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Via Electronic Filing

December 20, 2010

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. 4-606: Study Regarding Obligations of Brokers, Dealers, and Investment Advisers

Re: Study on Enhancing Investment Adviser Examinations under Section 914 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, File No. DF Title IX—Enhancing IA Examinations

Re: File No. S7-23-07: Release No. IA-3118, "Temporary Rule Regarding Principal Trades with Certain Advisory Clients"

Dear Ms. Murphy:

I submit these comments personally - and not on behalf of any firm nor organization to which I may belong.

"The relationship between a customer and the financial practitioner 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."

- Professors James J. Angel and Douglas M. McCabe, Georgetown University, Ethical Standards for Stockbrokers: Fiduciary or Suitability? (September 30, 2010). Available at SSRN: http://ssrn.com/abstract=1686756

It has become apparent from SEC Commissioner and staff speeches that the SEC may desire to proceed down a path which will create a "harmonized" "new federal fiduciary standard" – in effect, weakening the current fiduciary standard found within the Investment Advisers Act of 1940.

In this comment letter I first explore the long history of failures to adhere to the fiduciary principle as to the delivery of investment advice, and the adverse consequences of same to Americans. This section of the comment letter is entitled: "2025: A Fiduciary Odyssey." I opine that such an imprudent course of action – weakening the current fiduciary standard of conduct found under the Advisers Act – would possess substantial adverse consequences over the long term for both individual Americans, as well as for America itself.

I then review the current jurisprudence of the Advisers Act. I note the Section 913(f) of the ''Dodd-Frank Wall Street Reform and Consumer Protection Act" (hereafter "Dodd-Frank Act"] enables the Commission to commence rule-making "as necessary or appropriate in the *public interest* and *for the protection of retail investors* …." [*Emphasis added.*] I further note that Section 913(g)(1) of the Dodd-Frank Act provides that if the fiduciary duty is extended to broker-dealers, then "the standard of conduct for such broker or dealer with respect to such customer *shall be the same as* the standard of conduct applicable to an investment adviser under section 211 of the Investment Advisers Act of 1940"[1] [*Emphasis added.*] Within this context, I then seek to

[1] Section 913(g)(1) of the Dodd-Frank Act also illuminates several aspects of the fiduciary standard which were already well known:

- "The receipt of compensation based on commission or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer." Nothing in the fiduciary standard of conduct has ever prohibited commission-based compensation. However, the receipt of compensation which may vary depending upon the recommendation made, however such compensation is effected, remains problematic under the Advisers Act. Section 206(3) expressly permits such in the limited context of principal trading, provided several actions are undertaken by the investment adviser to protect the client.
- "Nothing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer *after* providing personalized investment advice about securities." [*Emphasis added.*] It has always been possible to define the termination of an engagement. However, when the relationship is terminated, it is all-important that provision of personalized investment advice about securities be completely terminated.
- "Where a broker or dealer sells only proprietary or other limited range of products, as determined by the Commission, the Commission may by rule require that such broker or dealer provide notice to each retail customer and obtain the consent or acknowledgment of the customer. The sale of only proprietary or other limited range of products by a broker or dealer shall not, in and of itself, be considered a violation of the standard set forth in paragraph (1)." The sale of proprietary products was permitted to occur by banks, to their trust customers, by state laws enacted largely in the early 1990's. However, each state law provides certain measures, including fee-offsets and/or strict due diligence requirements, to ensure that the client's best interests are protected.

However, Section 913(g) also confers express authority upon the Commission to "examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors."

provide the Commission and its Staff with additional discussion of the present issues, with recitations to authority, under the following main discussion points:

- The fiduciary standard is the ultimate in principles-based regulation; however, it is possible to discern more specific standards of conduct, under a bona fide fiduciary standard, to guide the actions of individual fiduciaries.
- Estoppel and waiver possess a place in anti-fraud law, generally. However, in a fiduciary legal environment estoppel and waiver operate differently than that found in purely commercial relationships. Core fiduciary duties cannot be waived. Nor can clients be expected to contract away their core fiduciary rights. Estoppel has a different role in the context of "actual fraud," as opposed to its limited role when dealing with "constructive fraud." For estoppel to make unactionable a breach of a fiduciary obligation due to the presence of a conflict, it is required that the fiduciary undertake a series of measures, far beyond undertaking mere disclosure of the conflict of interest.
- The jurisprudence of the Investment Advisers Act of 1940 amply illustrates the true nature of fiduciary obligations. When a conflict of interest is present, "disclosure" followed by "consent" are, in and of themselves, wholly insufficient to prevent a breach of fiduciary obligations. Disclosure must occur timely and be of all material facts. The burden is upon the investment adviser to reasonably ensure client understanding, and the client's "duty to read" is circumscribed. Such disclosure and achievement of client understanding is fundamental to securing not just the client's "consent," but rather the client's *informed consent*. Even then, the proposed action must remain substantively fair to the client.
- It has been well-known, both in the 1930's and in recent academic research into the behavioral biases affecting individual consumers – that disclosures do not work to protect the interests of individual investors. Disclosures are seldom read, less frequently understood in today's complex financial world, and ineffective due to strong behavioral biases possessed by 95% or more of individual investors. Worse yet, academic research has revealed that behavioral biases can actually cause the advice provided to become even poorer than the advice provided when conflicts of interest are not disclosed. Accordingly, the Commission's over-reliance on disclosures is misplaced.
- The Commission should recognize that the fiduciary relationship, and the protections it affords to individual investors, is a far stronger protection for individual Americans, and for the promotion of capital formation, than an arms-length relationship enhanced only with casual disclosures of conflicts of interest.
- The Commission should not "harmonize" BD and RIA regulation, in any way which would weaken or destroy the obligations of investment advisers under the bona fide fiduciary standard of conduct currently existing in the Advisers Act. The Commission would be proceeding against established judicial precedent, both in Advisers Act jurisprudence as well as under state common law (which informs the Advisers Act). The consequences of weakening the fiduciary standard are far too severe – to capital formation and economic growth – for the Commission to proceed down such a course of action.

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PART ONE: 2025 - A "FIDUCIARY ODYSSEY"

Imagine that it is now 2025, and over two decades have passed since the U.S. Securities and Exchange Commission (SEC) adopted a "new federal fiduciary standard" for the delivery of investment advice to retail consumers. Today hundreds of millions of individual Americans, and America itself, suffer from the consequences of the Commission's action.

Over the decades a string of failures by Congress, the SEC, and the NASD/FINRA failed to raise the provision of investment advice to the level of a true profession, bound together by the requirement of an appropriate strong fiduciary standard of conduct. Instead, investors remained in largely arms-length relationships with their "financial advisors."

All the while massive marketing campaigns by Wall Street firms touted "objective advice" from "financial consultants" who attended their client's soccer games and made so many believe that the "advice" received would result in the ability to afford that second home on the beach. All this occurred as the Commission, FINRA and other securities regulators ignored the fundamental truth that "to provide biased advice, with the aura of advice in the customer's best interest, is fraud."[2]

Following is an abbreviated history of the endeavors to apply fiduciary principle to the provision of investment advice, illustrating the many actions taken by the Commission and FINRA (formerly NASD). Before addressing such history, however, I visit the "present circumstances" (imagining that it is now 2025), in which I explore how these actions resulted in the current lack of trust in the securities markets, leading to inadequate capital formation, stagnant U.S. economic growth, and the resulting increased hardships suffered by all Americans.

The Consequences of the SEC's Actions: 2012-2025 and Great Depression II

The Commission should have known that, rather than fulfilling its mission to "protect investors" and to "facilitate capital formation," the results of its rule-making efforts in 2011-2012 (in which the fiduciary standard was re-defined as a much lower standard of conduct) would bring about the exact opposite result. Rather than enhancing the regulation of the market participants – who had largely effected the stock market crash of 2008-9 through the formulation and sale of "sh**ty" products to individual and institutional investors – the SEC instead chose to de-regulate, by lowering the standards of conduct expected of those who provide investment advice to dual registrants.

The SEC continued to permit dual registrants to "switch hats" back and forth, preparing financial plans and investment portfolio strategies for retail investors, and thereafter switching

[2] Angel, James J. and McCabe, Douglas M., Ethical Standards for Stockbrokers: Fiduciary or Suitability? (September 30, 2010), at p.23. Available at SSRN: http://ssrn.com/abstract=1686756.

back to a product sales role in which only casual disclosure was required of the existence of a conflict of interest. The SEC failed to require that the many hidden fees and costs of pooled investment vehicles were at least estimated and affirmatively disclosed to the client. Industry compensation practices between financial intermediaries, adverse to the interests of individual investors, such as 12b-1 fees, payment for shelf space, and payment for order flow continued. While rules existed to prohibit directed brokerage, any reasonable statistical analysis would have concluded that this conflicted practice persisted between mutual fund complexes and the brokerage firms which promoted the funds of those complexes.

Customers of both broker-dealer and investment adviser firms, believing they were receiving objective advice, instead received advice which was in the best interests of the brokerage or investment advisory firm. The term "best interest" came to be utilized far too loosely. In essence, clients of "fiduciaries" who said they "operated in the best interests of our customers" were sold "sh***y products" – often products with large fees, costs and tax inefficiencies – creating a huge drag on the returns of individual investors.

A small number of fee-only investment advisers remained out there, committed to avoiding – not just disclosing – conflicts of interest. But, by eschewing the multiple revenue sources enjoyed by those adhering to the lower "new federal fiduciary standard," these fee-only advisers remained a substantial minority. It was just too lucrative, and too attractive to new entrants into the securities industry, to become an advisor subject only to the much lower casual disclosure-based "harmonized" standard of conduct.

Broker-dealer and investment adviser firms operating under the new "federal fiduciary standard" often consumed 30% or more of the gross returns investors could expect from the capital markets. The financial services industry, as a proportion of the overall U.S. economy, grew to unforeseen levels.

Time passed, and slowly[3] clients realized the harm to which they were subjected. Media articles continued to appear noting the many conflicts of interests which were not avoided, and which infected the supposed "fiduciary relationship" between adviser and client.

Clients, already confused as to what obligations were owed to them by their "financial consultants," slowly began to realize that they could not trust *any* financial advisor. Yes, there were fee-only advisers out there, but the reasonable compensation these fee-only advisers received was insufficient to counter the large marketing budgets of the broker-dealer firms; hence, while fee-only advisers somewhat thrived within their small population, the movement never grew large enough, in the face of the economic incentives offered by regulators to those

[3] "[I]ndividuals continue to trust beyond the point where evidence points to the contrary. Eventually, however, the accumulated weight of evidence turns them towards distrust, which is equally reinforcing." Anand, Kartik, Gai, Prasanna and Marsili, Matteo, Financial Crises and the Evaporation of Trust (November 16, 2009). Available at SSRN: http://ssrn.com/abstract=1507196.

able to enjoy a lower standard of conduct, and to counter the large advertising budgets of the majority of the firms working in the conflict-ridden brokerage and advisory world. The use of common titles, and the high fees received by those operating under a conflict-ridden standard of conduct, resulted in the inability by higher-quality advisors receiving lower, level compensation arrangements to distinguish themselves.[4]

As a result, clients' trust was betrayed. The life savings they entrusted to their "fiduciary" adviser failed to earn returns even close to the market indices. Even worse, as the SEC de-emphasized the requirement of due diligence under the duty of care of a fiduciary, many new "sh**ty" investment products were developed and subsequently "blew up" – destroying the life savings of many individuals. Clients rightfully regarded the actions of their "advisers" as fraudulent. Clients of the new type of "fiduciary" advisor had their trust betrayed.

As the media continued to report on these travesties, investors largely abandoned the use of financial advisors altogether. Yet, lacking the skills to navigate the intricacies of the capital markets themselves, and subject to behavioral biases which were not countered with the aid of a knowledgeable and trusted adviser, investors fled the capital markets following the inevitable price declines in the equities markets, returning only well after prices had recovered nearly fully – thereby losing out on much of the long-term returns of the capital markets. And, unable to discern all of the fees and costs of the investment products existing, or the risks to which they were exposed, many investors paid dearly.

As scandal upon new scandal was exposed by the media, many individual investors fled the capital markets altogether, for all time. Not knowing who to trust, they chose to not participate at all in capital formation at all,[5] instead choosing to place their savings in depository accounts.

The result should have not been unexpected. The cost of capital dramatically increased for U.S. corporations, and less capital formation resulted. Economic growth stagnated,[6] and at times the

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[4] "Once agents receive fees that are too high, it becomes harder for the marginal agent to distinguish themselves when they are working harder for their client." Carlin, Bruce I., Viswanathan, S. "Vish" and Dorobantu, Florin A., Public Trust, the Law, and Financial Investment (November 27, 2007). Available at SSRN: http://ssrn.com/abstract=1033102.

[5] "[S]pecific trust in advice given by financial institutions represents a prominent factor for stock investing, compared to other tangible features of the banking environment." Georgarakos, Dimistris, and Pasini, Giacomo, Trust, Sociability and Stock Market Participation (2009). Available at http://www.aueb.gr/conferences/Crete2010/Senior/Georgarakos.pdf. *See also* César Calderón, Alberto Chong, and Arturo Galindo, Structure and Development of Financial Institutions and Links with Trust: Cross-Country Evidence (2001) ("We use a new World Bank data set that provides the most comprehensive coverage of financial development and structure to this date. We find that trust is correlated with financial depth and efficiency as well as with stock market development.") Available at http://www.iadb.org/res/publications/pubfiles/pubWP-444.pdf

[6] "It is well documented that public trust is positively correlated with economic growth (Putnam 1993; LaPorta, Lopez-de-Silanes, Shleifer, and Vishny 1997; Knack and Keefer 1997; Zak and Knack 2001) and with participation in the stock market (Guiso, Sapienza, and Zingales 2007a) … we develop a two-period theoretical model in which investors entrust their wealth to a continuum of heterogeneous agents and rely on the agents

U.S. economy even contracted. Foreign investors, sensing the problems with the U.S. system of securities regulation and the resulting economic difficulties, pulled back on their foreign equity and debt investments in U.S. companies, further exacerbating the U.S. economic decline. From 2020 to the present day, and continuing, another Great Depression is underway.

Unlike 2008 to 2011, when large fiscal and monetary stimuli (by government spending, tax cuts, and direct loans to and capital investments in businesses) helped the economy recovery, this time the Federal Government – already burdened with trillions upon trillions of both federal public debt – possessed insufficient resources to stimulate the economy. U.S. government debt was downgraded from its previous "AAA" rating, and other currencies in the world were now seen as safe havens. The costs of government borrowing escalated as interest rates rose, thereby further putting pressure on the Federal Government's depleted coffers.

Declining state revenues also led several states and many municipalities, saddled with their own large debt obligations, to default on municipal bond interest and principal payments. Individual investors suffered huge losses as the pace of public and private bankruptcy filings increased.

All the while, the Baby Boomers had now largely retired, and many turned to the U.S. and state governments for assistance. Individuals had poor returns derived from holdings in depository (rather than the greater returns offered over the long term in the capital markets). Those individual investors that participated in the capital markets, largely through intermediaries, suffered as well, due to the high fees and costs which deflected so great a portion of the gross returns of the capital markets into the hands of financial intermediaries.

Retirees were increasingly forced to turn to federal and state governments for assistance. But promised public benefits were not available, as social security and Medicare trust funds had been depleted. And continued economic decline led to even lower federal and state revenue

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to honor their fiduciary duty … Trust that arises from the law evolves because investors can rely on the government to make sure that agents honor their fiduciary duty to clients … we consider the effect that professional fees have on the trust that forms in markets … We show that when the value to social capital is relatively low and/or the growth potential in the economy is low, it is never optimal to institute a Coasian plan (absence of government regulation). We also show that *ceteris paribus* there should be more government intervention in a low-trust equilibrium than in a high-trust equilibrium." Carlin et. al., *supra* n. __.

"In our 37-nation sample … growth rises by about 1 percentage point on average for each 15-percentage point rise in trust … Trust, and the social and institutional factors that affect it, significantly influence growth rates. Thus, this research provides a new insight into the way that institutional factors affect economic performance." Zak, Paul J. and Knack, Stephen, Trust and Growth (Sept. 18, 1998). Available at SSRN: http://ssrn.com/abstract=136961 or doi:10.2139/ssrn.136961.

"Using data from the US states, we provide new evidence of a positive relationship between trust and economic growth and show that even in a high income country such as the US, in which property and contractual rights are protected more than the low income countries, high trust regions achieve higher economic growth." Dincer, Oguzhan C. and Uslaner, Eric M., Trust and Growth (July 2007). FEEM Working Paper No. 73.2007. Available at SSRN: http://ssrn.com/abstract=999922.

collections, resulting in the inability of governments to provide essential services to their citizens.

Now, it is 2025. Unemployment remains well above 20% in the United States. America's economy continues to contract, and deflation has set in. There is no end in sight to the current economic crisis, nor any available intercession by government to "turn the tide." America can no longer afford the social safety net promised to its citizens. As unemployment benefits prove inadequate or lapse, and requirements for food stamps become more strict, many more Americans have turned to food banks. But, in a much worse situation than 2009-2010, the cupboard was largely bare. Many of those who charitably contributed to food banks now were their customers. And many Americans, including children, go hungry each day as a result.

A Special Joint Commission has just reported back on the causes of the ongoing present economic crisis. Their conclusion? It all flowed back to the SEC's flawed rule-making in 2011 and 2012.

The SEC largely ignored the importance of trust in establishing the regulatory structures for broker-dealers and investment advisers (and their representatives), and the SEC refused to adhere to the established true nature of the fiduciary-client relationship. Following the enactment of the Dodd-Frank Act, the SEC instead enacted rules which resulted in "ethical pollution" of the investment adviser-client relationship. By permitting two hats to be worn, effectively, at the same time (and by enabling the switching of hats back and forth, at will), the SEC, in essence, enabled consumers' trust to be betrayed.

The SEC's adoption of a "new federal fiduciary standard" was <u>not</u>, in reality, anything like the fiduciary standard applied to other fiduciary professional advisors, such as attorneys and physicians. The SEC thereby eroded the entire concept of "fiduciary" within U.S. culture. As a result, consumers' trust in other professions also declined.

Looking back on the SEC rule-making efforts of 2011-2012, one can only wonder, "What were they thinking?"

- Why didn't the SEC foresee the dramatic adverse consequences, upon capital formation and economic growth, resulting from the erosion of trust?
- Why didn't the SEC see that Americans needed trusted advisors governed by a true, bona fide fiduciary standard – not "pretenders" capable of betraying trust at every opportunity?
- Why didn't the SEC realize that the "new federal fiduciary standard" the SEC adopted (which was not really a fiduciary standard at all, but rather only slightly enhanced the protections afforded to those in arms-length relationships) was doomed to utter failure, and with far-ranging negative consequences to individual Americans, and to America itself.

Now, in 2025, at last the Federal Government is poised to act. Congress, unwilling again to delegate to the SEC the formulation of standards of conduct, and reacting finally to an economic crisis of record proportions, has now enacted new legislation requiring that all those providing financial and investment advice to individual Americans – and to business entities, pension plans, and institutions – be governed by the *bona fide* fiduciary standard of conduct.

But, as a means of restoring trust in our system of regulating financial intermediaries, the U.S. Securities and Exchange Commission is to be disbanded. The U.S. Congress recognized that the SEC's "regulatory capture" by the securities industry was too prevalent, and that the American public would not have their confidence restored in the SEC. Instead, the SEC's functions are to be transferred to other agencies – the Federal Reserve, the Consumer Financial Protection Agency, and others.

At long last the "back-door" and often hidden compensation streams flowing to financial intermediaries from financial product manufacturers are to be shut down. No more 12b-1 fees. No soft dollar compensation. A requirement to ensure true best execution. Statistical tests to determine if the financial intermediaries engaged in selling a particular financial product are in any way favored over other brokers or dealers by the investment manager. And – no payment for shelf space.

And FINRA? 86 years was long enough to realize that FINRA was a failed experiment, in which standards of conduct were never (as long ago contemplated by Senator Maloney) raised to the highest levels, but instead migrated ever lower. FIRNA was disbanded as well, to be replaced with a true *professional regulatory organization*, with individuals as members, substantial representation by consumer advocates on its governing body. All securities professionals will be required to join this professional regulatory organization and be governed by its strict, bona fide, fiduciary standard of conduct.

What about the financial institutions themselves? They are shrinking, and consolidating. This too has caused disruption, as many highly intelligent individuals previously educated for and working in the capital markets were forced to go back to school to learn how to engage in professions and pursuits more valuable to the U.S. economy. Eventually they will emerge as engineers, physicians, innovators, and entrepreneurs.

At long last, truly effective reform of financial intermediation has taken place. Too bad it took so long. And it is so sad that America, suffering today, will take decades to recover (if it ever will) from the ill-advised rule-making efforts of the SEC in 2011 and 2012.

The SEC's 2011-2012 adopted rules – which lowered the standards of conduct for those providing investment advice – ended up destroying trust in financial intermediaries. This in turn resulted in less capital formation, which then led to the present economic crisis.

Too bad hundreds of millions of Americans had to suffer (and continue to suffer) from the ill-advised decisions made in 2011 and 2012 by a handful of SEC commissioners.

An Incorrect Assumption in the 1933 and 1934 Federal Securities Laws.

"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."[7]

While scholars anticipated that trusted advisors would be there to assist individual investors, it soon became apparent that more regulation was required. Hence, soon after the '33 Securities Act and the '34 Securities and Exchange Act, two major pieces of legislation were enacted to address the inadequacy of the disclosure regimes adopted in the '33 and '34 Acts. Each of these major pieces of legislation sought to create a profession for the delivery of investment advice. Each of these Acts failed in this endeavor, albeit for different reasons.

The 1938 Maloney Act Amendments: Addressing the Inadequacy of Disclosures, But a Failed Attempt to Create a Profession Among Registered Representatives of Broker-Dealers.

In 1938, the Assistant General Counsel of the SEC stated that the "Commission has concluded that the next stage in the job – the job of raising the standards of those on the edge to the level of the standards of the best – can best be handled … by placing the primarily responsibility on the organized associations of securities dealers throughout the country."[8] As a result, the 1938 Maloney Act gave the SEC the authority to create self-regulatory organizations for broker-dealer firms. This in turn gave rise to the NASD (which subsequently became FINRA).

The theme of continually raising the standards of the industry was repeated in a speech by SEC Commissioner George C. Matthews, shortly after the Maloney Act was passed in Congress, in which he stated, "Ideally, the industry should eventually play the predominant role in its own regulation and development …. It should in the largest possible measure achieve that ideal under democratic institutions which Josiah Royce described as the forestalling of restraint by self-restraint … I wish to re-emphasize the evolutionary character of the program provided for in the [Maloney] Act … it is our hope … that the work of construction [of regulation] will continue through the years until there shall finally have been erected a professional edifice

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[7] 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).

[8] Chester T. Lane, Address Before The Seattle Bond Club (Mar. 14, 1938), available at http://www.sec.gov/news/speech/1938/031438lane.pdf.

commensurate with the importance of the investment banking and over-the-counter securities businesses in our national economy."[9]

Senator Maloney himself noted that the Act had, as its purpose, "the promotion of truly professional standards of character and competence."[10]

Yet, what followed was a long string of NASD/FINRA's regulatory failures:

(1) Early in the 1940's, shortly after its formation, NASD hailed its achievement in preventing the possible mandated split of "dealer" (including investment underwriting) functions from the functions of a broker (i.e., undertaking trades as an agent);

(2) NASD's failed to prevent (and subsequent defense of) price-fixing activities in the mid-1990's, as to the activities of market makers [SEC Chair Levitt said that the evidence showed FINRA "did not fulfill its most basic responsibilities" and concluded that by FINRA's failure "American investors were hurt — large and small, sophisticated and inexperienced, institutional and individual — all were hurt by these practices"];[11]

(3) NASD's failed to prohibit stock analyst conflicts of interests (including very recent attempts to break down, to a degree, the Chinese Wall which was re-built after the scandals which occurred early years of this Century;

(4) NASD/FINRA failed to prevent a number of repeated industry-wide scandals that plagued the broker-dealer industry from the late 20th Century into the early 21st Century (*e.g.*, insider trading, penny stocks, limited partnerships, market-maker price-fixing, unsuitable mutual fund share classes, research conflicts of interest, auction rate securities, CDOs).

(5) NASD/FINRA failed to seek appropriate supervision of derivatives,[12] a substantial cause of the 2008-2009 "Great Recession";

(6) FINRA's decade-long advocacy promoting fee-based brokerage accounts, without subjecting them to the fiduciary standard of conduct, led to an SEC Final Rule which was overturned by the U.S. Court of Appeals in *Financial Planning Association vs. SEC* (2007);

(7) FINRA's continues to refuse to share information with state securities regulators;[13]

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[9] George C. Matthews, A Discussion of the Maloney Act Program, before the Investment Bankers Association of America, Oct.23, 1938, avail. at http://sec.gov/news/speech/1938/102338mathews.pdf.

[10] Senator Francis T. Maloney, Regulation of the Over-the-Counter Security Markets, Address at the California Security Dealers Association, Investment Bankers Association, National Association of Securities Dealers 2 (Aug. 22, 1939) (transcript available in the SEC Library at 11 SEC Speeches, 1934-61).

[11] Statement By SEC Chairman Arthur Levitt, Press Conference Regarding The NASD, Washington, DC, August 8, 1996. Available at http://www.sec.gov/news/speech/speecharchive/1996/spch113.txt

[12] *See* Alliance for Economic Stablility, "Securities Regulatory Reform: Addressing FINRA's Inherent Conflict and Moral Hazard," Jan. 4, 2010.

[13] *See* Testimony of Denise Voigt Crawford, Texas Securities Commissioner and President, North American Securities Administrators Association, Inc., Before the House Financial Services Committee, October 6, 2009.

(8) FINRA blatantly opposed raising standards of conduct for those providing investment advice above the very low standard of "suitability." While FINRA supported in 2010 "a uniform standard of care for broker-dealers and investment advisers when providing personalized investment advice to retail customers" and "a fiduciary duty to act in the best interests of the customer without regard to the professional's financial or other interests," [14] FINRA incorrectly advocated a version of the fiduciary standard based upon agency law.[15] Moreover, FINRA stated that it believed "it would be a mistake to … impose the investment adviser standard of care and other requirements of the Advisers Act to broker-dealers."[16]

Has FINRA achieved for its members "truly professional standards of character"? As observed six decades years ago by one commentator, it has long been recognized that FINRA has failed:

> 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 (1953). 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 is 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 ….."[17]

Why has FINRA failed to raise – over many, many decades, the standards of conduct of broker-dealer firms and their registered representatives? The reasons are likely many, but

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[14] Cmt. Letter of Marc Menchel, Financial Industry Regulatory Authority (FINRA), dated Aug. 25, 2010, p. 1. Available at http://sec.gov/comments/4-606/4606-1924.pdf

[15] *Id.* at p.2 ("[W]e note that the fiduciary standard is derived from common law agency principles of trust and confidence and can be applied differently depending on the nature of the relationship and dealings between the parties. This is because the common law permits the principal and agent to define by agreement the scope of the agent's duty to the principal, including any circumstances where the agent may have a permissible conflict. The Advisers Act effectively implements, and defines limits to, the scope of the agency relationship between an investment adviser and a customer … the fiduciary duty owed by an investment adviser to a retail customer is not absolute, as the customer may consent to certain conflicts after disclosure … FINRA urges the Commission to recognize these common law principles and legislative precedent in applying a fiduciary standard to broker-dealers.")

[16] *Id.* at p.8. FINRA also opposed the elimination of the broker-dealer exclusion from the definition of investment adviser.

[17] Tamar Hed-Hofmann, The Maloney Act Experiment, 6 B. C. Indus. & Com. L. Rev. 187 (1964-1965), available at http://sws1.bu.edu/tfrankel/Mahoney%20Act.pdf.

the overriding reason likely stems from the fact that FINRA is a membership organization, composed of for-profit commercial firms (and not individual advisors, as would have been proper for an organization of professionals). These broker-dealer firms exercise their influence to protect their commercial interests. It would be wholly unlikely that the executive of a broker-dealer firm, appointed to serve on FINRA's Board of Directors and to represent his or her firm, would ignore the profit motivations of his or her firm as rules of conduct are considered.

The 1940 Advisers Act: A Sincere Attempt to Create an Investment Profession

As stated by the U.S. Court of Appeals in 2007[18]: "In §202(a)(11) of the [Investment Advisers Act of 1940, or "IAA"], Congress broadly defined 'investment adviser' as 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities ... Just as the text and structure of paragraph of 202(a)(11) make it evident that Congress intended to define 'investment adviser' *broadly* and create only a precise exemption for broker-dealers, so does a consideration of the problems Congress sought to address in enacting the IAA … Congress reiterated throughout its proceedings *an intention to protect investors and bona fide investment advisers*. The overall statutory scheme of the IAA addresses the problems identified to Congress in two principal ways: First, by establishing a *federal fiduciary standard* to govern the conduct of investment advisers, broadly defined,[19] and second, by requiring full disclosure of all conflicts of interest. As the Supreme Court noted, Congress's 'broad proscription against `any … practice … which operates … as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end … [*T]he Committee Reports indicate a desire to . . . eliminate conflicts of interest between the investment adviser and the clients as safeguards both to `unsophisticated investors' and to `bona fide investment counsel*.'[20] The [IAA] thus reflects a . . . congressional intent to *eliminate*, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.'"[21] [*Emphasis added*.][22]

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[18] *Financial Planning Ass'n v. S.E.C.*, 482 F.3d 481, 489-490 (D.C. Cir., 2007).

[19] *Financial Planning Ass'n vs. SEC, citing Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979),

[20] *Financial Planning Ass'n vs. SEC, citing SEC vs. Capital Gains Research Bureau*, 375 U.S. at 191, 84 S.Ct. 275.

[21] *Financial Planning Ass'n vs. SEC, citing Capital Gains* at 191-92, 84 S.Ct. 275.

[22] For a detailed discussion of *SEC vs. Capital Gains Research Bureau*, and the incorrect interpretation of same by some members of the securities bar that it provides a "roadmap" to compliance with the Advisers Act by mere disclosure and consent, see succeeding sections of this comment letter.

At first, the SEC appeared to apply the Advisers Act correctly. Early pronouncements and decisions of the SEC noted the existence of the fiduciary duty of investment advisers, the necessity of *informed consent* when a conflict of interest was present following the disclosure of *all material facts* relating to the recommendation made to the client.

But then, over time, and especially following the repeal of fixed commission structures for brokerage transactions in 1975, the SEC chose to ignore the requirements of fiduciary law. At times it refused to apply fiduciary standards to those obviously engaged in advisory relationships. The fee-based brokerage accounts rule, overturned by the U.S. Court of Appeals in 2007, was but one example. Despite the judicial rebuke and reminder of the broad scope of the Advisers Act, shortly after that decision the SEC took the position that "solely incidental" could mean anything the SEC wanted it to mean (and not ascribing plain meaning to such words, nor applying the Advisers Act broadly as Congressional intent mandated); the SEC proposed a rule permitting "switching of hats" at will by dual registrants. The SEC also expanded principal trading through a "Temporary Rule" – thereby facilitating the most insidious of conflicts of interest in the world of financial intermediaries – countering its own decades-long rulings in the area.

In hearings before the Senate Banking Committee in 2010, Senator Levin's focus on why Wall Street firms could package and sell what a firm's employee admitted at the time was a "sh***y product" highlighted the ineffectiveness of the "suitability doctrine" which largely governs the conduct of broker-dealers and their registered representatives with respect to their customers. Congress was confused. And in their confusion, they delegated to the SEC the power to enact new rules to protect individual investors.

Yet, despite full knowledge among the Commissioners that disclosures don't work and that disclosure can even result in worse advice being given, and in contravention of existing jurisprudence, the SEC acted instead with its newfound authority to substantially weaken the fiduciary standard found in the Advisers Act. Instead of enhancing protections for investors, the SEC moved toward a financial intermediary-customer regime much closer to that of arms-length relationships, abetted with enhanced (yet still "casual," incomplete, and ineffective) disclosures of conflicts of interest, followed by the mere (uniformed) consent of the client. As a result, Congressional intent was frustrated, and the strong protections which the Advisers Act could have provided were instead denied to individual Americans.

PART TWO: A LEGAL DISCUSSION OF THE ADVISERS ACT AND SPECIFIC ISSUES ARISING THEREUNDER

A. WHAT DOES THE FIDUCIARY STANDARD MEAN?

1. Lord Millet's "Masterful Survey."

In dictum in the 1998 English (U.K.) case of *Bristol and West Building Society v. Matthew*, Lord Millet undertook what has been described as a "masterful survey" of the fiduciary principle:

> A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principle is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of the fiduciary obligations. They are the defining characteristics of a fiduciary.

2. The Triad of Duties, in a Nutshell

a. The Tri-parte Fiduciary Standard.

We can derive from the case law and reported administrative decisions applicable to investment advisers and financial planners, as well as general principles of fiduciary law, a listing of some of the specific principles or duties arising from the fiduciary standard of conduct. In this regard, in the United States we frequently refer to a triad of broad fiduciary duties – due care, loyalty, and utmost good faith. While useful as a clear and succinct statement of the law, these tri-parte general duties or principles still often fail to provide adequate guidance to advisors and those who regulate them. In this section a summary recitation of specific duties arising under the law is provided; subsequent sections explore each of the triad of fiduciary duties in greater detail.

b. Summary Recitation of the Parameters of the Fiduciary Duty of Due Care.

An advisor shall act with due care. In connection therewith (and not by way of limitation):

An advisor possesses a fiduciary duty to the client to exercise with good judgment, knowledge, and due diligence[23] as to the investment strategies, the investment products,[24] and

[23] "The broker or advisor implicitly represents to the client that he or she has an adequate basis for the opinions or advice being provided." Johnson v. John Hancock Funds, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006), citing Hanly v. S.E.C., 415 F.2d 589, 596-97 (2d Cir. 1969); Univ. Hill Found. v. Goldman, 422 F. Supp. 879, 893 (S.D.N.Y. 1976).

the matching of those strategies to meet the needs and objectives of the client,[25] and with that degree of care ordinarily possessed and exercised in similar situations by a competent professional properly practicing in his or her field.

An advisor shall maintain the confidentiality of client information in accordance with applicable law and the agreement with the client.

C. Summary Recitation of the Parameters of the Fiduciary Duty of Loyalty.

An advisor shall abide by his, her or its fiduciary duty of loyalty to the client at all times during the course of the relationship with the client. In connection therewith (and not by way of limitation):

The advisor shall at all times place and maintain his or her or its client's best interests[26] first and paramount to those of the advisor;[27]

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

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

[25] "[T]he broker handling a discretionary account becomes the fiduciary of his customer in a broad sense. Such a broker, while not needing prior authorization for each transaction, must … manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history." *Leib v. Merrill Lynch, Pierce, Fenner & Smith*, 461 F.Supp. 951,3 (E.D. Mich., 1978).

[26] In contrast to the "best interests" standard traditionally imposed upon investment advisers and financial planners under the Investment Advisers Act of 1940 and state common law, ERISA (at least prior to amendments made by the Pension Protection Act of 2006) imposed a "sole interests" standard. *See Keach v. U.S. Trust Co. N.A.*, 313 F.Supp.2d 818 (C.D. Ill., 2004) ("Under the section 404(a) duty of loyalty, ERISA fiduciaries must act 'solely in the interest of plan participants and beneficiaries' … for the 'exclusive purpose' of providing benefits to them."). *Id.* at 863.

The advisor shall not, through either false statement nor through omission,[28] mislead his or her or its clients;

The advisor shall affirmatively provide full and fair disclosure of all material facts[29] to his or her or its client prior to a client's decision[30] on a recommended course of action,[31] including but not limited to: (1) all fees and costs[32] associated with any investment, securities and insurance products recommended to a client, expressed with specificity for the particular transaction contemplated; and (2) all of the material benefits, fees and any other material compensation paid to the advisor (and additionally those benefits, fees and other material compensation paid to the advisor representative) or to any firm or person with whom he or she or it may be affiliated, expressed with specificity for the particular transaction which is contemplated.

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

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

[29] "Courts have imposed on a fiduciary an affirmative duty of `utmost good faith and full and fair disclosure of all material facts,' as well as an affirmative obligation `to employ reasonable care to avoid misleading' his customers." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

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

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

[32] Disclosure of just the "disclosed fees" and costs of a pooled investment vehicle is inadequate, in the view of this author, given the substantial impact of transaction costs and opportunity costs within many mutual funds and other pooled investment vehicles, and the non-inclusion of these costs in a fund's stated "annual expense ratio." *See* Ron A. Rhoades, JD, CFP®, Estimating the Total Costs of Stock Mutual Funds (April 22, 2009), available at http://www.josephcapital.com/Resources.html. "[W]e decline to find that providing a client with a prospectus is a complete defense, as a matter of law, to state claims that the stock broker or investment advisor misrepresented facts or failed to disclose facts material to his or her client's investment decisions." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

The advisor is under an affirmative obligation to reasonably avoid conflicts of interest[33] which would impair the independent and objective advice rendered to the client. As to any remaining conflicts of interest which are not reasonably avoided, the advisor shall undertake full and affirmative disclosure of such conflict of interest[34] and shall ensure the intelligent, independent and informed consent[35] of his or her or its client is obtained with regard thereto.

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[33] "[T]he Committee Reports indicate a desire to ... eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.' The [IAA] thus reflects a ... congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-2 (1963). "The IAA arose from a consensus between industry and the SEC that 'investment advisers could not 'completely perform their basic function — furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments — unless all conflicts of interest between the investment counsel and the client were removed.'" *Financial Planning Association v. Securities and Exchange Commission*, No. 04-1242 (D.C. Cir. 3/30/2007) (D.C. Cir., 2007) *citing SEC vs. Capital Gains* at 187.

[34] "The overall statutory scheme of the IAA addresses the problems identified to Congress in two principal ways: First, by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined, *see Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17 (1979), and second, by requiring full disclosure of all conflicts of interest." *Financial Planning Association v. Securities and Exchange Commission*, No. 04-1242 at p.17 (D.C. Cir. 3/30/2007) (D.C. Cir., 2007). The existence of "federal fiduciary standard" under the Investment Advisers Act of 1940 does not mean that deference is not provided to the scope of fiduciary duties as they exist under state common law. *See U.S. v. Brennan*, 938 F.Supp. 1111 (E.D.N.Y., 1996) ("Other spheres in which the existence and scope of a fiduciary duty are matters of federal concern are ERISA and § 523(a)(4) of the Bankruptcy code. The analysis under each of these statutes continues to be informed by state and common law. See, e.g., *Varity v. Howe*, ___ U.S. ___, ___, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996); *F.D.I.C. v. Wright*, 87 B.R. 1011 (D.S.D. 1988) (bankruptcy).") Id. at 1119.

[35] The fiduciary duty to avoid conflicts of interest, and the necessity to obtain the informed consent of the client as to conflicts of interest not avoided, were well known in the early history of the Advisers Act. In an address entitled "The SEC and the Broker-Dealer" by Louis Loss, Chief Counsel, Trading and Exchange Division, U.S. Securities and Exchange Commission on March 16, 1948, before the Stock Brokers' Associates of Chicago, the fiduciary duties arising under the Advisers Act, as applied in the Arleen Hughes release, were elaborated upon:

> The doctrine of that case, in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to make a scrupulously full disclosure of every element of its adverse interest in, the transaction.
>
> In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses. This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law 'acts not on the possibility, that, in some cases the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.' Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine 'has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that

In any event, the proposed arrangement remains should be prudently managed in order that the client's best interests are preserved[36] and that the proposed arrangement is substantively fair to the client.

d. Summary Recitation of the Parameters of the Fiduciary Duty of Utmost Good Faith.

An advisor shall act with utmost good faith[37] toward his, her or its client. Not by way of limitation thereof, an advisor shall not act recklessly nor with conscious disregard of the client's interests.

B. THE ROLE OF ESTOPPEL AND CLIENT ACCEPTANCE OF RESPONSIBILITY UNDER FIDUCIARY LAW.

1. Estoppel and Its (Limited) Role in Fiduciary Law.

In the context of arms-length relationships, disclosure and consent creates estoppel, as customers generally possess responsibility for their own actions. This is fundamental to anti-

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hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.'"

This time-honored dogma applies equally to any person who is in a fiduciary relation toward another, whether he be a trustee, an executor or administrator of an estate, a lawyer acting on behalf of a client, an employee acting on behalf of an employer, an officer or director acting on behalf of a corporation, an investment adviser or any sort of business adviser for that matter, or a broker. The law has always looked with such suspicion upon a fiduciary's dealing for his own account with his client or beneficiary that it permits the client or beneficiary at any time to set aside the transaction without proving any actual abuse or damage. What the recent Hughes case does is to say that such conduct, in addition 'to laying the basis for a private lawsuit, amounts to a violation of the fraud provisions under the securities laws: This proposition, as a matter of fact, is found in a number of earlier Commission opinions. The significance of the recent Hughes opinion in this respect is that it elaborates the doctrine and spells, out in detail exactly what disclosure is required when a dealer who has put himself in a fiduciary position chooses to sell his own securities to a client or buys the client's securities in his own name …

The nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases use of the term 'principal' itself may suffice. In others, a more detailed explanation will be required. In all cases, however, the burden is on the firm which acts as fiduciary to make certain that the client understands that the firm is selling its own securities …

[36] *See, generally, Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438 (Bankr. S.D.N.Y., 1994) ("The [fiduciary] relationship requires that [the fiduciary must not] exert influence or pressure upon the other or take selfish advantage of the trust in such a way as to benefit himself or prejudice the [client]. A breach of fiduciary duty has occurred when influence has been acquired and abused and when confidence has been reposed and retained.")

[37] "When a stock broker or financial advisor is providing financial or investment advice, he or she is required to exercise the utmost good faith, loyalty, and honesty toward the client." *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. App. 6/30/2006) (Tenn. App., 2006).

fraud law, as applicable to arms-length relationships ("actual fraud")[38]. Prosser and Keeton wrote that it is a "fundamental principle of the common law that *volenti non fit injuria*—to one who is willing, no wrong is done."[39]

Yet, the doctrine of estoppel springs from equitable principles, and it is designed to aid in the administration of justice where, without its aid, injustice might result.[40] And a breach of the fiduciary standard is "constructive fraud,"[41] not actual fraud. The role of estoppel in fiduciary

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[38] Common law fraud. Section 525 of the Restatement (Second) of Torts provides the general rule for fraudulent misrepresentation: "One who fraudulently makes a misrepresentation of fact, opinion, intention, or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation."

To prove common law fraud in most states, the plaintiff must show that

- the defendant made a material false representation or failed to communicate a material fact, which had the effect of falsifying statements actually made
- the defendant did this intentionally (the defendant knew that the representation or omission constituted a falsehood) or recklessly (the defendant made the representation without regard to whether it was true or false)
- the defendant intended that the plaintiff act on it
- the plaintiff did, in fact, rely on the representation or omission to his or her detriment.

A representation is material if either a substantial likelihood exists that a reasonable person would attach importance to it in making a decision or the person who made the representation has reason to know that the plaintiff is likely to regard it as important in making a decision, even though a reasonable person would not so regard it.

Fraudulent misrepresentation by omission may be actionable if the defendant has a duty to the plaintiff to disclose material facts and fails to do so, and if this failure results in a false impression being conveyed to the plaintiff. A defendant can also be liable for failing to disclose new information that makes previously disclosed information misleading.

To be actionable, a fraudulent misrepresentation generally must concern fact rather than mere opinion, judgment, expectation, or probability. However, a fraud case can be based on a representation of opinion when one or more of the following occurred:

- the defendant knew that the facts on which the opinion was based were false
- the defendant knew that the opinion was false
- the opinion was based on the defendant's special knowledge of information contained in it and the defendant knew that the plaintiff was justified in relying on this special knowledge
- the defendant claimed to have special knowledge of facts that would occur in the future
- the defendant had special knowledge superior to that of the plaintiff about value.

[39] W. Page Keeton et al., PROSSER AND KEETON ON THE LAW OF TORTS 112 (5th ed. 1992); see RESTATEMENT (SECOND) OF TORTS § 892A cmt. a (1977) (asserting that one does not suffer a legal wrong as the result of an act to which, unaffected by fraud, mistake or duress, he freely or apparently consents).

[40] *Levin v. Levin*, 645 N.E.2d 601, 604 (Ind. 1994).

[41] To prove a breach of fiduciary duty, a plaintiff must show that he or she and the defendant had a fiduciary relationship, that the defendant breached its fiduciary duty to the plaintiff, and that this resulted in an injury to the plaintiff or a benefit to the defendant.
It is not necessary for the plaintiff to prove causation to prevail on claims of certain breaches of fiduciary duty. It is the agent's disloyalty, not any resulting harm, that violates the fiduciary relationship. Comment b to section 874 of the RESTATEMENT (SECOND) OF TORTS recognizes that a plaintiff may be entitled to "restitutionary

law is different in fiduciary relationships than in its application to arms-length relationships in in which *caveat emptor* (even when aided by disclosure obligations under the '33 Act and '34 Act) plays a role. Mere consent by a client in writing to a breach of the fiduciary obligation is not, in itself, sufficient to create 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, the fiduciary is required to undertake a series of steps[42]:

(1) Disclosure of all material facts to the client must occur;[43]

(2) The disclosure must be affirmatively made (the "duty of inquiry" and the "duty to read" are limited in fiduciary relationships)[44] and must be timely made – i.e., in advance of the contemplated transaction;

(3) The disclosure must lead to the client's understanding – and 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;

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recovery," to capture "profits that result to the fiduciary from his breach of duty and to be the beneficiary of a constructive trust in the profits." In some circumstances, the plaintiff may recover "what the fiduciary should have made in the prosecution of his duties." RESTATEMENT (SECOND) OF TORTS § 874 cmt. b (1979); *see also* 2 DAN B. DOBBS, THE LAW OF REMEDIES 670 (2d ed. 1993) (noting that a fiduciary who wrongfully takes an opportunity, if "treated as a fiduciary for the profits as well as for the initial opportunity," would "owe[] a duty to maximize their productiveness within the limits of prudent management and might be liable for failing to do so")

[42] As stated by Professor Tamar Frankel, in the context of trustee-beneficiary relationships, the application of waiver or estoppel is not satisfied by mere disclosure, but requires other affirmative actions by the fiduciary: "Where the beneficiaries are all *sui juris* and consent to the sale, it cannot be set aside if the trustee made a full disclosure and did not induce the sale by taking advantage of his relation to the beneficiaries or by other improper conduct, and if the transaction was in all respects fair and reasonable. On the other hand, the sale can be set aside if the trustee did not make a full disclosure, or if he improperly induced the sale, or if the transaction was not fair and reasonable ... In order to transform the fiduciary mode into a contract mode, four conditions must be met: (1) entrustors must receive notice of the proposed change in the mode of the relationship; (2) entrustors must receive full information about the proposed bargain; (3) the entrustors' consent should be clear and the bargain specific; (4) the proposed bargain must be fair and reasonable." Frankel, Tamar, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209.

[43] Even in arms-length relationships, a ratification or waiver defense may fail if the customer proves that he did not have all the material facts relating to the trade at issue. *E.g., Davis v. Merrill Lynch, Pierce, Fenner & Smith*, Inc., 906 F.2d 1206, 1213 (8th Cir. 1990); *Huppman v. Tighe*, 100 Md. App. 655, 642 A.2d 309, 314-315 (1994).

In contrast, in fiduciary relationships the failure to disclose material facts while seeking a release has been held to be actionable, as fraudulent concealment. *See, e.g., Pacelli Bros. Transp. v. Pacelli*, 456 A.2d 325, 328 (Conn. 1982) ('the intentional withholding of information for the purpose of inducing action has been regarded ... as equivalent to a fraudulent misrepresentation.'); *Rosebud Sioux Tribe v. Strain*, 432 N.W. 2d 259, 263 (S.D. 1988) ('The mere silence by one under such a [fiduciary] duty to disclose is fraudulent concealment.')" (*Ibid.*)

[44] "Where a fiduciary relationship exists, facts which ordinarily require investigation may not incite suspicion (*see, e.g., Bennett v. Hibernia Bank*, 164 Cal.App.3d 202, 47 Cal.2d 540, 560, 305 P.2d 20 (1956), and do not give rise to a duty of inquiry (*id.*, at p. 563, 305 P.2d 20). Where there is a fiduciary relationship, the usual duty of diligence to discover facts does not exist. *United States Liab. Ins. Co. v. Haidinger-Hayes, Inc.*, 1 Cal.3d 586, 598, 83 Cal.Rptr. 418, 463 P.2d 770 (1970)' *Hobbs v. Bateman Eichler, Hill Richards, Inc.*, 210 Cal.Rptr. 387, 164 Cal.App.3d 174 (Cal. App. 2 Dist., 1974).

(4) The informed consent (which is not coerced by the fiduciary in any manner)[45] of the client must be affirmatively secured (and silence is not consent)[46]; and

(5) At all times, the transaction must be substantively fair to the client[47] – 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.

2. Disclosure is Not a Fiduciary Obligation, But Only a *Potential* Cure to a Breach of Fiduciary Duties.

Preliminarily, it must be remembered that there exists no fiduciary duty of disclosure (although disclosure may be imposed by other law or regulation, or by contractual obligations created between the parties). 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. Fiduciaries also possess the obligation not to derive unauthorized profits from the fiduciary position.

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. Additionally, Sect. 206(3) of the Advisers Act imposes an obligation of disclosure, in recognition of the conflict of interest present in principal trades by fiduciaries with their clients. 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 – silence is not consent – 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 and/or the no profit rule generally applicable to fiduciaries

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[45] There must be no coercion for the informed consent to be effective. The "voluntariness of an apparent consent to an unfair transaction could be a lingering suspicion that generally, when entrustors consent to waive fiduciary duties (especially if they do not receive value in return) the transformation to a contract mode from a fiduciary mode was not fully achieved. Entrustors, like all people, are not always quick to recognize role changes, and they may continue to rely on their fiduciaries, even if warned not to do so." Frankel, Tamar, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209.

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[47] In the absence of integrity and fairness in a transaction between a fiduciary and the client or beneficiary, it will be set aside or held invalid. *Matter of Gordon v. Bialystoker Center and Bikur Cholim*, 45 N.Y. 2d 692, 698 (1978) (2006 WL 3016952 at *29). As stated by Professor Frankel, "if the bargain is highly unfair and unreasonable, the consent of the disadvantaged party is highly suspect. Experience demonstrates that people rarely agree to terms that are unfair and unreasonable with respect to their interests." Frankel, Tamar, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209.

(including investment advisers) under the broad fiduciary duty of loyalty. If truly informed consent occurs following full disclosure of all material facts in a manner designed to ensure understanding given that particular client's knowledge base and present circumstances, and if the transaction remains substantively fair to the client (i.e., the client is not disadvantaged by the transaction, as no client would likely ever consent to harm), only then would a client be estopped from asserting a breach of fiduciary duty claim due to the presence of the conflict of interest.

3. Casual Disclosure of a Conflict of Interest is Insufficient.

While disclosures and informed consent are possible in some circumstances, the application of this device requires much more than casual disclosure. This is especially so in the context of principal trading, since dumping is so difficult to detect. Generally, and as stated by Professor Band in a 2006 white paper:

> In principle, any fiduciary duty can be modified by disclosure and consent. However, and the however is significant, achieving this end is not as easy as the principle may suggest. In order to be effective, contractual exclusions or limitations have to be agreed on the basis of full information, the consent has to be informed consent. Whilst this could be seen as an ordinary principle of contract law, this is not a helpful way to look at the issue in this context. Since the relationship between the parties is one which, *ex hypothesi*, would otherwise attract fiduciary duties, the fiduciary is not in a position where he can simply demand blind agreement to limitations on those duties. He has to provide information to enable the client to determine whether the limitation on the protection from which he would otherwise benefit is ultimately in his interests or whether [the client] should look elsewhere for another adviser who might look after [the client's] interest on a broader basis. In the financial services context, and indeed in many other professional advisory relationships, the problem will be whether the adviser is able to provide sufficient information, constrained as he will be by duties of confidentiality (whether fiduciary or otherwise) owed to other clients. What is required in terms of full disclosure depends on what duties are required of the fiduciary. There have to be some real doubts about whether the very general exclusion clauses work in circumstances where the institution has a real – as opposed to theoretical – conflict on its hands. Very often, of course, the client whose rights have been affected by reason of the fact that fiduciary duties have been curtailed is not in a position to challenge the validity of the consent which he gave since he does not know what information the institution had but felt unable to give him.[48]

4. The Duty Is Upon the Fiduciary to Ensure Client Understanding.

Where there is a conflict of interest which is not avoided and is present with respect to a particular proposed transaction, there is an obligation upon the fiduciary to disclose adequate facts to ensure client understanding. The amount of facts which are deemed

[48] Christa Band, Conflicts of Interest in Financial Services and Markets (2006) (Australia).

material, and required to be disclosed, will by necessity vary with the knowledge base already possessed the client. Those clients with a lesser knowledge base and/or cognitive abilities will require greater disclosure. There will arise circumstances, due to the complexity of the contemplated transaction and/or the cognitive abilities and knowledge base of the client, in which client understanding is unable to be secured; in these circumstances the conflict of interest must be avoided, as informed consent cannot be obtained.

5. Certain Fiduciary Obligations Cannot Be Waived.

Additionally, it must be remembered that an "irreducible core"[49] of fiduciary duties exist, which are not subject to waiver by disclosure and consent under any circumstances. For example, good faith and honesty can never be excluded from the core obligations of any fiduciary.

Moreover, broad waivers of rights of the client are likewise unenforceable. "Fiduciary duties of loyalty and care, however, are broad standard rules. Therefore, the bargain around these duties must carve out explicit and specific situations. A number of reasons can be offered for requiring specificity. First, specific rules are efficient for the parties' planning and for bargaining around the rules. Second, specificity is necessary to avoid misunderstandings among the parties. Third, in many cases, a broad waiver of duties is bound to be uninformed and speculative."[50]

C. DISCLOSURE ALONE IS NOT SUFFICIENT TO MEET AN ADVISOR'S FIDUCIARY OBLIGATION – BECAUSE DISCLOSURES DON'T WORK!

1. The Inadequacy of Disclosures Was Known in the 1930's.

Even in the 1930's, the perception existed that disclosures would prove to be inadequate as a means of investor protection. As stated by Professor Schwarcz:

> Analysis of the tension between investor understanding and complexity remains scant. During the debate over the original enactment of the federal securities laws, Congress did not focus on the ability of investors to understand disclosure of complex transactions. Although scholars assumed that ordinary investors would not have that ability, they anticipated that sophisticated market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors.[51]

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[49] *See* A. Trukhtanov, The Irreducible Core of Fiduciary Duties (2007) 123 LQR 342.

[50] Frankel, Tamar, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209.

[51] 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

2. Disclosures Just Don't Work – Recent Academic Research on the Insufficiency of Disclosures – They Can Actually Make Things Worse!

In reality, the saying "Sunlight is the best disinfectant" is just not true.

The insufficiency of disclosure as a means of investor protection was highlighted at the Fiduciary Forum, held in September 2010 in D.C. and co-sponsored by the Committee for the Fiduciary Standard, CFP Board, NAPFA, FSI, and FPA. Two of the professors presenting at that conference also have written extensively in this area, including these papers:

In a paper by Professors Daylian Can, George Loewenstein, and Don Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest," they challenged the belief of some that disclosure can be a reliable and effective remedy for the problems cause by conflicts of interest, and concluded: "In sum, we have shown that disclosure cannot be assumed to protect advice recipients from the dangers posed by conflicts of interest. Disclosure can fail because it (1) gives advisors strategic reason and moral license to further exaggerate their advice, and (2) the disclosure may not lead to sufficient discounting to counteract this effect. The evidence presented here casts doubt on the effectiveness of disclosure as a solution to the problems created by conflicts of interest. When possible, the more lasting solution to these problems is to eliminate the conflicts of interest. As Surowiecki (2000) commented in an article in the New Yorker dealing specifically with conflicts of interest in finance, 'transparency is well and good, but accuracy and objectivity are even better. Wall Street doesn't have to keep confessing its sins. It just has to stop committing them.'"[52]

In another paper co-authored by Professor Cain, he opined: "Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are honestly disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. This means that while disclosure may [insufficiently] warn an audience to discount an expert-opinion, disclosure might also lead the expert to alter the opinion offered and alter it in such a way as to overcompensate for any discounting that might occur. As a result, disclosure may fail to solve the problems created by conflicts of interest and it may sometimes even make matters worse. "[53]

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and '34 Acts (The Wheat Report)," 52 (1969); accord William O. Douglas, "Protecting the Investor," 23 YALE REV. 521, 524 (1934).

[52] See http://papers.ssrn.com/sol3/papers.cfm?abstract_id=480121.

[53] Cain, Daylian M., Loewenstein, George F. and Moore, Don A., The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest (December 1, 2003). Available at SSRN: http://ssrn.com/abstract=480121

The dimensions of the biases of advisors, when attempting to deal with non-avoided conflicts of interest, was revealed in a paper citing earlier research by Professor Cain and others, Professor Antonia Argandoña wrote:

> As a rule, we tend to assume that competent, independent, well trained and prudent professionals will be capable of making the right decision, even in conflict of interest situations, and therefore that the real problem is how to prevent conscious and voluntary decisions to allow one's own interests (or those of third parties) to prevail over the legitimate interests of the principal – usually by counterbalancing the incentives to act wrongly, as we assume that the agents are rational and make their decisions by comparing the costs and benefits of the various alternatives.
>
> Beyond that problem, however, there are clear, unconscious and unintended biases in the way agents gather, process and analyze information and reach decisions that make it particularly difficult for them to remain objective in these cases, because the biases are particularly difficult to avoid. It has been found that,
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> - The agents tend to see themselves as competent, moral individuals who deserve recognition.
> - They see themselves as being more honest, trustworthy, just and objective than others.
> - Unconsciously, they shut out any information that could undermine the image they have of themselves – and they are unaware of doing so.
> - Also unconsciously, they are influenced by the roles they assume, so that their preference for a particular outcome ratifies their sense of justice in the way they interpret situations.
> - Often, their notion of justice is biased in their own favor. For example, in experiments in which two opposed parties' concept of fairness is questioned, both tend to consider precisely what favors them personally, even if disproportionately, to be the most fair.
> - The agents are selective when it comes to assessing evidence; they are more likely to accept evidence that supports their desired conclusion, and tend to value it uncritically. If evidence contradicts their desired conclusion, they tend to ignore it or examine it much more critically.
> - When they know that they are going to be judged by their decisions, they tend to try to adapt their behavior to what they think the audience expects or wants from them.
> - The agents tend to attribute to others the biases that they refuse to see in themselves; for example, a researcher will tend to question the motives and integrity of another researcher who reaches conclusions that differ from her own.
> - Generally speaking, the agents tend to give far more importance to other people's predispositions and circumstances than to their own.

> For all these reasons, agents, groups and organizations believe that they are capable of identifying and resisting the temptations arising from their own interests (or from their wish to promote the interests of others), when the evidence indicates that those capabilities are limited and tend to be unconsciously biased.[54]

3. The Behavioral Biases of Consumers Render Disclosures Ineffective.

In a paper exploring the limitations of disclosure on clients of stockbrokers, Professor Robert Prentice explained several behavioral biases which combine to render disclosures ineffective: (1) Bounded Rationality and Rational Ignorance; (2) Overoptimism and Overconfidence; (3) The False Consensus Effect; (4) Insensitivity to the Source of Information; (5) Oral Versus Written Communications; (6) Anchoring; and (7) Other Heuristics and Biases. Moreover, as Professor Prentice observed: "Securities professionals are well aware of this tendency of investors, even sophisticated investors, and take advantage of it."[55]

Much other academic research into the behavioral biases faced by individual investors has been undertaken, in demonstrating the substantial challenges faced by individual investors in dealing with those providing financial advice in a conflict of interest situation.

4. Professor (now SEC Commissioner) Parades on the Limits of Disclosure.

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 the details of disclosure documents that regulation delivers. However, under the scrutinizing lens of stark reality, this picture gives way to an image a vast majority of investors who are unable, due to behavioral biases and lack of knowledge of our complicated financial markets, to undertake sound investment decision-making. As stated by Professor (now SEC Commissioner) Troy A. Paredes:

> 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"

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[54] Anonia Argandoña, Conflicts of Interest: The Ethical Viewpoint (2004).

[55] Robert Prentice, WHITHER SECURITIES REGULATION? SOME BEHAVIORAL OBSERVATIONS REGARDING PROPOSALS FOR ITS FUTURE, 51 Duke L.J. 1397 (available at http://www.law.duke.edu/shell/cite.pl?51+Duke+L.+J.+1397#H2N5). [Note, when I read this paper, several years ago, it sealed for me the importance of the bona fide fiduciary standard to consumers.]

rather than "optimize," and might fail to search and process certain information.[56]

5. Financial Advisors Use Consumers' Behavioral Biases to their Own Advantage.

As stated by Professor Prentice, "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."[57]

I have been personally trained, by marketing consultants, to take advantage of the behavioral biases of consumers. The instruction involves actions to build a relationship of trust and confidence with the client first, far before any discussion of the service to be provided or the fees for such services. It is well known among marketing consultants that once a relationship of trust and confidence is established, clients and customers will agree to most anything in reliance upon the binding of trust which has been formed.

6. "Informed Consent" Is Not Always Possible: The Burden is on the Advisor to Ensure Client Understanding of the Conflict of Interest, and all Material Facts Relating Thereto, in Order that Informed Consent Can Be Secured.

Consent is only informed if the client has the ability to fully understand and evaluate the information. Many complex products (such as CMOs, structured products, options, security futures, margin trading strategies, alternative investments and the like) are appropriate only for sophisticated and experienced investors. 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. *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 the transaction presents*. Fiduciary law reposes this burden – to ensure client understanding - on the advisor / fiduciary. It is <u>not</u> the client's responsibility. The "duty to read" generally possessed by consumers is somewhat circumscribed in a fiduciary relationship.

7. Do-It-Yourself Investors Are Also Hindered by Behavioral Biases.

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

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[56] Troy A. Parades, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 83 Wash.Univ.L.Q. 907, 931-2 (2003).

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

fees and costs of pooled investment vehicles.[58] 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,[59] and reveal the inability of individual investors to contract for their own protections.[60]

D. THE ADVISERS ACT'S JURISPRUDENCE: WHY THE FIDUCIARY STANDARD REQUIRES MUCH MORE THAN MERE DISCLOSURE

1. The *Rocky Mountain Financial Planning* No-Action Letter.

It has been argued by some that compliance with a fiduciary duty standard is solely a matter of disclosure and consent concerning a firm's potential conflicts of interest. Yet, the Commission staff long has disagreed with the notion that all that is required is disclosure and consent:

> We do not agree that "an investment adviser may have interests in a transaction and that his fiduciary obligation toward his client is discharged so long as the adviser makes complete disclosure of the nature and extent of his interest." While section 206(3) of the Investment Advisers Act of 1940 ("Act") requires

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[58] *Supra* n. ___.

[59] 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.

[60] 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.

> disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, **the adviser's fiduciary duties are not discharged merely by such disclosure and consent**. The adviser must have a reasonable belief that the entry of the client into the transaction is in the client's interest. The facts concerning the adviser's interest, including its level, may bear upon the reasonableness of any belief that he may have that a transaction is in a client's interest or his capacity to make such a judgment.[61]

It has long been the Commission's position that the "an investment adviser must not effect transactions in which he has a personal interest in a manner that could result in preferring his own interest to that of his advisory clients."[62] The Commission should not now embrace a "casual disclosure" regime, in which the client of an investment adviser is merely informed of the existence of a conflict of interest, and by some action consents thereto. Fiduciary law – both under the Advisers Act itself and under state common law, requires much more for the client's *informed* consent to be effective. It is the role of the Commission to conform the business practices of broker-dealers engaged in the delivery of investment advisory services to the law, and not to seek to weaken fiduciary law in order to conform same to the business practices of broker-dealers who have chosen to enter the field of investment advice to retail customers.

2. Arleen Hughes – "Informed" Consent is Required.

The pillar of undivided loyalty applicable to the investment adviser in his or her relationship with a client affords a level of protection to the client which goes far beyond the enhanced disclosure regimes of other federal securities acts. While disclosure alone does not satisfy the general fiduciary duty requirements of the Advisers Act, disclosure followed by informed consent of the client is the exception to the "no profit" and "no conflict" rules applicable to fiduciaries. As stated by the SEC in the very early decision *In the Matter of Arleen W. Hughes*:

> Since loyalty to his trust is the first duty which a fiduciary owes to his principal, *it is the general rule that a fiduciary must not put himself into a position where his own interests may come in conflict with those of his principal*. To prevent any conflict and the possible subordination of this duty to act solely for the benefit of his principal, a fiduciary at common law is forbidden to deal as an adverse party with his principal. An exception is made, however, where the principal gives his *informed consent* to such dealings...
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> These disclosures constitute a safeguard which the law imposes to prevent the possibility of abuse which is inherent in a situation presenting conflicts between a fiduciary's self-interest and his loyalty to his principal. These disclosures are required whether the fiduciary is moved by good or bad intentions for the law 'acts not on the possibility, that, in some cases, the sense of … duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all

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[61] *Rocky Mountain Financial Planning, Inc.* (pub. avail. Feb. 28, 1983) (Emphasis added.)

[62] SEC Rel. No. IA-1092, October 8, 1987, 52 F.R. 38400, *citing Kidder, Peabody & Co., Inc.,* 43 S.E.C. 911, 916 (1968).

> cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty' ….[63]

[*Emphasis added.*]

3. Examining the Structure of the Investment Advisers Act: Section 205, Hedge Clauses, Section 215, and Section 206 Itself.

The structure of the Investment Advisers Act itself argues against the "disclosure and consent" interpretation of the Advisers Act's fiduciary duties, as advocated by SIFMA.

a. Section 205.

The provisions of Section 205 forbidding profit-sharing apply whether or not the client gives consent.

b. Hedge Clauses.

The Commission staff has long found that hedge clauses in investment advisory agreements may be impermissible even if the client agrees and even if, read literally, nothing in the hedge clause was affirmatively misleading.[64]

c. Section 215.

Section 215 of the Act forbids investment advisers from seeking waivers from clients of the protections of the Act, no matter how fully informed the client is when the waiver is requested. If all that was required was "disclosure and consent" – as suggested by SIFMA – such disclosure and "consent" would operate as a waiver of the fiduciary standards of conduct, contrary to Section 215. This would far exceed narrow restrictions imposed on the scope of an engagement, which are generally permitted.

d. The Omission of Statement of Public Policy.

Unlike the Investment Company Act of 1940, the Advisers Act did not, in its final form, contain a recitation of the public policy or intent of Congress sought to be effected. As noted in footnote 34 of the U.S. Supreme Court's decision in *SEC v. Capital Gains*, the omission of this statement of public policy cannot result in the inference that the intent of Congress changed during the drafting process.

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[63] In the Matter of Arleen W. Hughes, SEC Release No. 4048 (February 18, 1948), citing Michoud v. Girod, 4 How. 503, 554-555 (1846).

[64] See Heitman Capital Management, LLC (publicly available Feb. 12, 2007) (discussing previous no-action requests concerning hedge clauses and announcing staff would not entertain future requests on the subject). Public policy supports the principle that professionals should not be free to seek to have clients negate the fiduciary duties to which they are subject. See Erlich v. First National Bank of Princeton ,208 N.J.Super. 264, 505 A.2d 220 (N.J.Super.L., 1984).

e. Applying Principles of Statutory Construction to the Advisers Act Section 206 Itself.

Certain principles of statutory construction can be applied to the Advisers Act to discern when investment advisers are permitted to possess conflicts of interest, or under what circumstances. As stated in *Financial Planning Association vs. SEC*, "[a]pplying the "traditional tools of statutory construction … the [courts look] to the text, structure, and the overall statutory scheme, as well as the problem Congress sought to solve." Hence, a review of the structure of the Advisers Act, and specifically at Section 206, is merited. That section provides:

> It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

The general anti-fraud provisions are found in subsections "(1)" and "(2)" of Section 206. Subsection "(4)" was added later, as a means of providing the SEC with rulemaking authority in this area. Subsection "(3)" contains a specific exemption from the broad language of subsections "(1)" and "(2)"_– in which principal trading by investment advisers is authorized under a very strict set of requirements. It is submitted that principal trading is already barred by subsections "(1)" and "(2)" of Section 206 and the fiduciary duty of loyalty these sections impose on investment advisers (and the resulting duty to avoid conflicts of interest). Subsection "(3)" was designed *not* as an additional prohibition but rather as a limited and very specific form of relief from subsections "(1)" and "(2)."

Hence, the Advisers Act only contains this specific exemption – for certain principal trades - from the "no conflict" rule applicable to fiduciaries, generally. If, as commentators suggest, all that would be required when an investment adviser possessed a conflict of interest is to undertake disclosure of such conflict, then in the context of principal trading there would be no

reason to need a subsection (3) in Section 206. It is more reasonable to infer from the structure of the Advisers Act, and general principles of statutory construction, that subsection (3) of Section 206 contains the *only exception* from the no-conflict rule and no-profit rules applicable to fiduciaries generally, including investment advisers.

4. SIFMA's Misinterpretation of *SEC vs. Capital Gains*.

a. Do Investment Advisers Possess a Duty to Avoid (or Properly Manage) Conflicts of Interest?

Under the law of agency, an agent is permitted to modify its duty of loyalty through clear disclosure and informed consent, provided the agent "acts in good faith" and otherwise "deals fairly" with the principal.[65] Securities laws attorneys often equate these general principles, arising under the law of agency, to an investment adviser's fiduciary duties.[66] It has been said by some in the Securities Bar that the U.S. Supreme Court's landmark decision in *SEC v. Capital Gains* provided a road map for an investment adviser's handling of conflicts of interest, in that disclosure of a conflict of interest would be sufficient.[67] Is this true, or did the U.S. Supreme Court intend something altogether different? In essence, have various staff at the SEC and/or other securities law attorneys misconstrued this decision? Does there exist, at least for investment advisers, a duty to avoid (or at least properly manage) conflicts of interest?

b. *What SEC vs. Capital Gains Research Bureau* Really Says.

In the seminal 1963 decision of *SEC v. Capital Gains Research Bureau*, the U.S. Supreme Court stated:

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[65] See text, supra at n.___.

[66] See, e.g., Stone, Steven W., and Hawkins, Michele, "Trading Conflicts of Interest" (April 2008), which outline is available at www.morganlewis.com, and stating in pertinent part ("under common law agency principles, an investment adviser is permitted to modify its duty of loyalty through clear disclosure and informed consent. In other words, an adviser can engage in a transaction even when the adviser is faced with a potential or actual conflict of interest, provided that the adviser informs its client in advance and obtains the client's consent."

[67] See Barbash, Barry P., and Massari, Jai, "The Investment Advisers Act of 1940: Regulation by Accretion," 39 Rutgers L.J. 627, stating: "[T]he Court in Capital Gains … provided investment advisers with clear guidance on fulfilling their obligations under the Act: appropriate disclosure can cure a conflict of interest. As the Court said, an adviser may "make full and frank disclosure" of the conduct in question to address the concerns raised by the Commission under the Advisers Act. The disclosure, the Court went on to say, would serve the purposes of the Act's anti-fraud provisions by allowing clients to evaluate 'overlapping motivations' …. in deciding whether an adviser is serving 'two masters' [i.e., the client and its own economic self-interest] or only one … Capital Gains both expanded the scope of the duties owed by an investment adviser to its client as a fiduciary and, consistent with the Advisers Act's approach, found disclosure an effective tool in curing conflicts of interest faced by an adviser..") Id. at 631, 633-4. See also Jennifer L. Klass, "Investment Adviser Conflicts of Interest Disclosures" (Outline for IAA Annual Compliance Workshop, Oct. 27, 2008), stating: "[T]heAdvisers Act, like the other federal securities laws, is based on the fundamental principal of "full disclosure.' In this regard, the Advisers Act reflects the "congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested." [Emphasis in article.]

> An adviser who, like respondents, secretly trades on the market effect of his own recommendation may be motivated – consciously or unconsciously – to recommend a given security not because of its potential for long-run price increase (which would profit the client), but because of its potential for short-run price increase in response to anticipated activity from the recommendation (which would profit the adviser). (Citation omitted.) *An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure*, in deciding whether an adviser is serving 'two masters" or only one, 'especially . . . if one of the masters happens to be economic self-interest.'[68] [*Emphasis added.*]

This section of the opinion may appear to suggest that, with disclosure of a conflict of interest, all that is required is that the client of the adviser be given the option of proceeding with the advisor's counsel. However, at a footnote to this section of the opinion, the U.S. Supreme Court went further, explaining the "no conflict" rule and providing alternative rationales behind the prohibition on serving two masters:

This 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* .... In *Hazelton v. Sheckells*, 202 U.S. 71, 79, we said: 'The objection . . . rests in their tendency, not in what was done in the particular case … The court will not inquire what was done. If that should be improper it probably would be hidden and would not appear.'[69] [*Emphasis added.*]

Moreover, the U.S. Supreme Court in the *Capital Gains* decision only held that the fiduciary investment adviser had an affirmative obligation to "to make full and frank disclosure of his practice of trading on the effect of his recommendations."[70] Why did the U.S. Supreme Court not go further, and hold that the Advisers Act prohibited the very existence of such a conflict of interest? The answer lies in the decision itself:

> It is arguable – indeed it was argued by 'some investment counsel representatives' who testified before the Commission -- that any 'trading by investment counselors for their own account in securities in which their clients were interested ….' creates a potential conflict of interest which must be eliminated. *We need not go that far in this case, since here the Commission seeks only disclosure of a conflict of interests with significantly greater potential for abuse than in the situation described above*.[71] [*Emphasis added.*]

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[68] 375 U.S. 180, ___, citing United States v. Mississippi Valley Co., 364 U.S. 520, 549.

[69] Id. at p.___, fn. 50, citing United States v. Mississippi Valley Co., 364 U.S. 520, 550, n. 14.

[70] Id. at p.___.

[71] Id. at p.___.

In other words, it was not necessary to the U.S. Supreme Court decision that it find that the Advisers Act outlaws significant conflicts of interest between investment advisers and their clients. Yet in the decision, the Supreme Court went to great lengths to recite legislative history, especially portions which discussed prohibitions on conflicts of interest as applied to investment advisers:

> Although certain changes were made in the bill following the hearings, there is nothing to indicate an intent to alter the fundamental purposes of the legislation. *The broad proscription against 'any ... practice … which operates … as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end.* And *the Committee Reports indicate a desire to preserve 'the personalized character of the services of investment advisers,' and to eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.'* The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested. [*Emphasis added.*]

Hence, while the U.S. Supreme Court was not called upon to decide if conflicts of interest should be avoided by investment advisers, this does not lead to the conclusion that that the "no conflict" and "no profit" rules do not remain imbedded within the Advisers Act. Nor can it be concluded from the decision, as some interpreters may have done, that all that is required when a conflict of interest exists is that disclosure of material facts to the client occur, followed by the client's consent to proceed with the recommendation or transaction despite the presence of the conflicts of interest.

Furthermore, some key aspects of the legislative history underlying the Advisers Act were further summarized by the U.S. Supreme Court's landmark 1963 decision, *SEC v. Capital Gains Research Bureau*, and this additional legislative history bolsters the conclusion that the "no-profit" and "no-conflict" rules are firmly embedded within the Advisers Act. In the decision, the U.S. Supreme Court stated:

> The Public Utility Holding Company Act of 1935 'authorized and directed' the Securities and Exchange Commission 'to make a study of the functions and activities of investment trusts and investment companies ….' Pursuant to this mandate, the Commission made an exhaustive study and report which included consideration of investment counsel and investment advisory services. This aspect of the study and report culminated in the Investment Advisers Act of 1940.
>
> The report reflects the attitude - shared by investment advisers and the Commission - that investment advisers could not 'completely perform their basic function - furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments -- unless *all conflicts of interest between the investment counsel and the client were removed*.' The report stressed that affiliations by investment advisers with investment bankers, or corporations might be

'an impediment to a disinterested, objective, or critical attitude toward an investment by clients …'

This concern was not limited to deliberate or conscious impediments to objectivity. Both the advisers and the Commission were well aware that whenever advice to a client might result in financial benefit to the adviser – other than the fee for his advice – 'that advice to a client might in some way be tinged with that pecuniary interest [whether consciously or] subconsciously motivated ….' The report quoted one leading investment adviser who said that he 'would put the emphasis . . . on subconscious" motivation in such situations. It *quoted a member of the Commission staff who suggested that a significant part of the problem was not the existence of a 'deliberate intent' to obtain a financial advantage, but rather the existence 'subconsciously [of] a prejudice' in favor of one's own financial interests*. The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations, which contained the following canon:

> '[An investment adviser] should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, *conscious* or *unconscious*; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect.' [Emphasis added in Supreme Court's own decision.]

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

This study and report -- authorized and directed by statute – culminated in the preparation and introduction by Senator Wagner of the bill which, with some changes, became the Investment Advisers Act of 1940. In its 'declaration of policy' the original bill stated that 'Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission … it is hereby declared that the national public interest and the interest of investors are adversely affected - … (4) when the business of investment advisers is so conducted as to defraud or mislead investors, or *to enable such advisers to relieve themselves of their fiduciary obligations to their clients.* 'It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are *to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section*.' S. 3580, 76th Cong., 3d Sess., § 202.

Hearings were then held before Committees of both Houses of Congress. In describing their profession, leading investment advisers emphasized their relationship of 'trust and confidence' with their clients and the importance of "strict limitation of [their right] to buy and sell securities in the normal way if there is any chance at all that to do so might seem to operate against the interests of clients and the public.' The president of the Investment Counsel Association of America, the

> leading investment counsel association, testified that the 'two fundamental principles upon which the pioneers in this new profession undertook to meet the growing need for unbiased investment information and guidance were, first, that they would *limit* their efforts and activities to the study of investment problems from the investor's standpoint, *not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their investment judgment*; and, second, that their remuneration for this work would consist *solely* of definite, professional fees fully disclosed in advance.'[72]
>
> Although certain changes were made in the bill following the hearings, there is nothing to indicate an intent to alter the fundamental *purposes* of the legislation. The broad prescription against 'any … practice … which operates … as a fraud or deceit upon any client or prospective client' remained in the bill from beginning to end. And the Committee reports indicated a desire to preserve 'the personalized character of the services of investment advisers' and to *eliminate conflicts of interest between the investment adviser and the clients* as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.' The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a *congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested.* [Citations omitted.] [*Emphasis added*.]

As seen in the text above, the U.S. Supreme Court's recitation of the legislative history of the Advisers Act references aspects of both the "no conflict" and "no profit" rule, and appears to indicate that the scope of an investment adviser's activities should be limited so as to avoid conflicts of interest and the derivation of profits (except as to profits derived from compensation paid directly by the client).

A Philosophy of Caveat Emptor is Not the Advisors Act's Only Purpose. While some commentators have advanced the argument that the Advisers Act's purpose was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*," a closer reading of the decision reveals that this purpose was set forth as a "common" purpose of the federal securities acts enacted in the 1930's and in 1940. This does not lead to the conclusion that the Advisers Act's *only* purpose was to require disclosure; it was merely one means by which Congress sought to protect clients of investment advisers.

Moreover, other commentators on the decision have focused on the language found in the last paragraph quoted above of the decision, that the "congressional intent" was "at least to expose" conflicts of interest. And they seize upon this language of the decision:

> An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping

[72] 375 U.S. 180, ____, citing "Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services," H. R. Doc. No. 477, 76th Cong., 2d Sess., 1.

> motivations, through appropriate disclosure, in deciding whether an adviser is serving "two masters" or only one, "especially . . . if one of the masters happens to be economic self-interest." *United States v. Mississippi Valley Co.*, 364 U.S. 520, 549.

Yet, again, this reading of the decision is far too narrow. While certainly disclosure is one means by which the intent of Congress was effected, the *avoidance* of conflicts of interest is another fundamental purpose of the Advisers Act. As the U.S. Supreme Court stated in its own footnote to the passage set forth above:

> This 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....

Furthermore, the Supreme Court near the end of its majority opinion stated: "The statute, in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested. To insure this it empowers the courts to require disclosure of material facts." But, again, this is but one requirement of the Advisers Act. The avoidance of investment adviser conflicts of interest, and profit-taking resulting from actions of investment advisers, are additional purposes of the Advisers Act.

Why did the Supreme Court not go further, and hold in the *Capital Gains* decision that the investment adviser's secret purchase of shares of a particular security shortly before recommending it to clients (and thereby profiting from the increase in market price which occurred as a result of the recommendation, by selling the shares) was prohibited? As mentioned above, the SEC's request for an injunction was limited to requiring disclosure, and not more. Hence, it should not be inferred from this language that investment advisers are only required to undertake disclosures of conflicts of interest, as opposed to avoiding them.

5. Generally, Mere "Disclosure and Consent" to a Conflict of Interest Does Not Meet the Requirement of Due Diligence.

The fiduciary duty standard is not just a "disclosure and consent" process standard - it is a substantive standard that requires a firm and an investment professional to act consistently with the longstanding and well-established duty to act as a "prudent investor". It is well-established that an element of fiduciary duty under the Investment Advisers Act is (as part of the duty of due care) a duty of due diligence to assure that the firm and the investment professional fully understand and have fairly evaluated an investment recommendation.

Even with full and fair disclosure and consent, if a firm or an investment professional gives investment advice that is inconsistent with what a prudent investor would do in similar

circumstances, then the firm and investment professional have violated their fiduciary duty to the client to engage in fair dealing and provide disinterested advice.[73]

It is vitally important that the Commission include these substantive elements of the fiduciary duty standard in its application of the Adviser Act fiduciary standard to broker-dealers who provide personalized investment advice.

In Conclusion.

I urge the Commission staff to cast aside any biases they may personally possess, to fully research the parameters of fiduciary obligations, to understand the substantial public policy reasons for the application of a bona fide fiduciary standard, and to provide recommendations to the Commissioners that adhere to the fiduciary principle.

I urge the Commissioners to not weaken the bona fide fiduciary standard of conduct. Should the Commission proceed down such a path, the adverse consequences to fiduciary law, individual Americans, and to America itself, will be both dramatic and severe.

Respectfully submitted,

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