Under the law there are two distinct forms of relationships: arms-length and fiduciary. A broker-dealer and its registered representatives are in an arms-length relationship when providing trade execution services. While providing trade execution services, the low suitability standard applies. The low suitability doctrine demands only that a broker/brokerage firm “will make specific recommendations of securities only if it has a reasonable basis for believing that they are suitable for the customer.”

In contrast, the fiduciary duties of due care, loyalty and utmost good faith have, for more than a century, been applied to the delivery of financial and investment advice. In recent decades, broker-dealers and their registered representatives have moved away from the world of fixed commissions for stock sales, and instead now recommend mutual fund and other investment managers and provide a wide variety of other financial and investment advice. Having transformed their businesses to incorporate the delivery of financial and investment advice, broker-dealers and their registered representatives should assume the duties and obligations of relationships of trust and confidence with clients; their relationship with customers has changed from arms-length to fiduciary.

The fiduciary obligations of broker-dealers and their registered representatives have been recognized by the U.S. Securities and Exchange Commission (SEC) and Financial Industry National Regulatory Authority (FINRA) since the early 1940s, and by the courts, via application of state common law, throughout the 20th Century. The Dodd–Frank Wall Street Reform and Consumer Protection Act empowers the SEC to formally apply, by rule, these fiduciary standards upon broker-dealers. In so doing, the SEC will merely codify securities regulation to reflect current state common law as applied to the expansion by broker-dealers of their activities into the delivery of personalized investment advice.

Should the SEC proceed to adopt rules under the Dodd-Frank Act to impose the fiduciary standard upon broker-dealers, the SEC would rebuff Wall Street’s attempt to create, out of thin air, a “new federal fiduciary standard,” which would only require casual and non-meaningful disclosures of conflicts of interest. Disclosure alone neither negates nor fulfills a fiduciary’s duties. In addition, while broker-dealers providing personalized investment advice are permitted to receive commission-based compensation, variable or differential compensation practices should be circumscribed. Broker-dealers’ sale of proprietary funds when providing personalized investment advice presents a fiduciary conundrum; yet, guidance in formulating appropriate regulation on the sale of proprietary products by fiduciaries to their clients can be gleaned from other regulators.
The Dodd-Frank Act’s section 913 represents an elegant return to the centuries-old fiduciary principle. The fiduciary standard is appropriate for the delivery of personalized investment advice to individual investors, who are too often faced with the daunting task of ensuring their retirement security while navigating the complexity of today’s modern capital markets.

Distinguishing Arms-Length and Fiduciary Relationships

There are two types of relationships between product and service providers and their customers or clients under the law. The first form of relationship is an “arms-length” relationship. This type applies to the vast majority of relationships between service providers and customers. In these relationships, the doctrine of “caveat emptor” (i.e., let the buyer beware) generally applies, although this doctrine is always subject to the requirement of commercial good faith. Additionally, this doctrine may be modified through the imposition of specific rules or doctrines by law, such as the low requirement of “suitability” imposed upon registered representatives of broker-dealer firms (i.e., brokers).

The second type of relationship is a fiduciary relationship. This in relationship involves trust, which includes vulnerability for the party who is placing trust in another. In such situations, one’s guard is down, one is trusting another to take actions on one’s behalf. Under such circumstances, to violate a trust is to infringe grossly upon the expectations of the person placing their trust. Because of this, the law creates a special status for fiduciaries, imposing duties of due care, loyalty, due care, and utmost good faith upon them. Under the law, the “fiduciary relationship” requires the fiduciary to carry on with their dealings with the client (a.k.a. “entrustor”) at a level far above ordinary, or even “high,” commercial standards of conduct.

<table>
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<th>The Sales Relationship</th>
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Arms-Length Relationships: The Broker’s Low Suitability Standard

When providing only trade execution services the sales—or arms-length—relationship exists between the broker-dealer or their registered representative and the customer. The “suitability doctrine,” explicitly set forth as a rule by FINRA and recognized by the SEC as a “fundamental duty of brokers” enforceable by FINRA under the securities laws’ general antifraud rule (Rule 10b-5), applies to govern the conduct of broker-dealers and their registered representatives in such circumstances. However, the low
suitability doctrine demands only that a broker/brokerage firm “will make specific recommendations of securities only if it has a reasonable basis for believing that they are suitable for the customer.”

Suitability essentially imposes upon broker-dealers the responsibility to not permit their customers to “self-destruct.” Suitability does not generally impose upon broker-dealers any obligation to recommend a “good” product over a bad one, or a less expensive product, or a product that meets the client’s objective for a tax-efficient and prudent investment portfolio. In other words, the suitability standard permits the sale of highly expensive, tax-inefficient and risky investment products, leaving the broker-dealers customer with little or no redress.

In the context of advisory recommendations, suitability serves to confine the duties of broker-dealers and their registered representatives to their customers to below that of the broad common law duty of due care. With the early 20th Century rise of the concept of the duty of due care, and the commencement of actions for breach of one’s duty of due care (via the negligence doctrine that saw accelerated development during such time), broker-dealers sought a way to ensure they would not be held liable under the standard of negligence. After all, “[t]o the extent that investment transactions are about shifting risk to the investor, whether from the intermediary, an issuer, or a third party, the mere risk that a customer may lose all or part of its investment cannot, in and of itself, be sufficient justification for imposing liability on a financial intermediary.” This appears to be a valid view as to the duty that should be imposed upon a broker-dealer; provided, however, that the broker-dealer is only providing execution services to the customer.

The sales of mutual funds and other pooled investment vehicles exploded a thousand-fold shortly following the SEC’s abolition of all fixed commission rates effective May 1, 1975. No longer were broker-dealers just performing trade execution services, but they were, in fact, recommending investment managers. Yet, inexplicably, the SEC and FINRA permitted the suitability doctrine to be extended, over the decades, to incorporate broker-dealers’ recommendations of investment managers. In essence, brokers continue to operate with a free hand today, unburdened by the duty of nearly every other person in the United States with respect to advisory activities, which, at a minimum, require adherence to the duty of due care of a reasonable person.

History
The fiduciary principle has its roots in antiquity. It is clearly reflected in the provisions of the Code of Hammurabi nearly four millennia ago, which set forth the rules governing the behavior of agents entrusted with property. Ethical norms arising from relationships of trust and confidence also existed in Judeo-Christian traditions, in Chinese law, and in Greek and Roman eras.
Through elaboration in English law and U.S. law, fiduciary law has evolved over the centuries to refer to a wide range of situations in which courts have imposed duties on persons acting in particular situations that exceed those required by the common law duties of ordinary care and fair dealing (as exist in arms-length relationships). Fiduciary duties find their origin in a mix of the laws of trust law, tort law, contract law, and agency law. Today fiduciary status attaches to many different situations. For instance, there has long been recognition that the mere provision of advice may result in a fiduciary relationship.\(^\text{10}\)

During the early part of the 20\(^{\text{th}}\) Century, stockbrokers were known to possess duties akin to those of trustees, including the duty of utmost good faith and the avoidance of receipt of hidden forms of compensation. By the early 1930s, the fiduciary duties of brokers acting as financial services intermediaries were widely known.

To a degree this was simply an extension of the laws of agency. Meanwhile, early court cases confirmed the existence of broad fiduciary duties upon brokers in situations where brokers possessed relationships of trust and confidence with their clients. For example, in the 1934 case of *Birch v. Arnold\(^\text{11}\)* involving a non-discretionary account, the relationship between a client and her stockbroker was found to be a fiduciary one, for it was a relationship based upon trust and confidence. In *Birch*, the Massachusetts Supreme Court held that, in these circumstances, facts “conclusively show that the relationship was one of trust and confidence”\(^\text{12}\) and therefore the broker could not make a secret profit from the transactions for which the advice was provided.

The 1934 Securities and Exchange Act was an attempt to raise the conduct standards by which broker-dealers must adhere. As Matthew P. Allen observed, “Roosevelt and Congress used the 1934 Exchange Act to raise the standard of professional conduct in the securities industry from the standardless principle of caveat emptor to a ‘clearer understanding of the ancient truth’ that brokers managing ‘other people’s money’ should be subject to professional trustee duties.”\(^\text{13}\) The subsequently enacted Investment Advisers Act of 1940 (“Advisers Act”) was designed to apply to investment counsel, a relatively new type of professional who was paid directly by the customers for advice. The Advisers Act required investment advisers to register with the SEC and imposed a fiduciary duty upon investment advisers. Brokers were exempted from the registration requirements of the Advisers Act, provided that their investment advice remained “solely incidental” to the brokerage transactions and they received no “special compensation.”

Early statements by the National Association of Securities Dealers (NASD), now known as the Financial Industry National Regulatory Authority, confirmed the existence of high fiduciary standards of conduct for brokers in the very early days of its existence. In only the second newsletter for its members issued by the self-regulatory organization for broker-dealers, the NASD unequivocally pronounced that brokers were fiduciaries.
The SEC also chimed in, early in its history, to confirm that broker-dealers were nevertheless fiduciaries when they assumed a role of providing personalized investment advice to their customers, stating: “Notwithstanding the absence of an explicit fiduciary standard, broker-dealers are subject to substantially similar requirements when they act as more than mere order takers for their customers’ transactions.”

Recently the fact that broker-dealers may, when providing more than trade execution services to individual investors, possess broad fiduciary duties was confirmed by the SEC Staff Study on Investment Advisers and Broker-Dealers (As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act) (Jan. 2011). In modern times, the courts continue to find broker-dealers and their registered representatives to be fiduciaries when providing personalized investment advice.

Since the mid-1970s, broker-dealers have blurred the line between their arms-length trade execution services and the delivery of personalized investment advice. Today they customarily provide personalized investment advice, yet far too often seek to negate or deny the associated fiduciary obligations.

Additionally, in recent years registered representatives began to utilize titles that imply relationships based upon trust and confidence, to which fiduciary duties should apply, such as “financial adviser,” “financial consultant,” “wealth manager,” etc. Yet, under state common law, the utilization of such titles remains a significant factor in determining whether a fiduciary relationship exists. For example, in a 2007 case, a registered representative crossed the line in “holding out” as a financial adviser. The registered representative sold a variable annuity and stated that ongoing advice would be provided to his customers, as well as other representations. The court found him to have formed a relationship of trust and confidence with the customers to which fiduciary status attached. Moreover, over the past several decades a shift occurred to employ trust-based sales techniques, leading to fiduciary status for financial and investment advisers.

**Public Policy Considerations Support the Application of Fiduciary Standards upon the Delivery of Personalized Investment Advice**

There are numerous reasons for imposing fiduciary duties on the range of new specializations in the delivery of certain financial services. The major reasons involve a combination of the disparity in knowledge between fiduciaries and their entrustors (clients), the difficulties in monitoring fiduciary conduct, and the promotion of important public policy goals.

**The Increased Knowledge Gap Between Financial Advisers and Consumers in Today’s Complex Financial World**

Without question there exists a substantial knowledge gap between fiduciary investment advisers and the vast majority of their clients in today’s modern, complex
financial world. Indeed, the world is far more complex for individual investors today than it was just a generation ago. There exists a broader variety of investment products, including many types of pooled or hybrid products, which in turn employ a broad range of strategies.

This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those few that best fit within the investor’s portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product’s true total fees and costs, investment characteristics, tax consequences, and risks. As the sophistication of our capital markets had increased, so has the knowledge gap between individual consumers and financial advisers. In constructing an investment portfolio today, a financial adviser must take into account not only the individual investor’s risk tolerance and investment time horizon, but also the investor’s tax situation and risks to which the investor is exposed in other aspects of his or her life.

This complexity of the modern securities markets, combined with the need for investors to properly manage investment portfolios over decades as a means of ensuring their retirement security, makes reliance upon another for personalized investment advice essential. As observed by the Financial Planning Association of Australia Limited, “The average person will no more become an instant financial planner simply because of direct access to products and information than they will a doctor, lawyer or accountant.”

The Limited Ability of Consumers to Close the Knowledge Gap

Academic researchers have long known that emotional biases limit consumers’ ability to close the knowledge gap. Recent insights from behavioral science call into substantial doubt some cherished pro-regulatory strategies, including the view that if regulators force delivery of better disclosures and transparency to investors that this information can be used effectively.

Note as well that, as observed by Professors Stephen J. Choi and A.C. Pritchard, “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.”

Moreover, Robert Prentice, who researches ethical decision making, writes, “not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but … competitive pressures almost guarantee that they will do so.” As a result, much of the training of registered representatives involves how to establish a relationship of trust and confidence with the client. Once a relationship of trust is formed, customers will generally accede to
the recommendations made by the registered representative, even when that recommendation is adverse to the customers’ best interests.

Financial Literacy Efforts, While Important, are Known to be Ineffective

Financial literacy is important, for the more educated the individual American, the better he or she will undertake financial decisions, with or without the aid of an adviser. However, financial literacy efforts are insufficient to overcome the vast knowledge gap between registered representatives and their customers.

As recently stated by Lauren E. Willis, “high financial literacy can be necessary for good financial decisionmaking, but is not sufficient; heuristics, biases, and emotional coping mechanisms that interfere with welfare-enhancing personal finance behaviors are unlikely to be eradicated through education, particularly in a dynamic market. To the contrary, the advantage in resources with which to reach consumers that financial services firms enjoy puts firms in a better position to capitalize on decisionmaking biases than educators who seek to train consumers out of them.”

Due to the Knowledge Gap, the Adviser Has the Ability to Abuse Trust and Power

The expert services of the fiduciary personal financial adviser are socially desirable. As in medicine or law, it can take many years to acquire the requisite degree of knowledge, skill, and experience to be a competent and effective personal financial adviser. Yet, it is this very expertise renders clients of personal financial advisers vulnerable to abuse of trust and lack of care. Hence, the advisory services undertaken by investment advisers are subject to general prescriptions under fiduciary law, as investment advisers must be free to react to a changing market environment. For example, if the fiduciary does not utilize his or her greater knowledge to promote the client’s best interests, the fiduciary could usurp the delegated power, authority, or trust in advice for the fiduciary’s own benefit. Accordingly, the duty of loyalty is imposed upon fiduciaries.

Reduction of Transaction Costs, when Monitoring Costs are High

In fiduciary relations, it is highly costly for the client to monitor, verify and ensure that the fiduciary will abide by the fiduciary’s promise and deal with the entrusted power only for the benefit of the client. Indeed, if a client could easily protect himself or herself from an abuse of the fiduciary adviser’s power, authority, or delegation of trust, then there would be no need for imposition of fiduciary duties.

Difficulty in Tying Performance Results to One’s Obedience to His or Her Fiduciary Duties

The results of the services provided by a fiduciary adviser are not always related to the honesty of the fiduciary or the quality of the services. For example, an investment adviser may be both honest and diligent, but the value of the client’s portfolio may fall as the result of market events. Indeed, rare is the instance in which an investment adviser provides substantial positive returns for each period over long periods of time.
Difficulty in Identifying and Understanding Conflicts of Interest
Most individual consumers of financial services in America today are unable to identify and understand the many conflicts of interest that can exist in financial services. For example, a customer of a broker-dealer firm might be aware of the existence of a commission for the sale of a mutual fund, but possess no understanding that there are many mutual funds available without commissions (i.e., sales loads). Moreover, brokerage firms have evolved into successful disguisers of conflicts of interest arising from third-party payments, including payments through such mechanisms as contingent deferred sales charges, 12b-1 fees, payment for order flow, payment for shelf space, and soft dollar compensation.

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

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

Fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment management or law, in recognition of the value such services provide to our society. For example, the provision of investment consulting services under fiduciary duties of loyalty and due care encourages participation by investors in our capital markets system. Hence, in order to promote public policy goals, the law requires the imposition of fiduciary status upon the party in the dominant position. Through the imposition of such fiduciary status the client is thereby afforded various protections. These protections serve to reduce the risks to the client that relate to the service, and encourage the client to utilize the service. Fiduciary status thereby furthers the public interest.

The Dodd-Frank Act: An Elegant Return to Fiduciary Principles
Through the enactment of the Dodd-Frank Act, the U.S. Congress has rightfully authorized SEC to apply fiduciary standards of conduct upon broker-dealer firms and their registered representatives who provide personalized investment advice to retail

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consumers. In essence, the U.S. Congress has enabled the SEC to conform brokerage practices involving the delivery of personalized investment advice, which have evolved over the course of the last few decades, to fiduciary principles that have been applied by the SEC and the courts throughout the past century.

The fiduciary standard is based upon principles, so a large number of rules need not be adopted by regulatory agencies. Indeed, the application of the fiduciary standard fulfills Wall Street’s repeated call for more “principles-based regulation.”

Through the Dodd-Frank Act, the U.S. Congress empowered the SEC to place restraints on the conduct of Wall Street. Specifically, in section 913 Congress explicitly authorized the SEC to promote a fiduciary standard for broker-dealers and their registered representatives providing “personalized investment advice” to “retail customers” which is “not less stringent” than the fiduciary standard applicable to registered investment advisers under the Investment Advisers Act of 1940.

The Dodd-Frank Act’s application of the fiduciary standard is an elegant solution. It properly applies the standard of conduct for broker-dealer firms that have strayed into the provision of personalized investment advice.

**Recommendation: Go Beyond Wall Street’s Unfortunate Attempt to Redefine the Fiduciary Standard as “Suitability + Casual Disclosure”**

In situations in which a fiduciary possesses a conflict of interest with a client, disclosure of such conflict is only one of the many requirements of the fiduciary duty of loyalty under the Advisers Act. Disclosure of a conflict of interest and mere consent of the client thereto does not discharge the fiduciary’s obligations. Instead, disclosure must be affirmatively and timely delivered in a manner designed to ensure client understanding, so that clients can provide informed consent. Moreover, it is a fundamental truth that no client would provide informed consent to be harmed.

Wall Street’s lobbyists often suggest that court precedent exists for the proposition that disclosure alone is all that is required to meet the fiduciary standard when a conflict of interest is present. These lobbyists are either engaged in wishful thinking or mistaken. This argument often relies upon language found in the U.S. Supreme Court’s seminal case applying the Advisers Act, *SEC vs. Capital Gains Research Bureau*. However, a correct construction of this case reveals that investment advisers are required to do much more than merely disclose conflicts. This follows centuries of common law applying the fiduciary standard, including application of the time-honored phrase, “no man can serve two masters.”

**Recommendation: Commission-Based Compensation Permitted, But Variable Compensation Restricted**

Charging a retail customer on a commission basis, in and of itself, is not inconsistent with a strong and uniform fiduciary standard of conduct. The Dodd-Frank Act and
the SEC’s January 2011 Staff Study make it clear that a commission-based pricing model can be consistent with a fiduciary standard. However, to the extent a firm or investment professional chooses to use a commission-based pricing model, it must recognize that it creates inherent conflicts of interest that are not present in asset-based, fixed-fee or hourly-fee based pricing models.

Conflicts of interest occur when variable or differential compensation flows as a result of recommending one investment product over another. Such compensation arrangements—such as those arising from different levels of commissions, payment for order flow, sales contests, and soft dollar\textsuperscript{27} compensation—present insidious conflicts of interest and should be banned. In other words, consistent with the fiduciary principle, and regardless of the form of compensation of the broker and its registered representative, the broker’s customer should agree to a reasonable method and amount of compensation in advance of making a specific investment recommendation. Any additional compensation should be avoided or rebated back to the client.

The avoidance of variable compensation will require changes in the asset management industry. However, variable or differential compensation poses a substantial threat to the integrity of fiduciaries, as the higher compensation received for the sale of one product over a similar product with lower compensation to the adviser can rarely be justified.\textsuperscript{28}

If a firm offers both commission-based and asset-based pricing models, the firm and the investment professional possess the obligation to recommend to the retail customer the pricing model that is in the customer’s best interest, and to monitor regularly to assure that the customer remains in the account structure that is in the customer’s best interest. All fiduciaries likewise possess the obligation to inform their clients that other firms may provide the substantially same services for lower fees.

**Recommendation: Use International Standards**

The issue of sales of proprietary products is one of the most vexing issues in applying fiduciary law to the practices of broker-dealer firms. However, banks and their trust departments have a history of selling proprietary mutual funds, when in trustee-beneficiary relationships, under guidelines provided via Office of the Comptroller of the Currency regulations.\textsuperscript{29} Moreover, other countries, such as Australia, have recently adopted standards that must be followed by fiduciaries prior to recommending proprietary products to clients.\textsuperscript{30} These and other regulations can be referenced as sources for appropriate standards for fiduciaries engaged in the sale of products manufactured by their firms or by affiliates.

**Recommendation: Creation of a Fiduciary Board of Standards**

One of the problems of securities regulation today is its focus on disclosure. In part, this is because securities examiners can test adherence to disclosure obligations fairly easily. Yet, evaluation of a professional adviser’s proper adherence to the full extent of
the fiduciary’s duty of loyalty, and many aspects of a professional adviser’s adherence to the fiduciary’s duty of due care, will often require the judgment of professionals with substantial experience.

I suggest that the SEC, in conjunction with other agencies, form a “Fiduciary Board of Standards,” composed only of those individual professionals fully committed to a bona fide fiduciary standard of conduct, along with representatives of consumer organizations. This Fiduciary Board of Standards would advise the SEC, the Department of Labor, the Office of Comptroller of the Currency, and state securities regulators on the development and application of professional rules of conduct. Both practitioners and regulators should be permitted to seek advisory opinions from this Fiduciary Board of Standards, as a means of understanding how the fiduciary duties are applied to real-life situations. Through the board’s issuance of advisory opinions and commentary on any adopted rules of conduct, the jurisprudence of the fiduciary standard can properly develop over time.

In making this recommendation, I would emphasize that the members of such a panel should be chosen for their commitment to a bona fide fiduciary standard of conduct and the interests of consumers. Otherwise, commercial self-interests could easily result in an evisceration of the true fiduciary standard of conduct.

**Conclusion**

The SEC should act swiftly to restore the confidence of capital markets participants by applying the fiduciary standard of conduct to the investment advisory activities of broker-dealers. It has long been known that brokers in relationships of trust and confidence with their clients are fiduciaries, despite the broker-dealers’ current business models, which were permitted to occur through ineffective SEC and FINRA oversight. Disruption of these business models will necessarily occur as the SEC proceeds with rulemaking in this area.

Wall Street’s call to decree a “new federal fiduciary standard” that ignores centuries of fiduciary law should be disregarded as an ill-advised attempt to lower a standard of conduct that has stood for centuries as a protector of consumer interests.

A period of adjustment should be provided for broker-dealer firms to adapt practices to meet their fiduciary obligations. However, the SEC should not delay substantially in this important rule-making effort. Only upon full implementation of the fiduciary standard for the delivery of all personal investment advice will investor confidence in our financial services system be restored, and a new era of capital formation and economic growth fostered.

**Endnotes**

1. See 17 C.F.R. § 240.10b-5, providing: “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

2. Clifford E. Kirsch, Broker-Dealer Regulation § 1:2 (2008). The suitability standard imposes both additional substan-

tive (fairness) and procedural (disclosure) obligations upon broker-dealers, in addition to the requirements of good

faith applicable to the performance of contracts between all those in arms-length relationships. The SEC and the U.S.

Consumer Futures Trading Commission (CFTC) recently summarized the broker-dealers suitability obligation as

follows:

Under the federal securities laws and SRO rules, broker-dealers are required to deal fairly with their customers. This

includes having a reasonable basis for recommendations given the customer's financial situation (suitability), engaging

in fair and balanced communications with the public, providing timely and adequate confirmation of transactions,

providing account statement disclosures, disclosing conflicts of interest, and receiving fair compensation both in

agency and principal transactions. In addition, the SEC's suitability approach requires BDs to determine whether a

particular investment recommendation is suitable for a customer, based on customer-specific factors and factors

relating to the securities and investment strategy. A BD must investigate and have adequate information regarding

the security it is recommending and ensure that its recommendations are suitable based on the customer's financial

situation and needs. The suitability approach in the securities industry is premised on the notion that securities have

varying degrees of risk and serve different investment objectives, and that a BD is in the best position to determine

the suitability of a securities transaction for a customer. Disclosure of risks alone is not sufficient to satisfy a broker-

dealer's suitability obligation.


3. 60 Am. U.L. Rev. 1265, 1275

4. “In 1980 there were 564 funds with assets totaling $134.8 billion.” John Howat and Linda Reid, 12 Fordham J. of

Corp. & Fin. Law 685, 686 (2007). The combined assets of U.S. mutual funds were $13.8 trillion dollars in April

2013, according to the Investment Company Institute (“Trends in Mutual Fund Investing: April 2013” per May 30,


Law 155, 157 (2010-11).

6. “[C]ourts have linked the fiduciary duty of loyalty to the biblical principle that no person can serve two masters.” Id.,
at pp.157-8. See also Beasley v. Swinton, 46 S.C. 426; 24 S.E. 313; 1896 S.C. LEXIS 67 (S.C. 1896) (“Christ said:

‘No man can serve two masters, for either he will hate the one and love the other, or else he will hold to the one and

despise the other. Ye cannot serve God and Mammon [money].’”) Id., quoting Matthew 6:24.

7. “Chinese historical texts also recognize fiduciary principles of trust and loyalty. One of the three basic questions of

self-examination attributed to Confucius (551 BC—479 BC) asks: ‘In acting on behalf of others, have I always been

loyal to their interests?’” Aikin and Fausti, supra n. vi. at p.158.

8. “Aristotle (384 BC—322 BC) consistently recognized that in economics and business, people must be bound by high

obligations of loyalty, honesty and fairness and that society suffers when such obligations are not required.” Id.

9. “Cicero (103 BC—46 BC) noted the relationship of trust between an agent and principal (known to Romans as manda-

tory and mandator, respectively), and emphasized that an agent who shows carelessness in his execution of trust

obligations of loyalty, honesty and fairness and that society suffers when such obligations are not required.” Id.

10. See, e.g., Restatement (Second) of Torts § 874 cmt. a (1979) (“A fiduciary relation exists between two persons when

one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the

relation.” citing Restatement, Second, Trusts § 2).


443, 444, 154 N.E. 303.

13. Matthew P. Allen, A Lesson from History, Roosevelt to Obama - The Evolution of Broker-Dealer Regulation: From

Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty, Entrepreneurial


1-2 (1933)).


abstract=1767564. See also Rhoades, Ron A., “Shhh!!! Brokers Are (Already) Fiduciaries ... Part 1: The Early Days,”

15. SEC Staff Study (Jan. 2011) at pp. iv. 51. See also A Joint Report of the SEC and the CFTC on Harmonization of


the statutes and regulations do not uniformly impose fiduciary obligations on a [broker-dealer (BD)], a BD may have

a fiduciary duty under certain circumstances, at times under state common law, which varies by state. Generally,

BDs that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their

customers, are found to owe customers a fiduciary duty similar to that of investment advisers ... State common law

imposes fiduciary duties upon persons who make decisions regarding the assets of others. This law generally holds that
a futures professional owes a fiduciary duty to a customer if it is offering personal financial advice.” Id. at pp.9-10. [Emphasis added.]


17. Western Reserve Life Assurance Company of Ohio vs. Graben, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007). See also, e.g., Hatleberg v. Norwest Bank Wisconsin, 2005 WI 109, 700 N.W.2d 15 (WI, 2005) (When a bank held out as either an “investment planner,” “financial planner,” or “financial adviser,” the Wisconsin Supreme Court held that a fiduciary duty may arise in such circumstances.)

18. Someone forgot to tell financial advisers that the use of trust-based sales techniques results in the application of fiduciary standards of conduct. In the latter half of the 20th Century, sales techniques evolved, as did salespersons’ view of themselves. Codes of ethics were developed, high-pressure sales techniques sometimes disavowed, and needs-based selling became a new paradigm. This evolved into “trust-based selling” and substantial changes in the sales process, with trust as a focus:

In the past few years, many authors have recognized that in the “relational era” there have been radical changes in sales-force activities and sales management practices (Darmon, 1997; Marshall, Moncrief and Lassk, 1999; Wotruba, 1996). In brief, salesmen are expected to become value creators (De Vincenitis and Rackham, 1996), customer partners and sales team managers (Weitz and Bradford, 1999), market analysts and planners (Wilson, 1993), and to rapidly shift from a hard selling to a smart selling approach (Sujan, Weitz and Kumar, 1994; Kohli, Shervani and Challagalla, 1998) … trust is a focal construct in the analysis of relationship marketing (see for example Blois, 1996; Doney and Cannon, 1997; Kumar, 1996; Morgan and Hunt, 1994).

Paulo Guenzi, “Sales-Force Activities and Customer Trust.” Where do we stand today? In the 2nd edition of the textbook, Sell (Cengage Learning, 2012), Professors Ingram, LaForge et. al. state that trust, when used as a sales technique, answers these questions:

1. Do you know what you are talking about? – competence; expertise
2. Will you recommend what is best for me? – customer orientation
3. Are you truthful? – honesty; candor
4. Can you and your company back up your promises? – dependability
5. Will you safeguard confidential information that I share with you? – customer orientation; dependability.”

(Sell, p.27).

In looking closely at this list, it appears that questions 1, 3 and 5 are closely associated with the fiduciary duty of care. Question 2 is close to the proposition of “acting in the client’s best interests” – one of the major aspects of the fiduciary duty of loyalty. And Question 3, acting with honesty and candor, translate into the fiduciary duty of utmost good faith.


See also Fernandes, Daniel and Lynch, John G. and Netemeyer, Richard G., Financial Literacy, Financial Education and Downstream Financial Behaviors (October 8, 2013). Forthcoming in Management Science. Available at SSRN: http://ssrn.com/abstract=2333898 (“Policymakers have embraced financial education as a necessary antidote to the increasing complexity of consumers’ financial decisions over the last generation. We conduct a meta-analysis of the relationship of financial literacy and of financial education to financial behaviors in 168 papers covering 201 prior studies. We find that interventions to improve financial literacy explain only 0.1% of the variance in financial behaviors studied, with weaker effects in low-income samples. Like other education, financial education decays over time; even large interventions with many hours of instruction have negligible effects on behavior 20 months or more from the time of intervention.”)

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

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


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

Wall Street’s abusive practices, seen in the late 1920’s (leading to the Great Depression) and more recently in the early part of this century (leading to the 2008-9 near-financial-collapse and the resulting Great Recession), have long been seen as fixable. “I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that ‘a man cannot serve two masters.’” Harlan Stone (future Chief Justice of the U.S. Supreme Court), The Public Influence of the Bar (1934) 48 Harv. L.Rev. 1, 8-9.


28. See, e.g., Mercer Bullard, “Protecting Investors – Establishing the SEC Fiduciary Duty Standard” (AARP Public Policy Institute, Sept. 2011) stating that Dodd-Frank Act’s requirement that brokers act in the best interests of their customers “without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice” likely requires that brokers should not be “unduly motivated or influenced by the amount of the compensation the broker-dealer receives in connection with the advice,” and further stating:

[B]roker-dealers that receive differential compensation, such as revenue-sharing payments from mutual funds, that varies depending on which investment they recommend, may be more vulnerable to claims that their advice was not given “without regard to the financial or other interests of the broker” than brokers that unbundle their fees and charge the same fee regardless of the investment selected …

[FN34. This unbundling incentive is also reflected in the SEC’s proposed 12b-1 fee reforms. See Mutual Fund Distribution Fees; Confirmations, Exchange Act Rel. No. 62544 (July 21, 2010), pp. 24–45. The issue is analogous to the debate regarding proposed rules that implement the Employee Retirement Income Security Act of 1974 (ERISA) requirement that certain advisers’ fees not be affected by the recommendations that they make to plan beneficiaries. See, generally, Investment Advice—Participants and Beneficiaries, 75 F.R. 9360 (Mar. 2, 2010) …]

The Section 913 Study does not indicate what practices should be examined pursuant to this mandate. The most likely candidates for prohibition may be compensation practices that create financial incentives for financial professionals to favor one course of action or investment product over another, regardless of which is in the client’s best interests. This would be consistent with Section 913’s mandate that the fiduciary standard require a broker-dealer or investment adviser to act in the customer’s best interest “without regard to [its] financial or other interest.” Id. at pp.12, 15.


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