

# Fiduciary Reference

## Analysis of Investment Fiduciary Issues

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### Key Principles for Fiduciary Best Practices and an Emerging Profession

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#### Introduction

Fiduciary law is complex in its nuances and structures; fiduciary principles are not so complex. Instead they reflect the wisdom of Emerson, who noted, “Nothing is more simple than greatness; indeed, to be simple is to be great.” So it is with principles on which fiduciary best practices and an emerging advisory profession must rest. This paper notes the attributes of *character*, suggests relevant operating principles or premises for best practices based on these attributes, why these principles matter, and how they starkly differ from principles underlying common brokerage sales practices aggressively advocated by brokerage lobbyists. Throughout, the *simplicity* of these principles and their meaning to investors stand out.

#### ***Character is The Distinguishing Mark of a Profession***

In a widely referenced article on professionalism, Richard B. Wagner in "To Think ... Like a CFP," writes "The classic professions are law, medicine, and theology. Additional ones might include journalism, teaching, nursing and architecture. All have the characteristics of working with ambiguity... a profession entails the conviction of divine influence, an altruistic motive, a strong ethical context, intense academic preparation, an esoteric common body of knowledge, and an educational curriculum." <sup>1</sup>

Crafting and upholding standards, codes of conduct and best practices is inherently challenging. Dr. Robert Kennedy, Professor, Ethics and Business Law, at the University of St. Thomas, notes the "distinguishing mark of a true professional is the ability to make sound judgments in conditions of uncertainty," and requires, not just knowledge and experience but also character and moral integrity. "A person of moral integrity needs also to develop two other character traits: courage and discipline." <sup>2</sup>

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The fiduciary obligations of loyalty, due care and utmost good faith are well outlined through common law and regulatory rulemaking and guidance. Advice must solely advance a client's best interest -- as opposed to the interest of the advisor, his firm or a third party.

Essential criteria for a profession of fiduciary advice naturally fall into two broad categories. The “technical” criteria such as education, knowledge and experience, which are most evident in the duty of due care. “Ethical” criteria such as character, honesty and transparency and clear communications, are most evident in the duties of loyalty and utmost good faith. While both sets of criteria are essential, they are not evenly addressed today. Advisors and their membership organizations put far greater emphasis on “technical” criteria over “ethical” criteria. <sup>3</sup>

“Ethical” criteria are revealed in how advisors view and address conflicts, the reasonableness and transparency of fees and expenses, and communications that are clear, complete, and truthful.

### ***Caveat Emptor* is the Distinguishing Mark of Brokerage Sales Practices**

While character is the hallmark of a profession, *caveat emptor*, the Latin term for “Let the buyer beware,” is the hallmark of brokerage sales practices. Explicitly, all brokers say they do right by their customers – and many brokers do operate at or near the fiduciary standard investor expect. Implicitly, however, a very different picture emerges as industry lobbyists vigorously defend and protect conflicted advice, opaque fees and expenses, and misleading or incomplete communications.

In a July 14, 2011 letter to the Securities and Exchange Commission, the Securities Industry Financial Markets Association (SIFMA) sets out its views as to what it believes SIFMA’s brokerage standard should comprise (the SIFMA standard) when brokers are supposed to “put investors’ interests first.” <sup>4</sup> Here, SIFMA advocates for brokers continuing to “offer products and services that are available today” (essentially negating a “due care” duty), chides the SEC for prioritizing *avoiding* – as opposed to *disclosing* – conflicts of interest, sets out weak disclosure protocols (which are more efficient for the broker dealer but less effective for the investor), limits and confuses when the SIFMA standard applies such that during a single broker / customer discussion, a facts / circumstances exploration may be required to determine if the SIFMA standard applies at all, and, finally, permits the SIFMA standard to be restricted contractually. (There is no mention in the letter, however, of controlling investment expenses, prohibiting certain products or practices, strictly avoiding any conflicts, or requiring informed client written consent in any specific instance.) <sup>5</sup>

These brokerage sales practices can be harmful to investors and the aggressive lobbying efforts to expand them underscore why the principles underlying fiduciary ‘Best Practices’ matter. Perhaps far more than is realized. Fiduciary principles appear “obvious,” “simple” and “uncontroversial.” And they are *if you agree with them*; they are not if you don’t. Brokerage lobbyists don’t; in fact they not only disagree, they dispute them at their core. They strenuously assert that fiduciary practices harm investors. This is why restating what these principles mean is important.

## Conflicts of Interest

Conflicts of interest have long been acknowledged as undermining independent and objective advice. As noted above, the Advisers Act was literally conceived from the concerns of investors' confusing advisors with product salesperson, or "so-called "tipster" organizations who disguised themselves as legitimate advisory organizations." <sup>6</sup>

Conflicts are deemed to be incentives, favors, benefits, or compensation which can reasonably be expected to impair objective advice. Compensation arrangements which directly alter payment levels to advisors or brokers depending on the investment strategy or product recommendations are well-known conflicts. Many conflicts are less obvious. At its heart, loyalty is being sensitive to, and competent at identifying and avoiding conflicts. With conflicts, a fiduciary advisor's conduct and practices should reflect these principles and premises:

- Objectivity is essential. It is the essence of the meaning of advice.
- Conflicts are bad; they can gut objectivity. In 2012, Carlo V. di Flora, then SEC Director, Office of Compliance and Inspections spoke on conflicts, "*Conflicts of interest can be thought of as the viruses that threaten the organization's wellbeing...and if not eliminated or neutralized even the simplest virus is a mortal threat to the body...*" <sup>7</sup>
- Neutralizing conflicts is needed. For unavoidable material conflicts, the harms from the conflict should be neutralized.
- Disclosure's impact is mixed – sometimes good, sometimes ineffective, sometimes harmful. While disclosure is at the heart of securities regulation, disclosure often does not work. Yale Management Professor Daylian Cain notes conflicts are corrosive and disclosure just can't be trusted. "Investors usually do not sufficiently heed even the briefest, bluntest and clearest disclosure warnings of conflicts." <sup>8</sup>
- Disclosure must be in writing to be effective.
- Disclosure along with instruction is better. Though simple disclosure is often ineffective, it can be improved with personalized counseling. The SEC notes, "No hard and fast rule can be set down as to an appropriate method for registrant to disclose... The method and extent of disclosure depends upon the particular client involved. The investor who is not familiar with the practices of the securities business requires more extensive explanation than the informed investor. The explanation must be such, however, that the particular client is clearly advised and understands before the completion of each transaction.." <sup>9</sup>

- Disclosure with informed client consent is even better yet. The standard is “informed, intelligent, and independent” written consent.
- Best’ always means ‘best’. Regardless of consent, the fiduciary advisor must show the transaction is fair and reasonable and consistent with the client’s best interest.
- Avoiding conflicts is best of all.

### **Reasonableness and Transparency of Fees and Expenses**

Research suggests that investors often understand little about advisers, brokers and their services and what they pay for investment services. The 2008 Rand Report (Rand) reports "In fact, focus group participants acknowledged uncertainty about the fees they pay for their investments and survey participants also indicate confusion about fees." 25% of respondents who reported using an advisor or broker also reported they pay \$0 for these services. <sup>10</sup> In a 2011 AARP study of 401 (k) plan participants, as 71% of participants reported they did not pay any fees, while 23% said they do pay fees. <sup>11</sup>

Jack Waymire, CEO of the Paladin Registry surveyed his members on the issue of transparency regarding, “credentials, ethics, compensation, investment expenses, and potential conflicts of interest.” Waymire states the survey shows “advisors want to selectively disclose the information they provide to investors.” 86% said they did not practice voluntary transparency or documentation;” 14% voluntarily discuss their method of compensation when marketing their services. <sup>12</sup>

A separate Paladin survey of 421 investors <sup>11</sup> found that 81% said they were “most concerned” about the various fees and commissions deducted from their accounts; 86% said they were “very confused” about the different expenses; only 19% said they were “comfortable” comparing fees and expenses of different advisors.

Bank of America Merrill Lynch wealth unit chief, John Thiel, according to an industry news report, recently spoke about the need to “create transparency around fees.” According to the report, Thiel said investors need three sets of information: an overall picture of what they pay in fees and commissions, specific information about what they are charged for transactions, and annual summaries. <sup>14</sup>

With fees and expenses, a fiduciary advisor’s conduct and practices should reflect certain principles, which include the following:

- Investor knowledge of fees and expenses is essential. Prospective clients should be fully apprised of the total *estimated* fees and expenses. Client’s should be fully apprised of the total *actual* fees and expenses and fees paid by any third party to the advisor.
- Investor misconceptions about fees / expenses are harmful; when intentionally perpetrated by misleading or false communications, these communications constitute fraud.

## **Communicate Clearly, Completely and Truthfully**

Warren Buffett is acclaimed world wide for his investment prowess; he is almost as well known as a champion of clear and candid communications to shareholders. Buffett associates successful investing with clear communications, "If you can't write something clearly it's because you haven't thought it through clearly enough." In Berkshire Hathaway's "Owners Manual," one of eleven principles reads, "We will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value (as) ... the CEO who misleads others in public may eventually mislead himself in private." <sup>15</sup>

Buffett's shareholder letters testify to his commitment to writing clearly and candidly. He personally writes several drafts of the letter over several months. Averaging about 12,000 words it is 'the longest shareholder letter in corporate America. Buffett explains he writes to be interesting and understood by his sisters, who are not experts in finance or business. They expect 'honest and accurate information' and 'straight answers to predictable questions.'

Buffett has criticized public company documents, "Too often I have been unable to decipher just what is being said or, worse yet, had to conclude that nothing is being said." Buffett continues, ... "In some cases, moreover, I suspect, that a less than scrupulous issuer doesn't want us to understand a subject it feels legally obliged to touch upon."

Unfortunately, many investment communications fall far short of the "Buffett Rule." The worst shortfalls range from examples of communications that seem to clearly mislead investors to instances where certain facts are omitted and an incomplete or inaccurate conclusion may be easily drawn. For example: a Government Accountability Office research report found numerous brokerage firms falsely advertising "free" IRAs <sup>16</sup>; a North American Securities Administrators' Association report found widely varying and inconsistent disclosures of brokers' fees and expenses <sup>17</sup>; and a New York district judge scolded Goldman Sachs for arguing in a legal pleading that its statement to put investors interests first, one of its business principles, was mere "puffery". <sup>18</sup>

The judicial scolding of Goldman Sachs regarding "puffery" raises an issue with brokers and fiduciary advice: how do brokers communicate their services to investors. Rutgers professor Arthur Laby argues that the strongest rationale for holding brokers to the fiduciary standard is that brokerages have advertised "trusted advice" services in explicit language and titles for decades, and have created "reasonable expectations" that brokers are fiduciaries. <sup>19</sup> Georgetown professors Angel and McCabe extend this argument noting that brokers should offer advice in the best interest of the client, because "To do otherwise is fraud because then the service delivered would not be what the customer thinks she or he is buying." <sup>20</sup>

In many instances, however, investment professionals fall short by simply failing to translate industry jargon into plain language. Writing expert, Dr. Deborah S. Bosley, reports how a study by her firm, The Plain Language Group, of the design of key documents that TIAA CREF sent to retirement plan beneficiaries was associated with a myriad of language problems. The study concluded that the lack of “plain language” left people confused, undermined their trust in the organization and their confidence in pursuing financial goals. <sup>21</sup> TIAA-CREF and The Plain Language Group designed an easy to understand document that achieved the goal of communicating clearly with complete transparency.

When communicating, orally or in writing, a fiduciary advisor’s conduct and practices should reflect certain principles, including the following:

- Plain language and investor *understanding* is essential. Plain language builds trust and confidence in the advisor and reinforces the importance of investing. The SEC’s revised ADV Part II reflects this understanding.
- Unclear language is a serious problem. Language that is incomplete or unclear is harmful. Language that is designed to fulfill legal obligations, and be only understood by attorneys but incomprehensible to investors, is worse yet.
- False statements disguised as “puffery” is very bad, considered fraud by some experts.

## Summary and Conclusion

The "ethical" criteria of fiduciary duties are the core elements of what we think of as *character*. They provide the foundation for best practices regarding conflicts, fee/expense transparency and communications. These principles represent established doctrine, embedded in centuries of law. They are noteworthy for their simplicity. For their elementary truths.

At their core, these principles reflect how we think about and seek to render objective advice; how we view our professional duty and serve our clients' best interests. Next to avoiding conflicts, applying the 'Buffett Rule' may best distinguish fiduciaries. We strive to make sure clients know the risks they take, the services we deliver and the fees they pay. It is what fiduciary advisors do and what so emphatically distinguishes *advice* from *sales*.

These principles contrast starkly with many underlying principles upholding brokerage sales practices - practices which are either legally permissible or, have become de facto, permissible. How stark? Explicitly, all brokers say they do right by their customers - and many brokers do so and operate at or near the fiduciary standard investor expect. Implicitly, however, a very different picture emerges as industry lobbyists vigorously defend and protect conflicted advice, opaque fees and expenses, and misleading or incomplete or incomprehensible communications. This is "the tone from the top" which is clear and unequivocal.

Examples are ubiquitous, so much so often they go unnoted. To mention a few: Rarely, if ever, do brokerage lobbyists criticize or discourage conflicted advice, (one lobbyist has actually suggested conflicted advice is *good* for investors. 22); urge short and simple written agreements or informed client consent agreements; or urge fee and expense disclosure (John Thiel's remarks a noteworthy exception), or truthfully say what "suitability" truly means, in law; i.e.: "Investors, watch out."

These examples suggest a theme: *Brokerage sales is notoriously conflict-filled and conducted in an opacity that helps perpetuate many investors' well documented and harmful misconceptions about brokerage services and fees.*

This theme appears to parallel what investors believe, fairly or not, about big financial institutions. So it is not surprising that pundits, observers and investors from across the political spectrum view Wall Street bad behavior and public distrust of the capital markets and financial institutions with dismay, if not disgust. 23 What to do? Robert Fronk, of the Harris Reputation Quotient Survey may have it right, "One thing the public is screaming loud and clear about financial services is: be more sincere, be more honest, be more transparent." 24

Fiduciary advisers need to recognize they alone, among all industry participants, can reclaim their proud heritage, unabashedly embrace the ethical principles of fiduciary duties and restate in the public square in the clearest terms possible what it means to be a fiduciary adviser. They alone can rededicate themselves to this mission, because they understand their true value to investors. They must lead a campaign to defend and protect this heritage - for today and to pass on to the next generation.



## Notes

1. <https://www.onefpa.org/businesssuccess/newtotheprofession/Documents/FPA%20Journal%20February%202004%20%20Best%20of%2025%20Years%20To%20Think%20Like%20a%20CFP.pdf>
2. "Ethics, Courage and Self-Discipline." In *Enron and World Finance*, edited by P. H. Dembinski, et al. Palgrave-Macmillan, 2006.
3. Many membership industry organizations discuss "soft" issues in general terms, but do not consistently identify specific best practices that are required (not recommended) for accreditation.
4. <http://www.sifma.org/issues/item.aspx?id=8589934675>
5. For a detailed discussion of these points, see the Institute letter to the SEC replying to the SIFMA letter. <http://www.thefiduciaryinstitute.org/wp-content/uploads/2012/04/Institute-for-the-Fiduciary-Standard-Letter-to-SEC.pdf>
6. For an excellent discussion of the differences between investment advisers and broker-dealers, see Arthur Laby's "Selling Advice and Creating Expectations: Why Brokers Should be Fiduciaries," For origins of Advisers Act, see pages 720, 721.
7. [http://www.sec.gov/News/Speech/Detail/Speech/1365171491600#.U\\_nt-2O4\\_IU](http://www.sec.gov/News/Speech/Detail/Speech/1365171491600#.U_nt-2O4_IU)
8. Cain, <http://www.thefiduciaryinstitute.org/wp-content/uploads/2011/10/Sept12release1.pdf>
9. In *The Matter of Arlene Hughes* at page 11. <https://www.sec.gov/litigation/opinions/ia-4048.pdf>
10. "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers," [http://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf) Rand set out to provide the SEC with "a factual description of the current state of the investment advisory and brokerage industries" and determine whether investors understand the differences between the relationships between investors and brokers or advisors.
11. <http://assets.aarp.org/rgcenter/econ/401k-fees-awareness-11.pdf>
12. <http://www.riabiz.com/a/24103040/why-a-reputation-of-shadiness-persists-in-the-financial-advisory-industry>
13. *ibid.*
14. <http://www.investmentnews.com/article/20140410/FREE/140419988/merrill-lynchs-thiel-fee-transparency-key-to-restoring-trust>



15. Buffett's Bites, The Essential Investors Guide to Warren Buffett's Shareholder Letters, J. Rittenhouse, p. 22--26, 170.
16. <http://www.gao.gov/products/gao-13-30>
17. <http://www.nasaa.org/30549/survey-finds-inconsistent-broker-dealer-fee-disclosure-questionable-markups/>
18. [http://scholar.google.com/scholar\\_case?case=9426814166492741205&q=richman+v.+goldman+sachs+group+inc&hl=en&as\\_sdt=20000006&as\\_vis=1](http://scholar.google.com/scholar_case?case=9426814166492741205&q=richman+v.+goldman+sachs+group+inc&hl=en&as_sdt=20000006&as_vis=1), footnote 8, page 15.
19. See note 4.
20. "Ethical Standards for Stockbrokers: Fiduciary or Suitability?" p. 17.
21. "From Chaos to Clarity: Overcoming Negative Emotional Responses Financial Information," Deborah Bosley.
22. See SIFMA letter to SEC, July 2011.
23. For a discussion of the public's negative views of Wall Street, see: [http://www.aei.org/files/2013/09/10/-five-years-after-the-crash-what-americans-think-about-wall-street-banks-business-and-free-enterprise\\_083339502447.pdf](http://www.aei.org/files/2013/09/10/-five-years-after-the-crash-what-americans-think-about-wall-street-banks-business-and-free-enterprise_083339502447.pdf)
24. <http://www.harrisinteractive.com/vault/2013%20RQ%20Summary%20Report%20FINAL.pdf>