description of the nature and scope of compensation to be received by the Financial Institution and financial advisor;

- A general description of any material conflicts of interest that may exist between the Financial Institution, financial advisor and investor

...

- The second tier disclosure would provide investors with access to detailed compensation and material conflicts information via the Financial Institution's website or brochures to be provided free of cost. These disclosures would be in lieu of the website disclosure requirements of BICE Section III(c). Utilizing hyperlinks and other internet functionality, investors will be able to receive detailed information concerning available investments, considerations for making investment decisions, and information explaining how a financial advisor and a Financial Institution receive compensation for a particular type of product. The disclosures are designed to allow investors to better understand both the existence of payments to be made to the Financial Institution and the purposes of such payments ....

Any undertaking to implement our proposed alternative should be a coordinated and joint effort between the Department, the SEC, FINRA and state securities regulators. In the absence of proper coordination, the true meaning of terms such as “best interest” will be determined by the judicial system, not the appropriate regulatory agencies. This is a risk that independent financial services firms – and, by extension, their clients – cannot afford to take ....

Bank of America’s Proposal. In its July 21, 2015 comment letter, Bank of America (which includes Merrill Lynch) affirmed the theme found in the above comment letters, as well as the same theme found in many of the broker-dealer firms’ comment letters, stating:

Bank of America supports the fundamental objective of the Department’s proposed rule: to hold Advisors to a “best interest” standard when they provide personalized investment advice to IRA account holders ... Bank of America has long supported a “harmonized” best interest standard ....

FINRA’s recent guidance on IRA rollover conversations arises out of a “suitability” standard but should satisfy the Department’s fiduciary best interest standard as well ...

Bank of America recommends ...

Conflicts of Interest. The Advisor firm would agree to disclose to the client material conflicts of interest with respect to the Advisor’s investment advice and recommendations to purchase, sell or hold securities or other assets in an IRA.

Policies and Procedures. Finally, the Advisor firm would represent that it has established policies and procedures, including supervisory procedures, that are reasonably designed so that: a) investment advice and recommendations are in the client’s best interests; b) material conflicts of interest are disclosed; c) the costs and fees are fair and reasonable; and d) the Advisor firm complies with the laws and regulations that apply to an IRA.

As will be seen in the sections that follow, these BIP proposals are not protective of the consumers’ interests, are not in accord with the requirements of ERISA, and are a mere sham intended to deceive the public that trust may be placed in a merchandizer.

**2. The term “Best interests” is commonly known to equate to the fiduciary duty of loyalty. Yet, the new “Best Interests” standard proposed by SIFMA and/or by FINRA does not impose a fiduciary duty of loyalty upon providers of investment and retirement advice.**

Far from the suggestion of some broker-dealer firms or their lobbyists that the term “best interests” needs to be defined, “best interests” is already utilized to describe the fiduciary duty of loyalty is frequently found in judicial decisions:

In explaining the duty of loyalty owed by a board of directors to the corporation, the instruction to a lay jury reads: “Each member of the ... board of directors is **required to act in** good faith and in a manner the director reasonably believes to be in **the best interests** of the corporation when discharging his or her duties.” *Schultz v. Scandrett*, #27158, Supreme Court of South Dakota, 2015 SD 52; 866 N.W.2d 128; 2015 S.D. LEXIS 85 (June 24, 2015).

In describing the fiduciary duty of the director of a corporation to the corporation and its shareholders, a court opined: “The duty of loyalty ‘mandates that the **best interest** of the corporation and its shareholders **takes precedence over any interest possessed by a director, officer or controlling shareholder** and not shared by the stockholders generally.’ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) (citing *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) and *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984)); see also *Diedrick v. Helm*, 217 Minn. 483, 14 N.W.2d 913, 919 (Minn. 1944). The classic example is when a fiduciary either appears on both sides of a transaction or receives a substantial personal benefit not shared by all shareholders. *Id.*” *DQ Wind-Up, Inc. v. Kohler*, Court File No. 27-CV-10-27509, Minnesota District Court, County Of Hennepin, Fourth Judicial District, 2013 Minn. Dist. LEXIS 118 (2013).

Similarly, “[t]he duty of loyalty requires that the **best interests** of the corporation and its shareholders **take precedence over any self-interest** of a director, officer, or controlling shareholder that is not shared by the stockholders generally.” *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

Also, “in dealing with corporate assets [the corporate officer] was required to **act in the best interests of the corporation** and he was prohibited from using either his position or the corporation's funds for his private gain.” *Levin v. Levin*, 43 Md. App. 380, 390, 405 A.2d 770 (1979).

A court, recently opining on ERISA’s fiduciary duty of loyalty, stated: “ERISA imposes a duty of loyalty on fiduciaries. *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.), cert. denied, 459 U.S. 1069, 74 L. Ed. 2d 631, 103 S. Ct. 488 (1982) (Friendly, J.). A trustee **violates his duty of loyalty when he enters into substantial competition with the interests of trust beneficiaries**. RESTATEMENT (SECOND) OF TRUSTS, § 170, comment p ... under the law of trusts, **a fiduciary is generally prohibited**, not just from acting disloyally, but also **from assuming a position in which a temptation to act contrary to the best interests of the beneficiaries is likely to arise**. *Grynberg* at 1319; 2 Scott on Trusts § 170, pp. 1297-98 (1967).” *Salovaara v. Eckert*, 94 Civ. 3430 (KMW), U.S. D.C. SDNY, 1996 U.S. Dist. LEXIS 323 (1996).

In describing an attorney’s fiduciary duty of loyalty to a client, a court stated: “**public policy requires that he not be subjected to any possible conflict of interest which may deter him from determining the best interests of the client** ... a client's right to the undivided loyalty of

his or her attorneys must be protected ... **The duty** of both the associate and the successor attorney is the same: **to serve the best interests of the client.**" *Beck v. Wecht*, No. S099665. , Supreme Court Of California, 28 Cal. 4th 289; 48 P.3d 417; 121 Cal. Rptr. 2d 384; 2002 Cal. LEXIS 4197; 2002 Cal. Daily Op. Service 5812; 2002 Daily Journal DAR 7326 (2002).

**[Emphasis added.]**

Numerous law review articles and academic texts also reflect on the fiduciary's obligation to act in the client's (entrustor's) "best interests":

"Tracing this doctrine back into the womb of equity, whence it sprang, the foundation becomes plain. Wherever one man or a group of men entrusted another man or group with the management of property, the second group became fiduciaries. As such they were obliged to act conscientiously, which meant in **fidelity to the interests of the persons whose wealth they had undertaken to handle**. In this respect, the corporation stands on precisely the same footing as the common-law trust." Adolf A. Berle, Jr. & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 336 (1939).

"The **underlying purpose of the duty of loyalty**, which the sole interest rule is meant to serve, **is to advance the best interest of the beneficiaries** ... There can be no quibble with the core policy that motivates the duty of loyalty. Any conflict of interest in trust administration, that is, any opportunity for the trustee to benefit personally from the trust, is potentially harmful to the beneficiary. The danger, according to the treatise writer Bogert, is that a trustee 'placed under temptation' will allow 'selfishness' to prevail over the duty to benefit the beneficiaries. 'Between two conflicting interests,' said the Illinois Supreme Court in an oft-quoted opinion dating from 1844, 'it is easy to foresee, and all experience has shown, whose interests will be neglected and sacrificed' ...

"The law is accustomed to **requiring that attorneys zealously pursue their clients' interests** and that they not indulge interests that may conflict with those of a particular client without first disclosing the potential conflict to the client and receiving the client's approval. There are some conflicts that cannot be overcome by the client's permission where the conflicted attorney would have to avoid the conflict entirely or quit the representation of the client. Law firms vigorously monitor potential conflicts between attorneys and clients. The **rules of professional responsibility go to great lengths to define the appropriate standard of conduct** for attorneys and describe what constitutes a conflict and how an attorney, law firm, and client should handle it. **These strictly enforced standards of conduct cover every facet of the attorney-client relationship and leave very little to chance** in a court's ex post determination of whether an attorney has breached her fiduciary duties. While fiduciary duties may apply to the relationship and zealous advocacy is clearly required, the obligation an attorney owes a client is not left to vague, unpredictable ex post judicial review. It is quite thoroughly described in codes of conduct that have grown ever more complete and sophisticated over time."<sup>4</sup>

**[Emphasis added.]**

We also see the term "best interests" used to describe the legal obligations arising for those who provide personalized investment advice to retail customers. On January 22, 2011, the Staff, fulfilling the mandate under § 913 of the Dodd-Frank Act, released its Study on the regulation of broker-dealers and investment

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<sup>4</sup>John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929 (March 2005).

advisers. The overarching recommendation made in the Study is that the SEC should adopt a uniform fiduciary standard for investment advisers and broker-dealers that is no less stringent than the standard under the Advisers Act. Specifically, the Staff recommended the following: “[T]he 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.**”<sup>5</sup> [Emphasis added.]

While the SEC Staff’s recommendation was a strong one, following on the actual language of the Dodd-Frank Act, one might argue that any confusion regarding the meaning of “best interests” has arisen from the acts of the SEC itself. The SEC began using the term to not describe the fiduciary duty of loyalty, but rather the fiduciary duty of due care – *i.e.*, to manage the client's portfolio in the best interest of the client—rather than part of an adviser's duty of loyalty to disclose and thereafter properly manage any unavoidable conflicts of interest.<sup>6</sup> However, any review of the history of the fiduciary standard and its legal underpinnings results in the only logical conclusion regarding the best interest standard – that it is part of a fiduciary’s duty of loyalty, not duty of care. This is because the essence of the fiduciary’s duty of loyalty requires that the fiduciary acts not out of self-interest, but rather in the best interests of the fiduciary. The fiduciary steps into the shoes of the client, with all of the fiduciary’s superior knowledge and skills, and acts as if the client would then act. As Judge Posner has written, “[a] fiduciary is required to treat his principal as if the principal were he, and therefore he may not take advantage of the principal's incapacity, ignorance, inexperience, or even naiveté ....”<sup>7</sup> In summary, the fiduciary is required to act as if the fiduciary were the client – *i.e.*, in the client’s best interests. By acquiring the duty of loyalty, the only “self-interest” the fiduciary is permitted to consider is the self-interest of the client, into whose shoes the fiduciary is now firmly planted.

The much higher standard of conduct of the fiduciary advisor flows from the requirement of the fiduciary “to adopt the principal’s goals, objectives, or ends.”<sup>8</sup> “It is what makes fiduciary law unique and separates fiduciaries from other service providers.”<sup>9</sup> As Professor Laby further explains:

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<sup>5</sup>SEC Staff, Study on Investment Advisers and Broker-Dealers ii (2011) [hereinafter SEC Staff Study], available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

<sup>6</sup>See Barbara Black, How to Improve Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act, 13 U. Pa. J. Bus. L. 59, 86 (2010).

<sup>7</sup>*Market St. Assoc. v. Frey*, 941 F. 2d 588, 593 (7th Cir. 1991).

<sup>8</sup> 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 (2<sup>D</sup>) 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 matters connected with the agency relationship.” RESTATEMENT (3<sup>D</sup>) 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.)

<sup>9</sup> Laby, *supra* n.65, at 130.

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.<sup>10</sup>

This begs the all-important question – who does the registered representative or insurance agent represent under SIFMA’s and FINRA’s proposed “best interests” standards represent? This is the key question, for the following is well known in the law:

The characters of buyer and seller are incompatible, and cannot safely be exercised by the same person. *Emptor emit quam minimo potest; venditor vendit quam maximo potest*. The disqualification rests ... on no other than that principle which dictates that a person cannot be both judge and party. No man can serve two masters. He that is interested with the interests of others, cannot be allowed to make the business an object of interest to himself; for, the frailty of our nature is such, that the power will too readily beget the inclination to serve our own interests at the expense of those who have trusted us.<sup>11</sup>

It is obvious that under SIFMA’s and FINRA’s proposed BIP standards, the registered representative would continue to act as sellers of products, thereby representing the broker-dealer firm and product manufacturers. This is a far, far cry from acting as a fiduciary, and acting as the representative of the purchaser.

Under BIP the broker-dealer’s representative or insurance agent would still represent the firm and/or the product manufacturer. Under BIP the registered representative or insurance agent would continue to be a merchandizer, not a trusted adviser bound by fiduciary obligations. Under BIP - and its fatal flaw as a regulatory construct - there exists no fiduciary duty of loyalty to the client.

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<sup>10</sup> Laby, *supra* n.65, at 135.

<sup>11</sup> *Carter v. Harris*, 25 Va. 199, 204 (1826); 1826 Va. LEXIS 26; 4 Rand. 199 (Va. 1826).

**3. Upon close analysis, the new “Best Interests” standard proposed by SIFMA and/or by FINRA is only a slight modification to the low standard of suitability; the suitability doctrine is inappropriate for the delivery of investment and retirement planning advice under ERISA. Additionally, under the new “Best Interests” standard proposed by SIFMA and/or by FINRA, the customer remains in an arms-length relationship, in which the doctrine of caveat emptor applies, rather than in a fiduciary-entrustor relationship as envisioned by ERISA’s detailed statutory prescriptions.**

*“Goldman’s arguments in this respect are Orwellian. Words such as ‘honesty,’ ‘integrity,’ and ‘fair dealing’ apparently [in Goldman’s eyes] do not mean what they say; [Goldman says] they do not set standards; they are mere shibboleths. If Goldman’s claim of ‘honesty’ and ‘integrity’ are simply puffery, the world of finance may be in more trouble than we recognize.”*

*– Judge Paul Crotty, Richman v. Goldman Sachs Group, Inc.,  
 868 F. Supp. 2d 261 (S.D.N.Y. 2012).*

As Judge Crotty alluded to, the broker-dealer community has a tendency to seek to redefine terms, in ways that permit them to hold themselves out as something they are not, while at the same time denying the fiduciary or other liabilities which flow from such representations. Broker-dealer industry attempts to distort the English language, as to the definitions of terms which have existed for decades if not centuries or even millenia, should be resisted by all those who treasure truth and candor over fraud and distortion.

In the table following I summarize the flaws in SIFMA’s and FINRA’s recent “best interests” proposals. In so doing I demonstrate why SIFMA’s proposed changes to FINRA’s suitability rule and FINRA’s proposal (as well as the proposals of Fidelity, Bank of America and others who tout this new “best interests” standard) do not come even close to the protections provided by the fiduciary standard:

***A Concise Comparison: Bona Fide Fiduciary Standard  
 vs. SIFMA’s and FINRA’s “Best Interests” Proposals***

<b>What requirements are imposed upon the person providing personalized investment advice?</b>	<b>Bona Fide Fiduciary Standard</b>	<b>SIFMA’s “Best Interest” Proposal (as outlined in its June 2015 release)</b>	<b>FINRA’S “Best Interest” Proposal (as outlined in its July 17, 2015 comment letter)</b>
Who does the financial representative represent?	The client.	The brokerage firm, and, through the firm, various product manufacturers. The financial representative functions as a “seller’s representative” with no substantial allegiance required to the purchaser (customer).	The brokerage firm, and, through the firm, various product manufacturers. The financial representative functions as a “seller’s representative” with no substantial allegiance required to the purchaser (customer).

What requirements are imposed upon the person providing personalized investment advice?	Bona Fide Fiduciary Standard	SIFMA’s “Best Interest” Proposal (as outlined in its June 2015 release)	FINRA’S “Best Interest” Proposal (as outlined in its July 17, 2015 comment letter)
Does a duty exist upon the representative to clearly and fully disclose all compensation received by the person providing advice, and by his/her firm?	Yes.	<u>No.</u> While annual disclosure occurs of “a good faith summary of the <i>investment-related fees</i> ” associated with an investment, there is no requirement in SIFMA’s proposal that the <i>compensation</i> of the broker-dealer or its registered representative be affirmatively quantified and then disclosed. As a result, customers will remain uninformed of the precise amount of the compensation of the broker and its registered representative. Hence, the client will not possess the means to assess the reasonableness of the compensation so provided, and the receipt of only “reasonable compensation” is a requirement for a fiduciary actor.	<u>No.</u> While annual disclosure occurs of a product’s “fees and all related expenses,” there is no requirement in FINRA’s proposal that the <i>compensation</i> of the broker-dealer or its registered representative be affirmatively quantified and then disclosed. As a result, customers will remain uninformed of the precise amount of the compensation of the broker and its registered representative. Hence, the client will not possess the means to assess the reasonableness of the compensation so provided, and the receipt of only “reasonable compensation” is a requirement for a fiduciary actor. Why do broker-dealer firms resist the fiduciary requirement to fully disclose a material fact – their compensation – to their customers? <i>Because a large proportion of these customers believe that their registered representative and brokerage firm is acting gratuitously, given broker-dealers’ ability to hide compensation from the customers.</i>
Is there a duty <i>upon the representative</i> to ensure client understanding of material facts, including material conflicts of interest?	Yes.	<u>No.</u> Under SIFMA’s proposal disclosures must only be “ <i>designed</i> to ensure client understanding.” There is no requirement, as exists for a fiduciary, that client understanding of conflicts of interest, and their ramification, actually occur.	<u>No.</u> Under FINRA’s proposal disclosures relating to products must only be provided to the customer. There is no requirement, as exists for a fiduciary, that client understanding of conflicts of interest, and their ramification, actually occur by means of affirmative obligations placed upon the registered representative.

What requirements are imposed upon the person providing personalized investment advice?	Bona Fide Fiduciary Standard	SIFMA's "Best Interest" Proposal (as outlined in its June 2015 release)	FINRA'S "Best Interest" Proposal (as outlined in its July 17, 2015 comment letter)
Is <i>informed</i> consent of the client required prior to the client undertaking <i>each and every</i> recommended transaction?	Yes.	<u>No.</u> There is no requirement in SIFMA's proposal that the client's consent be "informed" – a key requirement of fiduciary law before client waiver of a conflict of interest can take place. Nor is there a requirement that the client provide informed consent prior to each and every transaction. Rather, SIFMA would only require: "Customer <i>consent</i> to material conflicts of interest or for other purposes as appropriate <i>may be provided at account opening.</i> " Of course, consent "at client opening" often involves a customer briefly initialing a line, as one of many initials or signatures provided in account opening forms which are often <u>dozens of pages long</u> . The result of SIFMA's proposal is that clients can and will consent to be harmed – an outcome which cannot exist under a bona fide fiduciary standard. And such "consent" will hardly ever be "informed."	<u>No.</u> There is no requirement in FINRA's proposal that the client's consent be "informed" – a key requirement of fiduciary law before client waiver of a conflict of interest can take place. Nor is there a requirement that the client provide informed consent prior to each and every transaction. Rather, FINRA would only require brokers to "obtain client consent" to conflicts of interest. Such consent, often given with little or no understanding by the customer of the broker, creates an estoppel defense for the broker, who is in an arms-length relationship with the customer. As explained in this comment letter, the role of estoppel is very limited in fiduciary relationships, and much more than "simple consent" is required for the fiduciary to proceed when a conflict of interest is present.
Must the transaction remain, at all times, <i>substantively fair</i> to the client?	Yes.	<u>No.</u> There is only a requirement that the transaction be in accord with the client's "best interest" – a new SIFMA-proposed standard that is ill defined and which remains subject to much interpretation. Such interpretations will primarily occur through FINRA's much-maligned system of mandatory arbitration. In contrast, the fiduciary standard possesses centuries of interpretation and application. Under a bona fide fiduciary standard, clients are unable to waive core fiduciary duties; the role of estoppel is quite limited. This is enforced by the courts by requiring both <i>informed</i> consent of the client and that the transaction remain <i>substantively fair</i> to the client.	<u>No.</u> There is only a requirement that the transaction be in accord with the client's "best interest" – a new FINRA-proposed standard that is ill defined and which remains subject to much interpretation. Such interpretations will primarily occur through FINRA's much-maligned system of mandatory arbitration. In contrast, the fiduciary standard possesses centuries of interpretation and application. Under a bona fide fiduciary standard, clients are unable to waive core fiduciary duties; the role of estoppel is quite limited. This is enforced by the courts by requiring both <i>informed</i> consent of the client and that the transaction remain <i>substantively fair</i> to the client.

What requirements are imposed upon the person providing personalized investment advice?	Bona Fide Fiduciary Standard	SIFMA’s “Best Interest” Proposal (as outlined in its June 2015 release)	FINRA’S “Best Interest” Proposal (as outlined in its July 17, 2015 comment letter)
Does there exist a duty to <i>properly manage</i> investment-related fees and costs that the client will incur at all times?	Yes.	<u>No</u> . SIFMA expressly states: “Managing investment-related fees does not require recommending the least expensive alternative, nor should it interfere with making recommendations from among an array of services, securities and other investment products consistent with the customer’s investment profile.” These caveats leave the door wide open for the broker to recommend highly expensive products, including products which pay the broker more, in which the total fees and costs incurred by the customer will substantially lower the long-term returns of the investor.	<u>No</u> . FINRA does not appear to recognize that, under fiduciary law, there is an obligation imposed upon the fiduciary to ensure that any expenditures of the client’s funds, through payment of product-related fees and costs, be undertaken with close scrutiny. FINRA appears to desire that high-cost products could still be recommended compared with lower-cost products that possess nearly the same risk and other characteristics. The fiduciary standard of due care requires that the client’s expenses be controlled and that avoidable expenses be avoided. The fiduciary is permitted to obtain reasonable, professional-level compensation, through agreement with the client at the inception of the relationship, and with full disclosure of same.
Does there exist a duty to properly manage the design, implementation and management of the portfolio, in order to reduce the tax drag upon the customer’s investment returns?	Yes.	<u>No</u> . There is no express duty under SIFMA’s proposal to properly manage the tax consequences of investment decisions. Far too often under the suitability standard, and under this proposed “best interests” standard, customers of broker-dealers have and will possess substantial tax drag upon their investment returns that otherwise could have been avoided through expert advice.	<u>No</u> . Nothing in FINRA’s proposal addresses portfolio management. FINRA is mired in the ancient practice of providing products under the suitability standard. Today’s investors deserve expert advice from true fiduciaries, not the sale of products which generate high profits for the broker without proper consideration of how the product fits into the client’s overall portfolio.

As seen, SIFMA’s and FINRA’s proposed “Best Interest Paradigm” (BIP) standards fall far short of the protections afforded by ERISA’s fiduciary standard. The fact of the matter is that Wall Street wants to eat its cake and have it too. It wants to be perceived as acting in customer's "best interests," but enjoy the freedom to act in its own interests. Wall Street’s new “Best Interests of the Consumer” proposal, or BIP, is, in reality, only “Wall Street’s Self-Interest.”

Furthermore, BIP is only a slight modification to the existing suitability standard.

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.”<sup>12</sup> 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.<sup>13</sup> 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 disclosures of conflicts have been more limited than with advisers and apply at different points in the customer relationship.<sup>14</sup>

“[S]uitability is also applied to investment advisers – it is part of (but does not supersede) the adviser’s fiduciary obligations.<sup>15</sup> 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.”<sup>16</sup>

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<sup>12</sup> 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.”

<sup>13</sup> 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.”

<sup>14</sup> 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>.

<sup>15</sup> See Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (Mar. 16, 1994).

<sup>16</sup> 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](http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042006.pdf).]

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 does the suitability doctrine require the design or management of the investment portfolio for a client in a tax-efficient manner.

At its core, when it applies to the provision of advice, the suitability doctrine actually lessens the duty of due care. In the context of advisory recommendations, suitability serves to confine the duties of broker-dealers and their registered representatives to their customers to below that of the broad common law duty of due care.

By way of explanation, with the early 20th Century rise of the concept of the duty of due care, and the commencement of actions for breach of one's duty of due care (via the negligence doctrine that saw accelerated development during such time), broker-dealers sought a way to ensure they would not be held liable under the standard of negligence. After all, "[t]o the extent that investment transactions are about shifting risk to the investor, whether from the intermediary, an issuer, or a third party, the mere risk that a customer may lose all or part of its investment cannot, in and of itself, be sufficient justification for imposing liability on a financial intermediary."<sup>17</sup> This appears to be a valid view as to the duty of care that should be imposed upon a broker-dealer, and appears appropriate if the broker-dealer is only providing only trade execution services to the customer.

In essence, the suitability standard was originally designed solely to protect brokers who provided trade execution services from breaches of the duty of due care applicable to all product sellers, given the inherent risks of investing in individual securities. Yet, as broker's services have expanded, the suitability standard has inappropriately been applied to broker's other services, including those services that are clearly of an advisory nature.

In contrast to the individual stocks and bonds for which brokers mostly executed transactions in the 1930's, currently brokers often recommend mutual funds and other pooled investment vehicles (including but not limited to unit investment trusts, ETFs, variable annuity subaccounts and equity indexed annuities). Indeed, mutual fund sales exploded a thousand-fold shortly following the SEC's abolition of all fixed commission rates effective May 1, 1975. But, along the way, no longer were broker-dealers just performing trade execution services, but they were, in fact, providing advice through their recommendation of investment managers. Yet, inexplicably, the SEC and FINRA permitted the suitability doctrine to be extended to incorporate broker-dealers' recommendations of the managers of pooled investment vehicles. As a result, brokers operate with a free hand today when providing advice on mutual fund selection. Brokers, as a result of the incorrect expansion of the application of the suitability doctrine, are unburdened by the duty of nearly every other person in the United States with respect to their advisory activities, which, at a minimum, for other providers of advice require adherence to the duty of due care of a reasonable person.

Suitability's abrogation of the duty of care means that suitability lacks teeth when investment advice is provided. For example:

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<sup>17</sup>60 Am. U.L. Rev. 1265, 1275.

- Suitability does not generally impose upon broker-dealers and their registered representatives obligation to recommend a “good” product over a “bad” one.
- Suitability does not impose upon brokers and their registered representatives a duty to recommend a less expensive product over an expensive product, even where the product’s composition and risk characteristics are almost identical, and even though substantial academic research concludes that higher-cost products return less to investors than similar lower-cost products over longer periods of time.
- Suitability does not require brokers and their registered representatives to recommend products that meets most client’s objectives for tax-efficient and prudent investment portfolios.
- Suitability does not require brokers and their registered representatives to avoid conflicts of interest, nor to properly management conflicts of interest that remain to keep the clients’ best interests paramount at all times.

In summary, the suitability standard permits the conflict-ridden sale of highly expensive, tax-inefficient and risky investment products, leaving the customer with little or no redress.

Suitability remains a “nebulous and amorphous with respect to its content and parameters.”<sup>18</sup> It essentially imposes upon broker-dealers only the responsibility to not permit their customers to “self-destruct.”

In summary, the “suitability” standard was not originally designed to, nor should it be permitted to, apply to the provision of investment advice. Nor should “suitability,” as only slightly modified by BIP, apply to the provision of investment and retirement advice. For suitability abrogates the all-important duty of care required of nearly every other provider of services in America today.

In essence, suitability is a shield that protects brokers, not investors. It is such a low standard of conduct that, even when surrounded by a multitude of other rules and an enforcement regime, it is but a loud dog that lacks any teeth. Additionally, under the new BIP standard proposed by SIFMA and/or by FINRA, the customer remains in an arms-length relationship, in which the doctrine of caveat emptor applies, rather than in a fiduciary-entrustor relationship as envisioned by ERISA’s detailed statutory prescriptions.

By its BIP proposal SIFMA and FINRA do not turn brokers from sell-side merchandizers into buy-side purchaser’s representatives and fiduciaries. Rather, SIFMA’s and FINRA’s BIP proposal are nothing more than an attempt to obfuscate into some kind of obscene and confusing hybrid between the two, but even then grounded in the low requirements imposed by the suitability doctrine. In fact, the enhancement to the inherently weak suitability standard under these proposals is extremely modest, and it fails to arise to anywhere close to any fiduciary standard. Under BIP the inherently weak and ineffective suitability standard remains, with no real protections afforded to consumers.

One might wonder why FINRA has even proposed the BIC exemption, given its purported role as a regulator and protection of consumer interests. The answer might be found in the fact that FINRA is a

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<sup>18</sup>Lowenfels and Bromberg, *Suitability in Securities Transactions*, *The Business Lawyer* (Aug. 1999) 1557.

membership organization of broker-dealer firms. FINRA's litany of failures, due to the inherent conflict of interest of this "self-regulatory organization," have been well-documented.<sup>19</sup>

Why has FINRA had so many documented failures? Because — at its core — FINRA acts as the protector of its member firms, rather than protecting the public interest. As Tamar Frankel, America's leading scholar on fiduciary law as applied to the securities industry, wrote in 1965:

*NASD ... [does] not, as do the professions, consider the public interest as one of [its] goals ... Let us consider the attitude of the professions toward the public interest. The goal of public service is embedded in the definition of a profession. (Pound, The Lawyer from antiquity to modern times 5, 1963). A profession performs a unique service; it requires a long period of academic training. Service to the community rather than economic gain is the dominant motive. We may measure the broker-dealer's activities against these criteria ... Although at least part of his trade is to give service, profit is his goal. The public interest is stated in negative terms: he should refrain from wrongdoing because it does not pay. This attitude is the crux of the matter, the heart of the difference between a profession and the broker-dealer's activity ... The industry emphasizes its merchandising aspect, and argues that the broker-dealer is subject to the duties of a merchandiser even when he is also acting in his advisory capacity ... the NASD [has] proved incapable of establishing accepted standards of behavior for the activities of the trade ... Past experience has proved that it is unrealistic to expect the NASD to regulate in the public interest .... [Emphasis added.]<sup>20</sup>*

Sadly, Professor Frankel's observations from nearly five decades ago continue to ring true.

**4. The use of the term "Best Interests" to describe SIFMA and/or FINRA's proposed BIP standard, given the established use of that term as equivalent to the fiduciary duty of loyalty, is deceitful. Additionally, it will exacerbate already-widespread consumer confusion.**

Michelle Singletary, author of the nationally syndicated personal finance column, "The Color of Money," recently wrote:

The Labor Department, directed by the Obama administration, is proposing that more advisers, when giving retirement investment advice, put their clients' best interests first. You're probably thinking what I thought after learning about this: Wait, these advisers aren't already required to recommend investment products that are in my best interests?<sup>21</sup>

There are dozens, if not hundreds, of similar articles, which use the term "best interests." From all of these articles we can discern a simple truth - individual Americans believe that the term "best interests" mean that the advisor is loyal to the interests of the client.

<sup>19</sup> See, e.g., <http://scholarfp.blogspot.com/2013/07/disband-finra-unabridged-and-with.html>

<sup>20</sup>Tamar Frankel, f/k/a Tamar Hed-Hoffman, "The Maloney Act Experiment," 6 Boston College L.R. 186, 217 (1965)

<sup>21</sup> Michelle Singletary, Is your adviser truly protecting your retirement (The Washington Post, Sept. 12, 2015).

Yet, BIP tries to change this common understanding, by redefining a commonly utilized phrase which has an accepted definition. Why? One might speculate that the “redefinition” is to encourage the provision of trust and confidence by customers of brokers under the BIP standard, where no justification for such provision of trust should exist, as a means of facilitating the sale of products by broker-dealers and their registered representatives.

FINRA continues to permit its members and their registered representatives to use the titles “financial consultant,” “financial advisor,” and “wealth manager.” Yet, these terms infer a relationship based upon trust and confidence, when such relationship of trust and confidence is later denied by the broker and its registered representative.

FINRA has the ability to combat fraud by its member broker-dealer firms and their registered representatives. Exchange Act Section 15A(b)(6) requires the rules of an association be designed to promote just and equitable principles of trade. FINRA satisfies this statutory requirement in part through FINRA Rule 2010, which reads: “A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.” The SEC has held that FINRA’s authority under Rule 2010 relating to “just and equitable principles of trade” permits FINRA to sanction member firms and associated persons for a variety of unlawful or unethical activities, including those that do not implicate “securities.”

Additionally, Exchange Act Section 15(c) prohibits any broker-dealer firm from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance. Under this prohibition, broker-dealers are precluded from making material omissions or misrepresentations and from any act, practice, or course of business that constitutes a manipulative, deceptive, or other fraudulent device or contrivance.

Earlier this year Gil Weinrich quoted Dalbar’s CEO Lou Harvey as stating: “Imagine, for example, if anyone could describe themselves as ‘doctor’ or ‘attorney’ but the real ones were ‘fiduciary doctor’ and ‘fiduciary attorney’ . . . .”<sup>22</sup> The article goes on to state: “The heart of Harvey’s proposal is to restrict the use of the word ‘advisor’ (or ‘adviser’) to fiduciaries alone, leading to prosecution for non-fiduciaries using that label.”<sup>23</sup> At the fi360 Annual Conference in April 2013, Skip Schweiss, President of TD Ameritrade Trust Company, pointed out Lou Harvey’s suggestion during a panel discussion in which this author participated. Skip Schweiss also suggested that anyone calling himself or herself a “financial advisor” or “financial consultant” be held to the fiduciary standard of conduct.

The view that one holding out as an advisor should be governed by the fiduciary standard of conduct finds recent support in academic literature: “The relationship between a customer and the financial practitioner

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<sup>22</sup>Gil Weinrich, “A Modest Proposal: Prosecute Non-Fiduciaries Using Term ‘Advisor’ (Dalbar CEO Lou Harvey reacts to Tiberghien’s lament about ‘fiduciaries in name only’”, located at <http://www.advisorone.com/2013/04/08/advisors-are-you-a-fiduciary-or-a-fraud>.

<sup>23</sup> *Id.*

should govern the nature of their mutual ethical obligations. Where the fundamental nature of the relationship is one in which customer depends on the practitioner to craft solutions for the customer's financial problems, the ethical standard should be a fiduciary one that the advice is in the best interest of the customer. To do otherwise – *to give biased advice with the aura of advice in the customer's best interest – is fraud*. This standard should apply regardless of whether the advice givers call themselves advisors, advisers, brokers, consultants, managers or planners.”<sup>24</sup> [*Emphasis added.*]

There exists authority, as well, on the inappropriate use of titles, from the SEC itself. Very early on the SEC took a hard line on representations made by brokers. In its 1940 Annual Report, the U.S. Securities and Exchange Commission noted: “If the transaction is in reality an arm's-length transaction between the securities house and its customer, then the securities house is not subject to a fiduciary duty. However, the necessity for a transaction to be really at arm's-length in order to escape fiduciary obligations has been well stated by the United States Court of Appeals for the District of Columbia in a recently decided case: ‘[T]he old line should be held fast which marks off the obligation of confidence and conscience from the temptation induced by self-interest. He who would deal at arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector. He cannot commingle his trusteeship with merchandizing on his own account...’” [*Emphasis added.*]<sup>25</sup>

Additionally, in its 1963 comprehensive report on the securities industry, the SEC stated that it had “held that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship exists, imposing a particular duty to act in the customer's best interests and to disclose any interest the broker-dealer may have in transactions he effects for his customer ... [*BD advertising*] may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business ... Where the relationship between the customer and broker is such that the former relies in whole or in part on the advice and recommendations of the latter, the salesman is, in effect, an investment adviser, and some of the aspects of a fiduciary relationship arise between the parties.”<sup>26</sup> [*Emphasis added.*]

The fact that misrepresentations of one's status amounts to fraud is reflected in a recent regulatory action filed by the State of Illinois Attorney General, who sought civil penalties against Mr. Richard Lee Van Dyke, Jr. (a.k.a. "Dick Van Dyke"), a seller of fixed indexed annuities. Mr. Van Dyke is alleged to have stated in advertising: “If you want a successful financial plan, you need a financial advisor you can really trust ... He believes in principles like full disclosure and transparency and he doesn't sell investments on

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<sup>24</sup>James J. Angel and Douglas M. McCabe, Georgetown University, Ethical Standards for Stockbrokers: Fiduciary or Suitability? Sept. 30, 2010.

<sup>25</sup>Seventh Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1941, at p. 158, citing *Earll v. Picken* (1940) 113 F. 2d 150.

<sup>26</sup>1963 SEC Special Study, citing various SEC Releases. See also Arthur B. Laby, Reforming the Regulation of Broker-Dealers and Investment Advisers, 65 Bus. Law. 395, 400, 413-17 (2010) (arguing that the broker-dealer exclusion from the definition of "investment adviser" in 15 U.S.C. § 80b-2(a)(11)(C) should be lost if a broker-dealer markets itself or otherwise holds itself out as an "adviser" in light of the connotation of the word).

commission which means he's on your side so you get to reach your goals first before he does. When's the last time an investment advisor put you first?" The basis of the complaint is a violation of Illinois' Consumer Fraud and Deceptive Business Practices Act. The Attorney General's complaint notes: "The representations cited above, on which Defendants intended consumers will rely, as well as others on Defendants' website, lead consumers to believe Defendant Dick Van Dyke is an objective, knowledgeable and unbiased financial services expert for consumers facing retirement, when in fact he is an insurance salesman."<sup>27</sup>

As a result of regulatory missteps by FINRA over many decades, substantial consumer confusion now abounds as to the standard of conduct consumers can expect from their providers of investment advice. In large part this is due to the improper use of titles by registered representatives, which, as discussed above, rises in the view of many to the level of intentional misrepresentation (i.e., fraud). Yet FINRA does nothing to prevent these ongoing misrepresentations from occurring.

And now, by this BIP proposal, FINRA seeks to further exacerbate confusion, and to further permit the use of trust-based selling, by a purported re-definition of the term "best interests" despite a common understanding among consumers as to what that term means, and despite substantial legal precedent which indicates that the term "best interests" is equivalent to the fiduciary duty of loyalty.

FINRA seeks to have broker-dealers provide advice under a nebulous, and some would say nefarious, Best Interests Paradigm. Yet, BIP is but an attempt to disguise the merchandizing aspect of the relationship. And, more importantly, as stated by observers above, *to give biased advice with the aura of advice in the customer's best interest – is fraud.*

**5. Any proposal to create a prohibited transaction exemption based on this new "Best Interests Paradigm" (BIP) proposal advanced by SIFMA, FINRA, Fidelity or others would fail to meet the requirements for the Secretary of Labor's grant of an exemption under the express provisions of ERISA. The Secretary lacks the authority under ERISA to diminish consumer protections, from those afforded by the fiduciary-entruster relationship, to those minimal protections afforded in arms-length relationships as would exist under the SIFMA/FINRA proposals.**

In creating ERISA, Congress went to great pains to enunciate the fiduciary duties imposed by the statute. It provides the Secretary the ability to grant exemptive relief from ERISA's strict sole interests paradigm and prohibited transactions provisions, but only if the exemptive relief is protective of plan participants and beneficiaries and in their best interests.

Clearly, Wall Street's BIP proposal meets neither of these standards for the grant of exemptive relief. It would permit product sales to occur by merchandizers, under the aura of acting in the participant's best

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<sup>27</sup>Andy Gluck provides commentary on the case and Advisors4Advisors also provides a copy of the Complaint at <http://advisors4advisors.com/compliance/advertising-compliance/article/17314-financial-advisor-in-illinois-accused-in-lawsuit-by-state-securities-regulators-of-advertising-he-acted-as-a-fiduciary-says-hes-done-nothing-wrong>.

interests, as that term is commonly interpreted by the courts and the lay public today. Worse, BIP, if enacted, would perpetuate a great fraud on the American people.

FINRA, by its apparent endorsement of SIFMA's attempt to perpetuate this fraud, has revealed for all to see what it truly is - the protector of Wall Street, not Main Street. Fortunately, ERISA compels the U.S. Department of Labor to protect Main Street, not Wall Street.

**B. Contracting Out of Fiduciary Relationships is Impermissible and Any Exemptive Relief to Authorize Such a Procedure Would Fail to Meet ERISA's Statutory Requirements for the Grant of Exemptive Relief.**

In its comment letter, Fidelity speaks of permitting the “overall framework for the engagement” to “be freely negotiated.”<sup>28</sup> Yet, fiduciary duties are imposed by law, and at their core fiduciary duties restrain the conduct of the fiduciary. No fiduciary should be permitted to seek to have the client “free negotiate” the terms of the relationship.

- 1. Whether imposed by the express terms of ERISA, by Congress' grant of authority to the U.S. Department of Labor to enact rules on qualified retirement plan and IRA accounts, or by the common law (such as when a relationship of trust and confidence exists), the ability of the advisor and client to “contract out” of the fiduciary-client relationship, and return to an arms-length (sales-customer) relationship, is negated.**

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.”<sup>29</sup> “Arms-length” relationships apply to the vast majority of

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<sup>28</sup> Fidelity Cmt. Ltr., Page A-5.

<sup>29</sup> “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.

service provider–customer engagements.<sup>30</sup> In arms-length relationships, the doctrine of “caveat emptor”<sup>31</sup> generally applies,<sup>32</sup> although there are many exceptions made to this doctrine which effectively compel affirmative disclosure of adverse material facts in diverse contexts.<sup>33</sup> 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.”<sup>34</sup>

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.”<sup>35</sup> “Absent express agreement of the parties<sup>36</sup> or extraordinary circumstances, however, parties dealing at arms-length in a commercial transaction lack the requisite level of trust or

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<sup>30</sup> 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).

<sup>31</sup> *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).

<sup>32</sup> “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).

<sup>33</sup> 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).

<sup>34</sup> *Meinhard v Salmon*, 249 NY 458, 464 (N.Y. 1928).

<sup>35</sup> *Exxon Corp. v. Breezevale Ltd.*, 82 S.W.3d 429 (Tex. App., 2002).

<sup>36</sup> *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 ....”).

confidence between them necessary to give rise to a fiduciary obligation.”<sup>37</sup> Ordinary “buyer-seller relationships” do not give rise to the imposition of fiduciary duties upon the seller.<sup>38</sup>

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”<sup>39</sup> in the

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<sup>37</sup> *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.”).

<sup>38</sup> *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.

<sup>39</sup> 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.”)

performance of their obligations; this doctrine is fundamental to all commercial transactions.<sup>40</sup> Good faith requires that each party perform their respective obligations and enforce their rights honestly and fairly.<sup>41</sup> 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,<sup>42</sup> except where one party’s superior knowledge renders non-disclosure of an essential fact inherently unfair<sup>43</sup> or a “special relationship” exists.<sup>44</sup> Instead, actors in commercial relationships generally possess a duty to undertake

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<sup>40</sup> 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 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.”

<sup>41</sup> 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.” Hough, Emily, “The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?” Utah Law Review, 2005. Available at SSRN: <http://ssrn.com/abstract=622982>.

<sup>42</sup> 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”).

<sup>43</sup> *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.

<sup>44</sup> 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.*)

diligent inquiry in order to ascertain facts.<sup>45</sup> However, if disclosures are undertaken by a party, the statements made must be truthful and complete<sup>46</sup> or actual fraud<sup>47</sup>, also called “common law fraud,” exists. 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.<sup>48</sup> 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.”<sup>49</sup> 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.”<sup>50</sup>

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

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<sup>45</sup> 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).

<sup>46</sup> 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 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.”

<sup>47</sup> “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).

<sup>48</sup> 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.

<sup>49</sup> *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”).

<sup>50</sup> *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’”).

fiduciary protections, specific statutes or regulations may nevertheless protect consumers.<sup>51</sup> 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<sup>52</sup> can have ill effects.

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.<sup>53</sup> Over the decades, federal securities laws and regulations have evolved to protect investors largely through requiring the

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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<sup>51</sup> 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.

<sup>52</sup> 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.”

<sup>53</sup> 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)).

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.”<sup>54</sup>

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<sup>55</sup> 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<sup>56</sup> 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 (and former 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 making decisions by adopting heuristics that simplify complicated tasks. In Simon’s terms, when faced with complicated tasks, people tend to “satisfice” rather than “optimize,” and might fail to search and process certain information.<sup>57</sup>

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 ....<sup>58</sup>

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:

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<sup>54</sup> Thomas Lee Hazen, *The Law Of Securities Regulation*, Vol. 1, § 8.1[1][B], at 740 (4th ed. 2002).

<sup>55</sup> 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 ....”).

<sup>56</sup> For an overview of various individual investor bias such as bounded irrationality, rational ignorance, overoptimism, overconfidence, the false consensus effect, insensitivity to the source of information, the fact that oral communications trump written communications, and other heuristics and bias, *see* Robert Prentice, “Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future,” 51 *Duke L. J.* 1397 (2002).

<sup>57</sup> Parades at p.3.

<sup>58</sup> Jill E. Fisch, “Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst,” 10 *Lewis & Clark L. Rev.* 57, 74-83 (2006).

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.<sup>59</sup>

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.<sup>60</sup> 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,<sup>61</sup> and reveal the inability of individual investors to contract for their own protections.<sup>62</sup>

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.*”<sup>63</sup>[*Emphasis added.*] Moreover, “*not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of*

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<sup>59</sup> 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).

<sup>60</sup> *Supra* n. 17.

<sup>61</sup> 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 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>.

<sup>62</sup> 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>.

<sup>63</sup> Stephen J. Choi and A.C. Pritchard, “Behavioral Economics and the SEC” (2003), at p.18.

*weaknesses in human cognition, but ... competitive pressures almost guarantee that they will do so.*<sup>64</sup> [Emphasis added.] 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 higher cost but performance on average is no better, and often worse, than readily available no-load funds.<sup>65</sup>

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.”<sup>66</sup>

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.”<sup>67</sup> Indeed, the Latin root of the word fiduciary – *fiduciaris* – means one in whom trust – *fiducia* - reposes. Legal usage in many jurisdictions also

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<sup>64</sup> 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).

<sup>65</sup> Donald C. Langevoort, “The SEC, Retail Investors, and the Institutionalization of the Securities Markets” (Jan. 2009), prior version available at available at SSRN: <http://ssrn.com/abstract=1262322>.

<sup>66</sup> *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”).

<sup>67</sup> BLACK’S LAW DICTIONARY, 5th Edition (1979)].

developed an overlay - an implication of a particular relationship of confidence between the fiduciary and those who had placed their trust in that person.

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.<sup>68</sup> [*Emphasis added.*]

Should an advisee should be able to “opt out” of the fiduciary relationship, by contract? Many securities industry participants appear to believe that the fiduciary relationship is a matter of contract. For example, the SPARK Institute<sup>69</sup> 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.”<sup>70</sup> Similarly, the Financial Services Institute opined that a “practical approach” should exist which “preserves investor choice and accommodates a range of business models.”<sup>71</sup> And, in its July 21, 2015 comment letter, Fidelity has now opined that “If the parties’ advice relationship evolves over time, any amendments to the terms of the engagement, including on a transaction-by-transaction basis, would be accomplished through the same disclosures and unilateral contracting process.”

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

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<sup>68</sup> *Von Noy v. State Farm Mutual Automobile Insurance Company*, 2001 WA 80 (WA, 2001) (J. Talmadge, concurring opinion).

<sup>69</sup> 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.

<sup>70</sup> 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.”)

<sup>71</sup> 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.

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 typically 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. Similarly, the DOL seeks to expand the definition of "fiduciary" to encompass more parties providing investment advice, and in so doing the DOL is imposing, pursuant to its statutory authority, fiduciary status as a matter of law.

Third, as alluded to above, core fiduciary duties are not capable of broad waiver. Any contract between the parties which seeks to negate the protections afforded by fiduciary status are disregarded.

Moreover, 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."<sup>72</sup> 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.*"<sup>73</sup> [Emphasis added.]

And, as set forth below, in the advisor-client context, just as fiduciary status is imposed as a matter of law, disregarding any attempt by the parties to contract out of the fiduciary's status as a fiduciary, core fiduciary duties cannot be waived.

## **2. The application of the concepts of estoppel and waiver are limited in the fiduciary realm.**

Concepts of waiver and estoppel, while commonly applied in arms-length relationships, have limited application to the fiduciary realm. The most important application of this principle is found in fiduciary law's treatment of the resolution of an unavailed conflict of interest.

In a fiduciary relationship, the law requires that the fiduciary must not bring her or his own interests into conflict with the interests of the client. This requirement is called the "no conflict" rule. It is derived from English law concepts that have flowed into American law from centuries past.

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<sup>72</sup> *In re Clarkeies Market, L.L.C.*, 322 B.R. 487, 495 (Bankr. N.H., 2005).

<sup>73</sup> Tamar Frankel, "Fiduciary Law," 71 Calif. L. Rev. 795, 817 (1983).

The “no conflict” rule has nothing to do with good or bad motive. The U.S. Supreme Court, in discussing conflicts of interest, has said: ‘The reason of the rule inhibiting a party who occupies confidential and fiduciary relations toward another from assuming antagonistic positions to his principal in matters involving the subject matter of the trust is sometimes said to rest in a sound public policy, but it also is justified in a recognition of the authoritative declaration that no man can serve two masters; and considering that human nature must be dealt with, the rule does not stop with actual violations of such trust relations, but includes within its purpose the removal of any temptation to violate them ....’”

And, as the U.S. 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.”

In arms-length relationship consent by a customer to proceed, when a conflict of interest is present, is generally permitted. *Caveat emptor* (“let the buyer beware”) applies to such merchandiser-customer relationships. The customer is not represented by the merchandiser but is rather in an adverse relationship - that of seller and purchaser.

In such arms-length relationships, it is a fundamental principle of the common law that *volenti non fit injuria* – to one who is willing, no wrong is done. Customer consent to the transaction generally gives rise to estoppel – *i.e.*, the customer cannot later state that he or she can escape from the transaction because a conflict of interest was present, or because full awareness of the ramifications of the conflict of interest were absent. The customer, in such instances, bears the duty of negotiating a fair bargain. The law permits customers, in arms-length relationships, to enter into “dumb bargains.” Generally, jurists will not set aside unfair bargains unless fraud, misrepresentation, mutual mistake of fact exists or unless the contract is so unjust and burdensome that it is deemed unconscionable.

But the fiduciary relationship is altogether different. The entrustor (client) and fiduciary actor have formed a relationship based upon trust and confidence. In such a form of relationship, the law guards against the fiduciary taking advantage of such trust. As a result, judicial scrutiny of aspects of the relationship occurs with a sharp eye toward any transgressions that might be committed by the fiduciary. Hence, mere consent by a client in writing to a breach of the fiduciary obligation is not, in itself, sufficient to create waiver or estoppel. If this were the case, fiduciary obligations – even core obligations of the fiduciary – would be easily subject to waiver.

Instead, to create an estoppel situation, preventing the client from later challenging the validity of the transaction that occurred, the fiduciary is required to undertake a series of steps:

First, disclosure of all material facts to the client must occur. [For some commentators on the fiduciary obligations of investment advisers, this is all that is required. Often this erroneous conclusion is derived from misinterpretations of the landmark decision of SEC v. Capital Gains Research Bureau.]

Second, the disclosure must be affirmatively made and timely undertaken. In a fiduciary relationship, the client's "duty of inquiry" and the client's "duty to read" are limited; the burden of ensuring disclosure is received is largely borne by the fiduciary. Disclosure must also occur in advance of the contemplated transaction. For example, receipt of a prospectus following a transaction is insufficient, as it does not constitute timely disclosure.

Third, the disclosure must lead to the client's understanding. The fiduciary must be aware of the client's capacity to understand, and match the extent and form of the disclosure to the client's knowledge base and cognitive abilities.

Fourth, the informed consent of the client must be affirmatively secured. Silence is not consent. Also, consent cannot be obtained through coercion nor sales pressure.

Fifth, at all times, the transaction must be substantively fair to the client. If an alternative exists which would result in a more favorable outcome to the client, this would be a material fact which would be required to be disclosed, and a client who truly understands the situation would likely never gratuitously make a gift to the advisor where the client would be, in essence, harmed.

These requirements of the common law – derived from judicial decisions over hundreds of years – have found their way into our statutes. For example, ERISA's exclusive benefit rule unyieldingly commands employee benefit plan fiduciaries to discharge their duties with respect to a plan solely in the interest of the plan's participants and for the exclusive purpose of providing benefits to them and their beneficiaries. And the Investment Advisers Act of 1940 was widely known to impose fiduciary duties upon investment advisers from its very inception, and it contains an important provision that prevents waiver by the client of the investment adviser's duties to that client. (However, SEC enforcement of Section 215 of the Advisers Act, prohibiting waivers of the duties of investment advisers, is sorely lacking.)

We must also ask, when would the client of a fiduciary ever knowingly consent to a conflict of interest that was otherwise unavoidable? In essence, when would a client ever provide informed consent to transform the key aspect of the relationship away from that of fiduciary-client and to an arms-length relationship in which the advisor permitted to act out of the advisor's self-interest.

To answer this question it is important to first realize that disclosure is neither a fiduciary duty nor a cure (without much more) to the breach of one's fiduciary obligations. In other words, it must be understood that, quite frankly, there exists no fiduciary duty of disclosure. While disclosure may be imposed by other law or regulation, or by contractual obligations created between the parties, disclosure is not, itself, a core fiduciary obligation found in the common law.

Rather, fiduciaries owe the obligation to their client to not be in a position where there is a substantial possibility of conflict between self-interest and duty. Again, this is called the "no-conflict" rule, derived from English law. Fiduciaries also possess the obligation not to derive unauthorized profits from the fiduciary position. This is called the "no profit" rule, also derived from English law.

While there is no fiduciary duty of disclosure, questions of disclosure are often central in the jurisprudence discussing fiduciary law, as many cases involve claims for breach of the fiduciary duty due to the presence of a conflict of interest. In essence, a breach of fiduciary obligation – either the obligation not to be in a position of conflict of interest and the duty to not make unauthorized profits – may be averted or cured by the informed consent of the client (provided all material information is disclosed to the client, the adviser reasonably expects client understanding to result given all of the facts and circumstances, the informed consent of the client is affirmatively secured, and the transaction remains in all circumstances substantially fair to the client).

In essence, asking a client to consent to a conflict of interest by the fiduciary is requesting that the client waive the no conflict rule, the no profit rule, or both rules. Again, clients would only do so in circumstances where the client is not harmed. It would be difficult to believe that client is so gratuitous to his or her investment adviser that the client would incur a detriment, beyond reasonable compensation previously agreed to, in order to provide the adviser with more lucre or other benefits.

Hence, disclosure, alone and without much more, is not a cure. And disclosure is only one of the five important requirements, all of which must be met, for a client’s waiver of a fiduciary obligation to be valid. Such waivers, while they may be required for unavoidable conflicts of interest, should be rare indeed. And even then the conflict of interest to which consent to proceed is given must be properly managed, for no client would ever knowingly consent to be harmed.

Some academics suggest that fiduciary duties are merely default rules, and that fiduciary obligations may be contracted away. But, the application of these views is found mainly in the realm of business relationships, such as those between business partners. The advisor-client relationship is an altogether different relationship, in which there are not two sophisticated parties of relatively equal bargaining power (or at least able to hire attorneys to assist in same). Rather, in the investment adviser-client relationship there exists a huge gulf of knowledge and sophistication. For this reason, even the “contractualists” academics who argue for a contract theory of fiduciary law (as might be applied in business settings, such as between business partners), accept the proposition that core fiduciary duties cannot be waived, at least in adviser-client settings.

**3. The ability to “contract away” the protections afforded by ERISA’s detailed statutory regime is not the basis for an exemption for which relief can be granted, given that contracting away such legal protections is neither protective of the plan beneficiaries nor in the interests of plan beneficiaries.**

ERISA requires the Secretary to determine, prior to the grant of exemptive relief, that such exemption is — (1) administratively feasible, (2) *in the interests of the plan and of its participants and beneficiaries*, and (3) *protective of the rights of participants and beneficiaries of such plan.*” 29 U.S.C. §1108(a) (in pertinent part) [*Emphasis added.*]

It is clear that if a client could be asked to contract away the fiduciary protections afforded to the client, most would do so readily. They do not know the consequences of such a waiver. Nor will such consequences be adequately explained by the adviser.

If they were aware of the consequences of contracting out of a fiduciary-client relationship, and into an arms-length relationship, clients would not enter into such a contract. They would not freely give up the substantial protections afforded by the fiduciary standard of conduct, in favor of the much lower suitability standard (whether modified by the BIP proposal, or not).

**C. A Requirement for Demonstration of Actual Reliance by the Entrustor on the Fiduciary's Advice Is Not Properly a Condition for Imposition of Fiduciary Status; Imposition of Such A Requirement Would Violate ERISA as Well as ERISA's Established Requirements for the Grant of Exemptive Relief.**

**1. While reliance by consumers on the investment and retirement planning advice they receive is commonplace, it is not a pre-condition to the law's imposition of fiduciary status.**

As discussed above, there are many public policy reasons behind the imposition of fiduciary status, whether by Congress when it enacted ERISA or the Advisers Act, or under state common law.

Yet, whether a fiduciary duty exists cannot be determined "by recourse to rigid formulas."<sup>74</sup> While reliance, or the placing of trust and confidence, is often found in the judicial decisions, the mere holding

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<sup>74</sup>*Scott v. Dime Sav. Bank of New York*, 886 F. Supp. 1073, 1078-79 (S. D. N. Y. 1995).

out as a fiduciary is sufficient to give rise to the possibility of a fiduciary relationship,<sup>75</sup> as is the actual delivery of advisory services, even to wealthy customers.<sup>76</sup>

Any attempt to establish such a pre-condition to the imposition of fiduciary status would not be in accord with established common law which applies fiduciary status upon those in relationships of trust and confidence with their clients, regardless of whether reliance is proven.

**2. Any attempt to establish a “reliance” pre-condition to the imposition of fiduciary status is in accord with ERISA, which does not impose such a precondition.**

Nowhere in ERISA does there exist the pre-condition that the client must possess, or prove, reliance upon the advice or the advisor.

Additionally, the test of whether a fiduciary relationship exists under the common law often requires a fact-intensive inquiry.<sup>77</sup> While “reliance” may be a factor, there are many other factors which may lead to the finding of a fiduciary relationship. Indeed, a variety of circumstances may indicate that a fiduciary

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<sup>75</sup> See, e.g., *Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 2005). [When a bank held out as either an “investment planner,” “financial planner,” or “financial advisor,” the Wisconsin Supreme Court held that a fiduciary duty may arise in such circumstances.]

<sup>76</sup> See, e.g., *Merrill Lynch, Pierce, Fenner & Smith vs. Millar* (W.D. Pa. 2003). [“Merrill Lynch invited the Millars to its headquarters in New York City to meet with some of its highest ranking executives. At that time, Merrill Lynch was aware that the Millars were meeting with other firms in order to find advisors to help them manage their wealth and achieve their investment objectives. Merrill Lynch was also acutely aware that the Millars had a net worth at that time in excess of \$10 million. Moreover, the program that Merrill Lynch presented Doug Millar was its Private Advisory Services. The PAS offered the Millars world class advisors that would work with and through the Millars local advisors. This is what Merrill Lynch was selling. Merrill Lynch did not at any time assert to the Millars that it would not monitor their account or that it would not give them advice on an ongoing basis. To the contrary, Merrill Lynch told the Millars it would work with them to formulate strategies with the most suitable recommendations for their investment needs ... There is no evidence that would suggest that the aggressive option strategy employed by Merrill Lynch was developed by Doug Millar. This was Dave Foster's strategy. Further, there is no evidence that Doug Millar would call Dave Foster on a systematic basis and instruct him to buy or sell puts and calls. To the contrary, Dave Foster was the prime mover behind the options strategy. Yet, 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. The Millars were not invited to Merrill Lynch headquarters in New York City merely to find technicians capable of executing a brokerage order. Regardless of Merrill Lynch's argument that the duty owed to the Millars was surprisingly narrow, the Panel found an unambiguous indication of the Millars' intent to sell 100,000 shares of Free Markets stock on September 5, 2000. Moreover, whether a fiduciary duty exists cannot be determined "by recourse to rigid formulas." *Scott v. Dime Sav. Bank of New York*, 886 F. Supp. 1073, 1078-79 (S. D. N. Y. 1995) ("Under New York law, stockbrokers may owe fiduciary duties to their customers.") 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." *Id.* More simply, "the existence of fiduciary duties depends on the facts of a particular relationship." *Vannest v. Sage, Ruty & Co.*, 960 F. Supp. 651, 655 (W. D. N. Y. 1997) (quoting *Boley v. Pineloch Assoc., Ltd.*, 700 F. Supp. 673, 680 (S. D. N. Y. 1988)). The Panel obviously determined that the relationship between the Millars and Merrill Lynch exceeded that found ordinarily between a broker and a nondiscretionary account holder ... Aside from an obvious failure to execute its client's order, Merrill Lynch clearly failed to deliver the services it promised to the Millars. Instead of using its "world class advisors" to implement a reasonable and prudent plan of monetization and conservative diversification that would have allowed the Millars to preserve a portion of their \$10 million nest egg, Dave Foster placed their money into the high risk arena of options trading. This strategy was unsuitable to meet the clear objectives of the Millars ...."]

<sup>77</sup> 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”).

relationship exists, as opposed to an arms-length relationship. Such circumstances, or indicia or evidential factors, include influence, placement of trust, vulnerability<sup>78</sup> or dependency, substantial disparity in knowledge,<sup>79</sup> the ability to exert influence, placement of confidence,<sup>80</sup> 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.”<sup>81</sup> 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.

### **3. A plethora of sound public policy reasons exist for the imposition of fiduciary status by ERISA, which have nothing to do with reliance.**

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.”<sup>82</sup> “The Act was designed to apply to those persons engaged in the investment-advisory profession -- those who provide personalized

<sup>78</sup> 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).)

<sup>79</sup> 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 as compared to the other’ ... ‘Allegations of reliance on another party with superior expertise, standing by themselves, will not suffice’”) (*citations omitted*).

<sup>80</sup> 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.”)

<sup>81</sup> *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.”)

<sup>82</sup> *Lowe v. SEC*, 472 U.S. 181, 200, 201 (1985).

advice attuned to a client's concerns, whether by written or verbal communication<sup>83</sup> ... The dangers of fraud, deception, or overreaching that motivated the enactment of the statute are present in personalized communications ....<sup>84</sup>

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

The inability of clients to protect themselves while receiving guidance from a fiduciary does not arise solely due to a significant knowledge gap or due to the inability to expend funds for monitoring of the fiduciary. Even highly knowledgeable and sophisticated clients (including many financial institutions) rely upon fiduciaries. While they may possess the financial resources to engage in stringent monitoring, and may even possess the requisite knowledge and skill to undertake monitoring themselves, the expenditure of time and money to undertake monitoring would deprive the investors of time to engage in other activities. Indeed, since sophisticated and wealthy investors have the ability to protect themselves, one might argue they might as well manage their investments themselves and save the fees. Yet, reliance upon fiduciaries is undertaken by wealthy and highly knowledgeable investors and without expenditures of time and money for monitoring of the fiduciary. In this manner, "fiduciary duties are linked to a social structure that values specialization of talents and functions."<sup>85</sup>

### ***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.

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<sup>83</sup> *Id.* at 208.

<sup>84</sup> *Id.* at 210.

<sup>85</sup>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.

### ***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.<sup>86</sup>

### ***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.

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<sup>86</sup> 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>.

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.

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.

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.

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."<sup>87</sup>

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"

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<sup>87</sup> 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).

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 standards of conduct. This would have negated to a large degree economic incentives<sup>88</sup> 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.*<sup>89</sup>

### ***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.”<sup>90</sup> 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

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<sup>88</sup> 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 *Cardozo 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.

<sup>89</sup>482 F.3d 481 (D.C. Cir., 2007).

<sup>90</sup> Tamar Frankel, *Trusting And Non-Trusting: Comparing Benefits, Cost And Risk*, Working Paper 99-12, Boston University School of Law.

risks to the client which relate to the service, and encourage the client to utilize the service. Fiduciary status thereby furthers the public interest.

***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<sup>91</sup> 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.<sup>92</sup>

***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.<sup>93</sup>

As seen, there are many public policy reasons behind ERISA's imposition of fiduciary status. While reliance may be a small aspect of fiduciary-client relationships, it is not, alone, the major reason why fiduciary duties are imposed.

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<sup>91</sup> "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.

<sup>92</sup> "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>.

<sup>93</sup> 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.

**4. Imposition of a precondition requirement of “reliance” would enable widespread consumer harm.**

Under Fidelity’s proposal, one would surmise that broker-dealers would simply provide, as one paper among a myriad of paperwork (often 60 pages or more) that customers sign when an account is first opened, a sheet in which the client acknowledges that reliance does not occur upon the adviser or the advice provided.

As stated above, usually by this point a relationship of trust and confidence is already formed. Moreover, verbal statements trump written documents, when trust exists. It is easy to get the customer to sign nearly anything.

The result of this proposal, if it were to find its way into a prohibited transaction exemption, would be, effectively, contracting out of the fiduciary relationship by signatures to a statement of non-reliance which the customer would rarely read, nor if read even understand.

**5. Accordingly, any precondition requirement before fiduciary duties would be imposed would not be in the interests of beneficiaries, nor protective of plan beneficiaries, and hence any exemptive relief which might be granted on the basis of a reliance precondition requirement would exceed the Secretary’s authority, absent some other means of protecting the beneficiary.**

There exists no factual record under which the Secretary can conclude that the actual showing of reliance by a customer should be a precondition to the ability of a fiduciary to escape fiduciary obligations. As stated previously, fiduciary duties are imposed by ERISA, and they cannot be negated by the acts of the parties, whether such act is called a “contract” or a “statement of non-reliance” or otherwise. Widespread harm would result if such an exemption were to be granted. Accordingly, any exemptive relief which might be granted on the basis of a reliance precondition requirement would exceed the Secretary’s authority.

**D. Fiduciary Duties Apply During the Formation of the Advisor-Client Relationship.**

Fidelity’s comment letter provides in pertinent part:

A conceptually simple and straightforward solution to the sales dilemma is to separate the terms of engagement of the advisor - that is, the otherwise conflicted components of the transaction - from the underlying investment recommendation. The framework for engaging the advisor is agreed to by the investor after full disclosure which permits that framework to be established outside the relationship. However, once that fiduciary relationship is established, all recommendations with the framework must be in the investor’s best interests.

However, under established law, dealings between a fiduciary and a client, even preliminary dealings, result in the imposition of fiduciary status upon the fiduciary.<sup>94</sup> Fiduciary duties exist even during the negotiation of the contract between the fiduciary and an entrustor.<sup>95</sup>

This is because fiduciary duties are imposed on relationships. In fact, fiduciary law is not derived solely from contract law, nor from tort law, nor trust law, nor agency law. Rather, “fiduciary law is ultimately a law of *relationships*.”<sup>96</sup> [*Emphasis in original.*]

There is no requirement for fiduciary status to result that a contract actually be signed between the parties. Fiduciary duties are imposed by operation of law, not by the agreement of the parties.

Given the nature of the fiduciary obligation, and its role in protecting the weak against the powerful, if fiduciary obligations were not applied during the formation of the relationship, and prior to the actual entry into a contract between the parties, then great abuse could occur of the client. For example, the client could easily be manipulated to pay unreasonable fees, or to waive core fiduciary obligations.

While Fidelity may struggle with this concept - that fiduciary duties extend even before the entry into any contract between the parties, it should be noted that the fiduciary standard of conduct permits negotiation to occur regarding the compensation of the fiduciary. The client is protected *during this negotiation* by the fiduciary standard and its requirement that compensation be reasonable. Any attempt to take outside the coverage of fiduciary protections the negotiation of compensation could easily result in agreements for unreasonable compensation, which persist in the securities industry today and which are major instances of abuse which the DOL’s Conflict of Interests proposed rule is designed to address.

#### **E. Fidelity’s Proposal to Simplify Disclosures of Conflicts of Interest Does Not Meet the Fiduciary Requirement of Affirmative Disclosure.**

As discussed above, the existence of a conflict of interest is, in essence, a breach of one’s fiduciary obligation. There is a multi-step process necessary to cure that breach. Part of that process is disclosure. Yet, to be effective, disclosure must be affirmatively made.

As the SEC Staff has stated, “The 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

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<sup>94</sup> See, e.g., *Dexter & Carpenter, Inc. v. Houston*, 20 F.2d 647 (4th Cir. 1927), holding that the fiduciary obligation of joint venturers “begins with the opening of the negotiations for the formation of the syndicate”. *Id.* at 652.

<sup>95</sup> See, e.g., *Waite v. Sylvester*, 560 A.2d 619 (N.H. 1989) (dictum) (citation omitted). stating: “The rule generally accepted... imposes a fiduciary duty not only with respect to transactions occurring during the partnership but also with respect to ‘those taking place during negotiations leading to the formation of the partnership.’” *Id.* at 625. Also see *DeVaux v. American Home Assurance Co.*, 444 N.E.2d 355 (Mass. 1983) (holding that an attorney might be liable for malpractice despite absence of a clear acceptance by him of an attorney-client relationship).

<sup>96</sup> Rafael Chodos, *The Nature of Fiduciary Law and Its Relationship to Other Legal Doctrines and Categories*, 91 Boston Univ.L.R. 837, 839 (2011).

investors may fully understand them.”<sup>97</sup> Moreover, the duty is on the fiduciary to ensure the the client understands the disclosures.<sup>98</sup>

Mere provision of access to disclosures does not ensure that the fiduciary’s duty of disclosure is met. Nor does it meet the fiduciary’s duty to ensure understanding of those disclosures.

Given consumers’ propensity to not read disclosures, we should resist any attempt to make access to disclosures more difficult, and/or to negate the requirement that all disclosures of material facts be undertaken affirmatively and in a manner in which the advisor ensures each client’s understanding.

**F. Fidelity’s Proposal to Expand the Seller’s Carve-Out to Small Plan Sponsors Would Negate the Essential Protections Small Business Owners Require.**

The so-called “seller’s carve out” proposed by the DOL applies only to large plan sponsors, and even then only to those who large plan sponsors who possess (or are advised upon) by those with sufficient financial expertise. Smaller plan sponsors rarely, if ever, possess the benefit of a trusted expert, objective adviser, independent of the product salesperson.

Fidelity’s letter wants to extend the seller’s carve-out to small plan sponsors, but without these protections. Clearly this would not meet the requirements for the grant of exemptive relief under ERISA. The very abuses that the DOL seeks to end today would continue, as to plan sponsors, should Fidelity’s wish be granted.

**G. Fidelity’s Proposal to Expand the Carve-Out for Investment Education to Include Recommendations of Specific Investment Alternatives Impermissibly Creates a Loophole, and Would Not Meet ERISA’s Standards for the Grant of Exemptive Relief.**

**1. Advice, whether it is provided to one person, to a small group, or to a large group, is advice.**

Advice is advice. It does matter if it is given in-person, over the phone, in a one-on-one conversation, in a group setting, by e-mail, by facsimile, by computer program, by video, or by any other means.

Under ERISA, the provision of advice is a fiduciary act.

Under the DOL’s Conflict of Interest rule proposal and PTE proposals, the use of asset allocation models that identify specific investment alternatives would no longer be treated as non-fiduciary investment education. This appears entirely proper. Advice is advice, even when delivered in group “educational” settings. Substance trumps form.

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<sup>97</sup> SEC Staff Study, as mandated under Section 913 of Dodd Frank, p.117.

<sup>98</sup> *Id.*, at fn.532: “Cf. letter from Ron A. Rhoades dated Dec. 20, 2010 (“The burden is upon the investment adviser to reasonably ensure client understanding”) (“Rhoades Letter 2”); Financial Planning Coalition Letter, supra note 471 (“It is not sufficient for a firm or an investment professional to make full disclosure of potential conflicts of interest with respect to such products [e.g., collateralized debt obligations and structured products]. The firm and the investment professional must make a reasonable judgment that the client is fully able to understand and evaluate the product and the potential conflicts of interest that it presents.”).

Yet, Fidelity in its comment letter seeks a grand expansion of the education advice exemption, even to situations in which very specific recommendations on investment products is provided.

**2. Given the extension of the definition of “fiduciary” under the DOL’s proposed “Conflicts of Interest” rule, there appears to be no need to any exemption for investment education. Education should be provided by fiduciaries.**

The “education exemption” was initiated to provide for consumer education at a time when most “retirement plan consultants” were not fiduciaries. The purpose of the exemption was to encourage education of a general nature.

Yet, with the DOL’s extension of the definition of fiduciary to encompass nearly all who provide advice to plan sponsors and plan participants, one must ask - why is there a need for the education exemption at all? Why wouldn’t you hold a fiduciary to a plan sponsor responsible for education provided to plan participants, especially if that advice touches on important subjects such as asset allocation?

I would urge the DOL to sunset the education exemption, perhaps after a period of one year. It is simply no longer necessary.

**3. Recommendations of specific securities clearly are investment advice. Any ability by a non-fiduciary advisor to undertake specific security recommendations would create a giant loophole, which over time would swallow up ERISA’s important fiduciary protections.**

Should the DOL amend its proposed PTE to provide that specific investment recommendations could be made to plan participants on specific investments, in group educational sessions, the result will be the delivery of investment advice by brokers and insurance agents almost exclusively under this arrangement.

The non-application of fiduciary standards to the delivery of specific investment recommendations is, simply put, nonsensical - which the DOL has recognized in its most recent proposals.

**4. Accordingly, any expansion of the education exemption would not be protective of plan beneficiaries, nor in their interests, and hence would fail to satisfy the requirements for the grant of exemptive relief.**

Substantial abuse which could take place if specific investment advice, including specific advice on which investment products to choose to implement a client’s investment plan, were permitted to occur in group “educational” sessions.

There is no longer any need for the education exemption. Those who provide education to plan participants, including advice on asset allocation (perhaps the most important decision an individual faces in terms of designing an investment policy), should be held to a fiduciary standard with respect to such advice.

At the minimum, Fidelity’s proposal to expand the proposed PTE to encompass the recommendation of specific products would create a giant loophole, into which non-fiduciaries would jump wholeheartedly.

And, the plan participants would, unfortunately, follow them into this non-fiduciary black hole of conflicted advice delivered under the meaningless (from the standpoint of consumer protections) standard of suitability.

### In Conclusion.

Judge Cardozo in *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928) famously wrote:

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

[**Emphasis added.**]

The U.S. Department of Labor should reject the attempt by Fidelity, SIFMA, FINRA, and many others to redefine the established legal term “best interests.” In essence, these opponents to the DOL’s proposed Conflicts of Interest rule seek to eliminate the fiduciary duty of loyalty altogether and replace it with a modified, though still inherently weak, suitability standard.

*The “Best Interests Proposal” - B.I.P. - should be sent to File 13, where it should forever R.I.P.*

Additionally, the DOL should resist attempts to insert additional “particular exceptions” to fiduciary requirements that fail to meet ERISA’s standards for the protection of plan participants and the requirement that any exemption serve the interests of plan participants.

Instead, the DOL should consider whether the existing and proposed PTEs, including the education exemption, and (as I have stated in a previous comment letter) BICE, should be sunset. There is a significant danger that the exemptions will be interpreted in such a manner that they swallow up the fiduciary protections which ERISA otherwise affords. At a minimum, I suggest that the DOL automatically sunset each and every PTE at some future date, with the requirement that any extension of the PTE be shown to be necessary.

Sunseting PTEs is wise and reflective of the rapid changes occurring in financial services. The investment advisory industry is changing rapidly, and fee-only and other independent providers of advice, under level compensation arrangements, are growing rapidly in market share. The delivery of retirement planning and investment advice through web-based platforms, with and without substantial human touches, is a promising development which is still in its infancy. Rapid developments may well occur in just the next few years.

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Moreover, new fee structures for securities and insurance products have emerged in recent years; many more investment products are now designed for the independent RIA marketplace. The DOL should encourage these trends by planning for a sunset of the PTEs. Of course, this could be done with the proviso that a further extension of the PTEs may occur should the marketplace at the time dictate their continued necessity, after a staff study of the advisory industry at the time.

Thank you for the opportunity to submit these comments. I would be happy to meet with the Department staff to review any aspect of this comment letter, at a mutually convenient time.

Yours truly,

Ron A. Rhoades, JD, CFP®