fi360® global fiduciary insights

An FI360 Background Paper March 13, 2009

Fiduciary Duties: At the Heart of Investment Advisor Responsibilities, the Key to Restoring Trust in Capital Markets

Introduction and Summary

This paper briefly summarizes some key background points of a fiduciary standard. As policymakers consider different regulatory reform measures, the importance of strengthening and broadening a fiduciary standard has not been as apparent since the 1930s. Then, President Roosevelt insisted that high ethical standards be made central to the new securities laws. Now, it is apparent that a recommitment to high ethical standards is imperative to address the collapse of investor trust in financial organizations and their representatives.

A fiduciary standard is not a new concept. It is well established in common law, and has been affirmed by the Supreme Court as a precept of the Advisers Act of 1940. SEC staff have expressed clear views on what it means and how it is applied in meeting requirements of the Advisers Act. In the current transformation from a financial products industry to a financial advice profession, investors are generally unaware of the different legal responsibilities that distinguish a fiduciary standard and the weaker suitability or “commercial” standard. Yet, consumers also seem to clearly associate sharply different expectations of sales/commercial occupations as compared to advice/professional occupations.

The Financial Crisis and the Need for Change

The financial crisis has prompted industry observers and media pundits to offer insights as to what needs to be fixed. Common themes have emerged. They range from greater transparency and regulatory enforcement to the more fundamental need to restore “competitive” capitalism and a culture of strong business ethics and “old-fashioned” values. President Obama made restoration of certain values a cornerstone of his inaugural address:

Our challenges may be new. The instruments with which we meet them may be new. But those values upon which our success depends - hard work and honesty, courage and fair play, tolerance and curiosity, loyalty and patriotism - these things are old.

These things are true. They have been the quiet force of progress throughout our history. What is demanded then is a return to these truths. What is required of us now is a new era of responsibility - a recognition, on the part of every American, that we have duties to ourselves, our nation, and the world, duties that we do not grudgingly accept but rather seize gladly, firm in the knowledge that there is nothing so satisfying to the spirit, so defining of our character, than giving our all to a difficult task. This is the price and the promise of citizenship...

The president is not alone in this quest. In his most recent book, John Bogle, former CEO and founder of The Vanguard Mutual Fund Group, makes a similar call for a return to "old values" in reminding us of the virtues of 18th century values, particularly as seen in the life of Benjamin Franklin. Bogle notes(1):

Perhaps the paradigm of the eighteenth century man was Benjamin Franklin. I cite him not only as a remarkable illustration of the values of the Enlightenment.... (but also for) extraordinary accomplishments as Founding Father, framer, statesman, diplomat, scientist, philosopher, author.... For Franklin the getting of money was always a means to an end not an end in itself. The other enterprises he created, as well as his inventions, were designed for the public wealth not for personal profit. (Bogle 198-200)

Likewise, the restoration of a fiduciary standard is a return to principles firmly established in common law and American history. Fiduciary principles were a building block of the Advisers Act of 1940, as reaffirmed by the Supreme Court. Its resurgence to the forefront of financial adviser regulation has never been more important than today.

An SEC Staff View of Fiduciary Duties

Three years ago Lori Richards, the SEC's director of the Office of Compliance, Inspections and Examinations, outlined her views on the role of a fiduciary standard.(2) She made several vital points, some of which are excerpted below:

Richards begins by noting that the importance of fiduciary duty cannot be overstated.

Understanding fiduciary duty is critical because it is at the core of being a good investment adviser. In a very practical sense, if an adviser and the advisers' employees understand the meaning of fiduciary duty and incorporate this understanding into daily business operations and decision making, clients should be well-served and the firm should avoid violations and scandal.... if their decisions large and small and everyday doing what's right by the client, in all likelihood the decision will be right under the *securities laws.*

The definition of a fiduciary, according to Richards, is derived from common law and is also well understood.

Fiduciary duty is the first principle of the investment adviser -- because the duty comes not from the SEC or some other regulator, but from common law. Some people think fiduciary is a vague word that is hard to define, but its really not difficult to define or to understand. Fiduciary comes from the Latin word for 'trust.' A fiduciary must act for the benefit of the person to who he owes fiduciary duties.

I would suggest that an adviser as that trustworthy fiduciary has five major responsibilities when it comes to clients. They are: 1) To put clients' interest first, 2) To act with utmost good faith, 3) To provide full and fair disclosure of all material facts, 4) Not to mislead clients, and 5) To expose all conflicts of interest to clients.

These responsibilities overlap in many ways. If an adviser is putting clients interests first, then the adviser will not mislead clients. And if the adviser is not misleading clients, then it is providing full and fair disclosure, including disclosure of any conflicts of interest.... (The key here is) is to disclose material conflicts of interest in a "full and a fair" manner and to ensure your clients understand any material conflicts of interest before taking action.

In this single presentation, Richards lays out a compelling rationale for the efficiency and effectiveness of applying a fiduciary standard to ensure that investors' interests are put first.

The Supreme Court Steps In – SEC v. Capital Gains Research Bureau Inc. (3)

The Investment Adviser Act did not in its text use the term, "fiduciary duty"; that task was left to the Supreme Court in 1963. Here the court explained:

A fundamental purpose common to these statutes [securities legislation enacted in the 1930s and 1940] was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry ... (as) 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 Supreme Court's interpretation of the Advisers Act is best appreciated in the context of views expressed by President Roosevelt on the need for regulating the markets after the stock market crash. The importance of a "high standard of business ethics" was uppermost in FDR's mind. In fact, from the outset FDR viewed reforming Wall Street as much a moral issue as a regulatory issue. He was determined to "ensure the character of the people who composed the securities industry.(4) When FDR signed the Advisers Act, he recognized his legacy. Since 1933, he said, it had been his 'purpose to aid the honest businessman and to assist him in bringing higher standards to this particular corner of the business community....'"

Investors' Views of Stock Brokers and Investment Advisors Legal Responsibilities; Sales Occupations versus Professional Occupations

Research of investors' views of stock brokers and investment advisors (IAs) indicates most investors do not understand the different standards and legal responsibilities that apply to each.(5) Among the findings, 54% of investors believe that stockbrokers and IAs are required to act in the investors' best interest, 47% believe that stockbrokers are required to disclose all conflicts of interest and 43% are unaware that different levels of investor protection even exist.

While this research illustrates investors can not describe the different legal responsibilities of stockbrokers and IAs, other research suggests that consumers do understand there is a central difference between the role of "salesmen" and the role of "professionals." Consumers do see significant differences in ethical standards between occupations based on a sales relationship and occupations based on a trusted professional relationship. They appear to generally view "sales" occupations less positively as compared to other occupations.

For example, the Gallup Poll(6) measures consumer views of different occupations in terms of their "honesty and ethical standards." In these surveys, 64% and 84% of consumers, respectively, rank medical doctors and nurses highly. Pharmacists also rank highly at 70%. Yet, at the same time, only 12% and 13% view stockbrokers and insurance salesmen, respectively, as honest and ethical. In comparison, advertising "practitioners" earn 10%, car salesmen 7% and telemarketers, just 5% of consumers' trust.

Consumers are simultaneously clear about occupations they trust, and also confused about the different standards of financial intermediaries. State and federal policymakers can and should remedy this uncertainty.

Conclusion

President Obama's call for a return to "values upon which our success depends," values that have been "the quiet force of progress throughout history" is important. It is a call to use regulatory reforms to help fully complete the ongoing transition to a financial advice *profession*. It is, in its essence, a call to unequivocally establish a fiduciary standard as the defining benchmark of this profession.

Notes

1. Bogle, John C. 2009. *Enough: True Measures of Money Business, and Life*. Hoboken, New Jersey: John Wiley & Sons, Inc. Pages 198, 200

2. Richards, Lori. "Fiduciary Duty: Return to First Principles", Eighth Annual Investment Adviser Compliance Summit, February 27, 2006, www.sec.gov/news/speech/spch022706lar.htm (accessed March 12, 2009).

3. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963)

4. Walsh, John. 2001. A simple code of ethics: a history of the moral purpose inspiring federal regulation of the securities industry. *Hofstra Law Review 29*

5. TD AMERITRADE Institutional, "Investor Perception Study 2006." Advisor Education Kit, http://www.tdainst.com/advisor/advisoreducationkit.html (accessed March 12, 2009).

6. Saad, Lydia. "Nurses shine, bankers slumb in ethics ratings: annual honesty and ethics poll rates nurses best of 21 professions." *Gallup*. http://www.gallup.com/poll/112264/Nurses-Shine-While-Bankers-Slump-Ethics-Ratings.aspx (accessed March 12, 2009).