



WHAT ARE YOUR SPECIFIC FIDUCIARY DUTIES?

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Agenda

- **The Four Elements of Trust**
 - Two Types of Relationships
 - **Why Fiduciary Duties Exist**
 - **Sources of Fiduciary Status**

 - **Duty of Due Care**
 - **Duty of Loyalty**
 - **Duty of Utmost Good Faith**
- **ISSUES in Fiduciary Law**
 - **Waivers**
 - **Scope of Engagement**
 - **Termination**
 - **Consequences/Fiduciary Status**

 - **Best Practices**
 - **Fiduciary Standards of Conduct**

 - **The Appeal of the Fiduciary**

 - **Questions and Answers**

The Fiduciary, the Priest, the Attorney, and the SHARKS



Trust Me ...

- **Expert**
- **Best Interests**
- **Candor**



The Elements of Trust ...

- **Expert Due Care**
- **Best Interests Loyalty**
- **Candor Utmost Good Faith**

The Fourth Dimension of Trust



Fundamentally ... *Two Types of Relationships*

ARMS-LENGTH RELATIONSHIP

Product Manufacturers



Salesperson



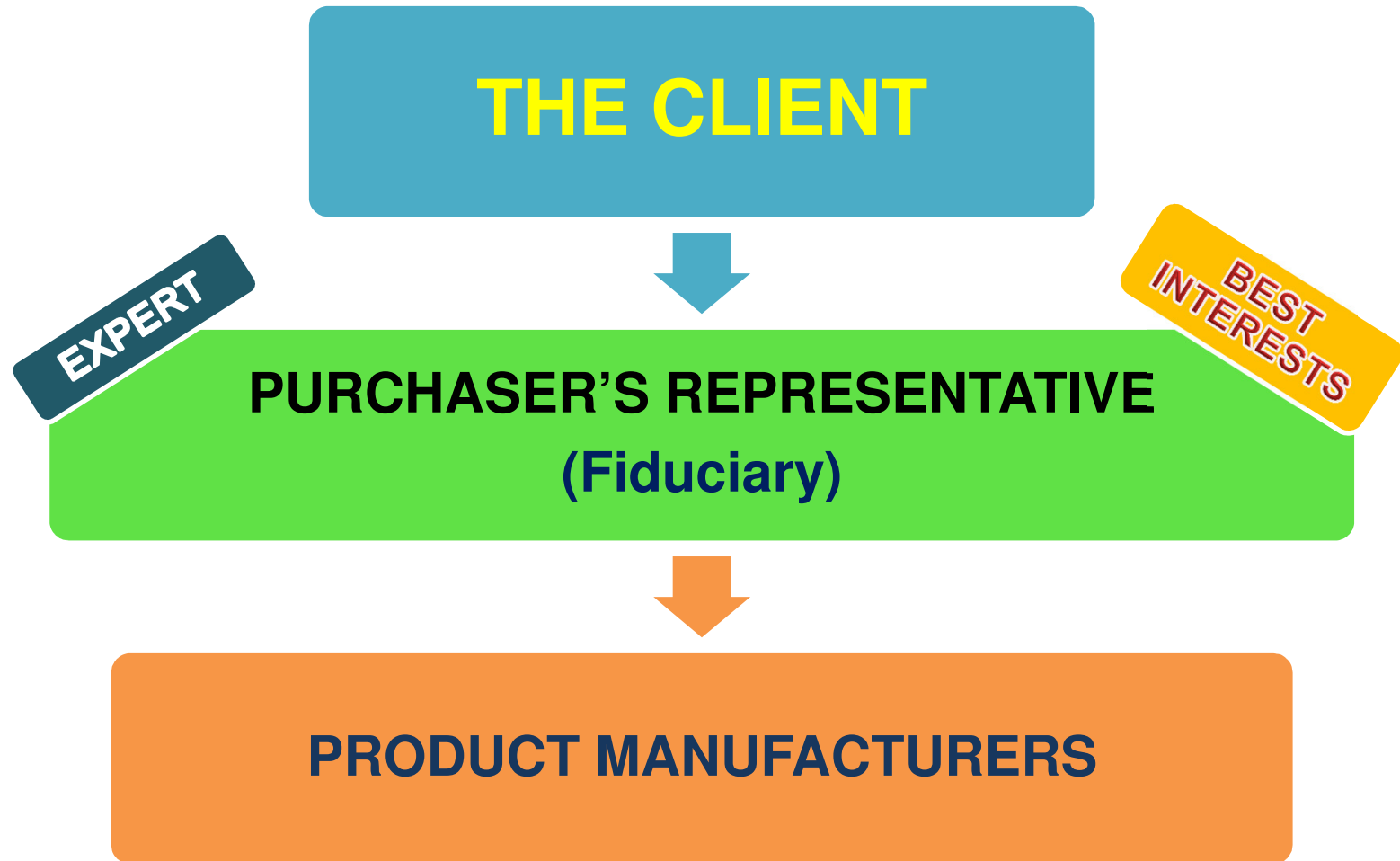
Customer

ARM'S LENGTH



Fundamentally ... *Two Types of Relationships*

FIDUCIARY RELATIONSHIP



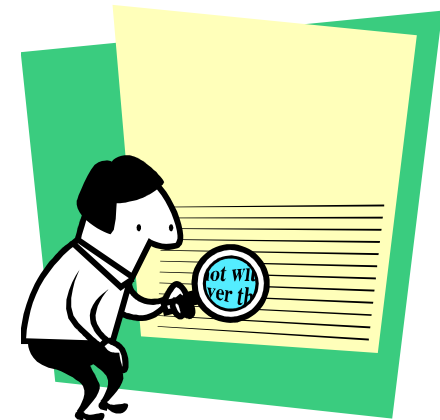
Why ... do we have fiduciary relationships?

- **Knowledge Gap Exists**
- **Prevent Overreaching**
- **Reduce Monitoring Costs**
- **Difficulties in Tying Results to the Advice**
- **FOSTER TRUST ... positive benefits to society**

Why ... do we have fiduciary relationships?

DISCLOSURES DON'T WORK

- Not read
- Not understood
- Don't solve bias problem



FINANCIAL LITERACY EFFORTS DON'T WORK

Sources of Fiduciary Status

- **ERISA**
- **Investment Advisers Act of 1940**
- **State Advisers Act statutes**
- **STATE COMMON LAW** 
- *Other ...*
 - **Express Agreement of the Parties**
 - **If You are a Trustee, Attorney-in-Fact, Guardian**
 - **Hold out as financial planner (Wisconsin)**
 - **Viatical settlement brokers (most states)**
 - **Mortgage brokers (Washington State, California)**



The Duty of Due Care

- Competence
- Diligence
- Confidentiality
- Prudence
 - Investment Strategy Formulation
 - Investment Product Selection
 - Fitting Strategy and Product to Specific Client Needs



Issues in the “Duty of Due Care”

- **Due Diligence – what is required?**
- **Reasonableness of “Total Fees and Costs” of Products**
 - “Hidden fees and costs”
 - Adequate evaluation ?
 - Adequate disclosure ?
 - Mutual fund portfolio turnover rates – misleading ?
- **Duty to Minimize Tax Drag**
 - *Does such a duty exist?*
 - Can duty be negated by contract terms?

The Duty of Loyalty

Avoidance of Conflicts of Interest

ERISA:

- “Sole interests” standard
- Prohibited transaction rules

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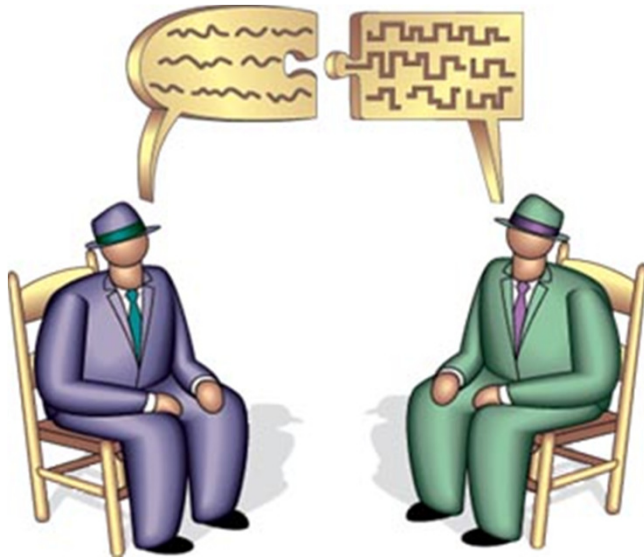
ERISA



Advisers Act and State Common Law

- “best interests standard”

The Beauty of *Avoiding* Conflicts of Interest



Numerous *or* substantial conflicts of interest
... can **undermine** TRUST and increase
likelihood of disputes with clients

The Duty of Loyalty ("Best Interests" Standard)

- If a *Conflict of Interest* exists ...

- Disclosure of ...

- ALL material facts

- Identify of Conflict + Ramifications to Client + Additional Facts

- **Affirmatively**

- Timely

- **Consent of client is obtained**

- *Informed consent* must occur

- **Transaction is *substantively fair* to the client**



Mixing Hats ... Where **Trouble** Occurs

- "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.



Duty of Loyalty: The Issue of ORDERING

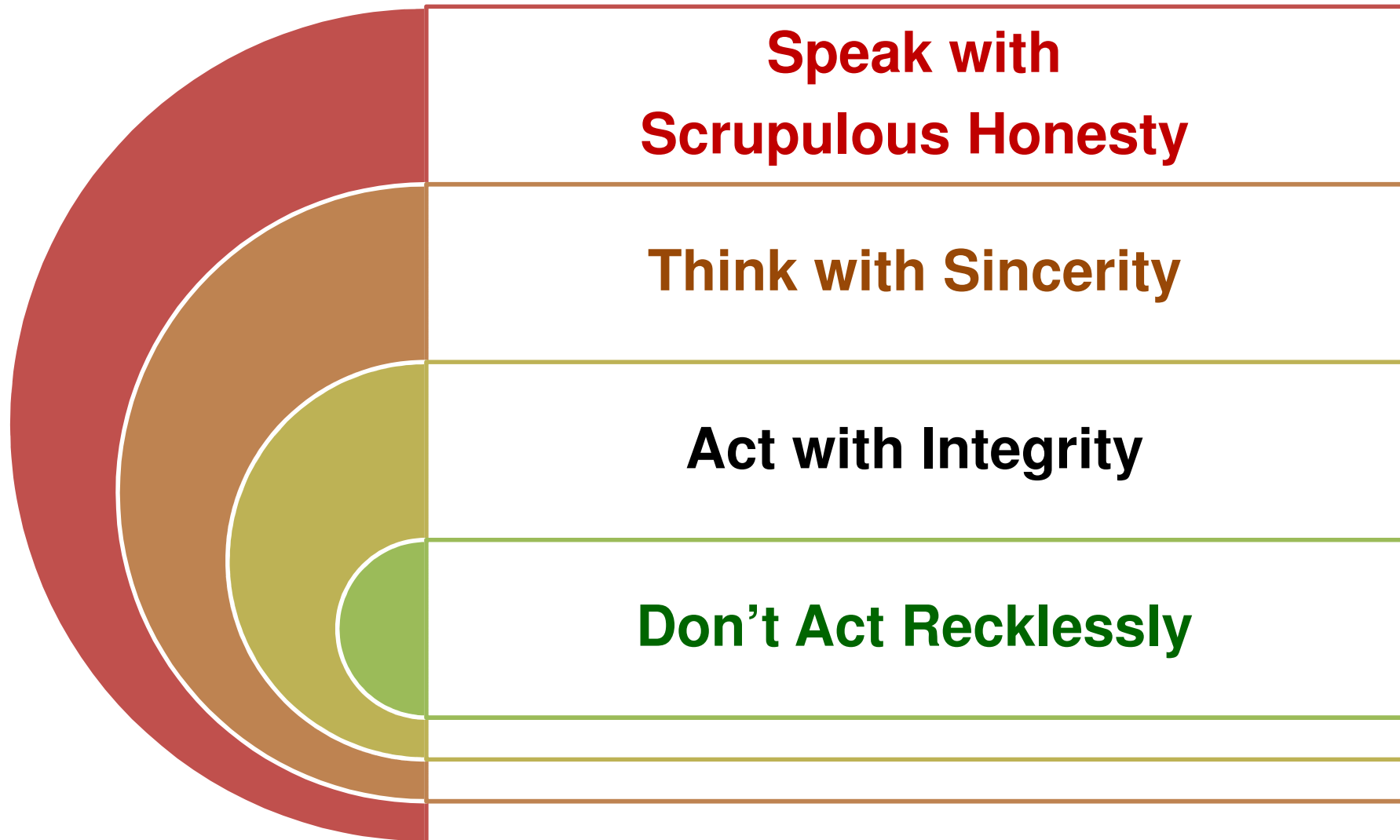
Primary Duty

- To Your
CLIENT

Secondary Duty

- To Your
Firm

The Duty of *Utmost Good Faith*



Issue: “Waiver” vs. “Scope of the Engagement”

- Broad fiduciary duties of due care, loyalty, and utmost good faith **cannot** be waived by clients
 - Fiduciary status under state common law **NOT** determined by the parties, but rather by facts and circumstances
- But ... **REASONABLE LIMITATIONS** on the *Scope of the Engagement* are permitted
- Where is the line drawn?

Issue: Switching from Fiduciary to Non-Fiduciary Status

(Termination of Fiduciary Status)

- Fiduciary duties under state common law are ...



STICKY

Major Consequences of Fiduciary Status

- **Three major fiduciary duties imposed**
- **Shifting of burden of persuasion**
- **Inability to “contract away” broad duties**
- **For clients**
disintermediation and reintermediation

Should You Fear (Increased) Liability?

- Not if you UNDERSTAND your fiduciary obligations
- Not if you ADOPT “Best Practices”
- Not if you COMMUNICATE effectively with your clients

Best Practices

- **INVESTMENT POLICY STATEMENT**

- **“No Crystal Ball”**
- **Historic Volatility of Investment Portfolios is Provided**
 - **Distribution of Returns is Not “Normal” – Skewness, Fat Tails**
 - **Historic Range of Returns is NOT Boundary of Future Returns**
- **Choice of Asset Allocations (60/40, 50/50, etc.) – Client Selects**
- **What is “THE PLAN” - if Asset Class Valuations Go UP or DOWN substantially?**
 - **Stress Importance of Adherence to the Plan.**
 - **“Buy Low, Sell High”**
- **Client Signature to IPS - and Amendments**

Best Practices

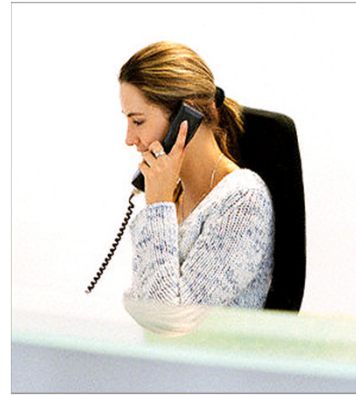
- **Client Profile**



- **Updated Annually
(at a minimum)**

Best Practices

- **Points of Contact**
 - Define
 - follow



- **TAKE NOTES**

(Always)

and Retain
Them



Best Practices

Investment Strategy Due Diligence

Investment Product Due Diligence

1. Possess an Investment Committee ... MEETINGS
2. Research and document your INVESTMENT STRATEGY
 - *why you chose it*
 - *why others rejected*
 - **back-testing and/or academic research**
3. Evaluate INVESTMENT PRODUCTS
 - follow diligent process
 - pay close attention to “total fees and costs”
4. Review periodically

Best Practices

- **Add Specific Fiduciary Duties explanations to ...**



- **Train firm personnel**
 - Discuss recent cases
 - Discuss hypothetical situations
 - Encourage “second opinion”
on proper management of conflicts



Investment Adviser Standards of Professional Conduct (in handout)

Section 1. Definitions

Section 2. General Obligations; Utmost Good Faith

- 2.1 Knowledge of Law
- 2.2 Truthfulness
- 2.3 Scrupulous Honesty, Integrity
- 2.4 No Insider Trading
- 2.5 Role as an “Advisor”

Investment Adviser Standards of Professional Conduct (in handout)

Section 3. Duty of Loyalty

- 3.1 Undivided Loyalty; Bests Interests vs. Sole Interests
- 3.2 Reasonably Avoid Conflicts of Interest
- 3.3 Disclosure of Material Facts;
Proper Management of Conflicts of Interest
- 3.4 Conflicts Arising due to Multiple Clients
- 3.5 When Client's Capacity Diminished

Investment Adviser Standards of Professional Conduct (in handout)

Section 4. Duty of Due Care

- 4.1 The Standard of Due Care
- 4.2 Competence
- 4.3 Consultation with Other Professionals
- 4.4 Diligence (Promptly, Thoroughly)
- 4.5 Suitability
- 4.6 Due Diligence (Investment Strategy, Products)
- 4.7 Reasonableness Fees and Costs
- 4.8 Tax Reduction Strategies

Investment Adviser Standards of Professional Conduct (in handout)

- **Section 5 Confidentiality**
- **Section 6 No “Waiver” of Broad Duties; “Scope of Engagement”**
- **Section 7 Duties to Employer**
Resolving Conflicts: Client vs. Employer
Oversight of Employees Providing Services
- **Section 8 When Other Advisers Commit Violations**

The Appeal of the Fiduciary Business Model

- 86 percent of 157 independent BDs / insurance firms believe ...
... **“Independent RIA route an attractive business model”**
 - reduces perceived conflicts of interest
 - easier to understand pricing model for clients
 - independence
 - access to greater range of products
 - greater predictability in revenue

– Schwab Institutional

Be a Happy Dolphin !



Further Reading ...

- **Outline, *Specific Fiduciary Duties of RIAs***

THANK YOU!
... Questions and Answers

