

Final Report on Financial Planner Standards of Conduct

prepared by the

FPA® FIDUCIARY TASK FORCE

for review by the

**FINANCIAL PLANNING ASSOCIATION
BOARD OF DIRECTORS**

June 1, 2007

*WITH EXECUTIVE SUMMARY, PREFATORY NOTE,
FINDINGS, RECOMMENDATIONS AND COMMENTARY*

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FINANCIAL PLANNING ASSOCIATION

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EXECUTIVE SUMMARY

The FPA[®] Fiduciary Task Force was appointed by the Financial Planning Association's Board of Directors and is composed of representatives of many different constituencies within the financial planning community. The FPA[®] Fiduciary Task Force's goal is to examine the word, the meaning, and the concept of the term "fiduciary" in both its present and historical contexts and assess its relevance and applicability to financial planning/financial planners as a complete and all-encompassing standard of conduct.

A Renewed Call For Professionalism. Consumers of financial services are dazed and confused. As the corporate world has moved from defined benefit plans managed by professionals to defined contribution plan accounts, individual consumers have both the burden of saving for their retirement and other needs and managing their nest eggs both before and after retirement. At the same time the investment world has become increasingly complex – with a greater variety of products and strategies, many of which are loosely regulated and subject to abuse if incorrectly utilized. Our tax laws present not only challenges for savers and investors, but also opportunities for those able to successfully navigate the tax law's complexity. Compelling evidence demonstrates that consumers need a guiding hand through a nearly lifelong maze of complex financial planning decisions. At the same time, recent consumer surveys reveal that consumers do not know whom to turn to for trusted advice. Moreover, recently adopted regulations at the federal level have not alleviated consumer confusion – they have rather served to exacerbate it.

Deciding "how we ought to live" is the charge given to the FPA[®] Fiduciary Task Force. In response to the compelling needs of consumers of financial services coupled with the desire to insure that consumers of these services receive effective and uniform protection, the answer is clear. Financial planners are specialists in a distinct area within the financial services industry. As experts who deal directly with consumers and who are equipped with a significant amount of knowledge relative to that of the consumer, financial planners should adopt principles of daily conduct of the highest order. With the adoption of such strict rules of professional conduct, financial planning will arise to become a profession.

As stated over 16 years ago by Dick Wagner, "all professions consist of individuals who are there because they have a calling." The members of the Fiduciary Task Force urge the members of the financial planning community to take up this calling and to form a community of professionals. Indeed, many have taken up this calling, as many financial planners already conduct themselves in a professional manner. These financial planners have helped to define and exemplify the standards promulgated in this report. We now ask that these individuals organize into a formal and recognized profession – the final step in the process of this evolution. Part of this final step is the adoption of reliable and fixed standards of professional conduct upon which clients of financial planners may always rely, and it is to this end that the efforts of the FPA[®] Fiduciary Task Force are dedicated.

Following are *findings* as to the current state of the law or certain practices. These are followed by a set of concrete *recommendations* for FPA's Board of Directors to consider. Given the

complexity of the issues presented, extensive materials are included with this Final Report to explain each of these findings and recommendations.

Findings As to the Current State of the Law and Practice. This Final Report first addresses the current state of the law with regard to the application of fiduciary and quasi-fiduciary standards of conduct upon various financial intermediaries. While registered investment advisers are clearly fiduciaries under the Investment Advisers Act of 1940 and the *Capital Gains* decision, in most instances registered representatives and insurance agents do not possess broad fiduciary status absent special facts and circumstances. As to financial planners, there exist legitimate questions of law as to whether fiduciary status attaches when a financial planner ceases the presentation of a financial plan and moves to implement the financial plan, or when a person “holds out” as a financial planner but then engages the customer in another capacity. Hence, outside the application of fiduciary duties when the financial planner is governed by either the Investment Advisers Act of 1940 or ERISA, the application of fiduciary duties to all financial planning activities is unclear under current law.

The Fiduciary Task Force undertakes the following *findings* with respect to the current state of the law and certain practices affecting the financial planning community:

- A. *Many financial planners meet the definition of “investment adviser” or “investment adviser representative” under the Investment Advisers Act of 1940 and therefore are subject to the broad fiduciary duties imposed by that law.*
- B. *Financial planning activities that are governed by ERISA fall under similar, if not stricter, fiduciary standards.*
- C. *Other statutes may explicitly impose fiduciary duties upon financial planners in specific situations or when practicing in specific geographic regions.*
- D. *Financial planning activities which are not subject to the Investment Advisers Act of 1940, ERISA, or other statutory law which clearly impose fiduciary status upon the financial planner, may nevertheless be subject to fiduciary duties under a common law “facts and circumstances” analysis.*
- E. *There are many factors which may tend to apply common law fiduciary status upon a registered representative. Applying these factors, fiduciary status is found by a court or arbitrator treating the account as “discretionary” in situations where “practical control” over the account has been assumed by the registered representative. These factors include:*
 - 1. *Whether the role of the advisor (registered representative) is one which the consumer would recognize as one to which a fiduciary relationship with the consumer does not normally attach (such as involving the sale of life insurance, or a banker-customer relationship discussing a bank depository product). In other words, what is the consumer’s reasonable expectation of the role of the financial intermediary?*

2. *Whether the registered representative holds himself/herself out as an “expert” with regard to the subject matter upon which advice is given.*
 3. *The degree of knowledge, sophistication and experience possessed by the advisor, relative to that of the consumer, with regard to the subject matter upon which advice is given, including consideration of the following specific facts: (a) whether there is dependence and inequality based on weakness of age or mental strength; (b) whether there is lack of “intelligence” or “business intelligence” by the consumer with respect to the subject matter; (c) whether the consumer possesses a lack of education or possesses inferior knowledge as to the material facts surrounding the advice given; (d) the frequency of contact between the registered representative and the consumer, as well as the existence of social contacts; and (e) whether other circumstances exist which provide an advantage to one side over the other.*
 4. *The nature of the relationship as “discrete” or “episodic” versus “continuous.”*
- F. *Insurance agents are deemed under a general agency analysis to bear fiduciary duties to the insurance companies they represent. Insurance agents generally are not deemed to owe fiduciary duties to their customers – unless the facts and circumstances of the individual relationship dictate otherwise.*
- G. *Insurance brokers are generally fiduciaries to their customers under the common law.*
- H. *Financial planners’ status as fiduciaries or non-fiduciaries varies under the common law of the various states.*
- I. *Not everyone who renders “financial advice,” as that term is broadly utilized, is in fact a fiduciary. For example, in most instances a banker, insurance agent and registered representative (not acting as a dual registrant subject to the Investment Advisers Act of 1940) are not fiduciaries.*
- J. *A financial planner could be found under the common law to be a fiduciary to one particular client without necessarily being a fiduciary for other clients, even though she or he may be performing similar services for each client.*
- K. *When fiduciary status is imposed, it is imposed by law.*
- L. *The parties may contract for fiduciary status to be imposed upon the financial planner.*
- M. *There exist various general definitions of the word “fiduciary.” Nonetheless, there is general consensus that “fiduciary” means a person who is in a relationship of trust and confidence with a client and who owes the client broad duties of due care, utmost good faith, and loyalty.*

- N. Neither the holding of custody of client securities nor the authority to exercise discretion with regard to the trading of a client's securities is essential to finding that a fiduciary relationship exists under either statutory or common law.*
- O. Evidence from recent surveys of consumers reveals that:*
- 1. The majority of individual investors do not understand the distinctions between registered representatives, investment advisers, and financial planners.*
 - 2. The majority of individual investors do not understand the distinctions in legal responsibilities which different financial services providers may possess with respect to their customer or client.*
 - 3. Most investors do not understand the concept of "fiduciary duty," although they do desire that the same investor protection rules be applied when the same financial services are provided.*
- P. Disclosure and informed consent, when a financial planner desires to change from the role of acting in the client's best interests to an arms-length transaction with his or her customer, is not adequate for the majority of consumers of financial services and products.*
- Q. The current separate regulatory scheme for broker-dealers (and their registered representatives), registered investment advisers (and their representatives) and insurance companies (and their brokers and/or agents) lacks clarity with regard to its application to financial planners, is inappropriate for the regulation of financial planning services, and fails to adequately protect consumers of financial planning services.*
- R. A professional organization can serve several important purposes, including enhancing the reputation of a profession for fair and honest service by establishing standards for doing business and by disciplining those who do not abide by those standards.*
- S. Professional associations often may assume or be granted certain control regarding access to professional privileges and/or the use of certain titles or designations. In such instances proceedings relating to the admission, suspension and termination of membership in a profession must be rationally and consistently applied given the potential for judicial review.*
- T. An association's code of ethics or standards of practice does not give rise to an independent cause of action for negligence or malpractice, but it may be evidence of the appropriate standard of care to be followed by the association's member. Additionally, a professional code may be advantageous or disadvantageous to a professional in civil proceedings, as professionals may seek to have the code admitted as evidence that the professional has in fact complied with the applicable standard of care.*

- U. *There should be a reasonable expectation among clients of professionals that the professional association's code of ethics or rules of conduct will be followed.*
- V. *If a professional association's codes are not actually enforced, or are just aspirational in nature, the primary rationale for using the code as evidence of a standard of care would not exist.*
- W. *A professional association's decisions relating to expulsion or other discipline of a member is subject to legal challenge, even when the association's action would not substantially preclude the member in question from competing in the marketplace.*

In conclusion as to the Findings undertaken by the FPA[®] Fiduciary Task Force, the current regulatory structure does not provide adequate and consistent regulation of financial planning activities. While the evolution of financial planning has served to educate and inform all financial intermediaries as to how to better understand and serve their clients' needs, most current marketing materials and disclosure materials do not serve to adequately inform consumers of the distinctions in the different legal duties of various financial intermediaries, especially when a change in the nature of the relationship occurs. This leads to many confused and poorly protected consumers.

Recommendations Relating To Adoption of Professional Standards of Conduct. This Final Report also includes recommendations as to the professional standards of conduct which should be adopted for financial planners. The FPA[®] Fiduciary Task Force notes that its work is to be followed by the FPA[®] Standards of Conduct Task Force, as well as the ongoing work of various committees, to address the issues raised by this Final Report and by recent developments.

The FPA[®] Fiduciary Task Force undertakes the following *recommendations* to FPA's Board of Directors as to positions which should be undertaken in future policy initiatives:

- A. *The six-part financial planning process as it currently exists is adequately set forth in the July 2003 CFP Board's Financial Planning Practice Standards.*
- B. *The definition of "personal financial planning subject areas" contained in the terminology section of the July 2003 CFP Board's Financial Planning Practice Standards is reaffirmed.*
- C. *"Financial planning" shall include activities which relate to "retirement planning," "estate planning," "risk management planning," and other portions of a comprehensive financial planning process, and the "best interests of the client" standard shall apply in each of those instances.*
- D. *The "best interests of the client" standard shall apply when a financial planner implements any portion or element of a financial plan presented by that financial planner to the client.*

D.1. The “best interests of the client” standard arises out of an advisory relationship. An advisory relationship exists between an individual and a client when one or more of the following facts and circumstances are present:

- (1) Either existing law (including both statutory and common law) or regulation dictate that the individual possesses a fiduciary duty to the client with regard to the advice provided to the client;*
- (2) The nature of the services provided is financial planning, or one or more of the material elements of financial planning;*
- (3) The terms and conditions of the contract between the individual and the client include an express assumption of the individual’s duty to act in the best interests of the client;*
- (4) The individual “holds out” as a financial planner (or similar terms), thereby creating the rightful expectation that an advisory relationship exists.*

E. The “best interests of the client” standard shall apply to persons holding out as financial planners or who otherwise create a reasonable expectation regarding an advisory relationship.

F. When the circumstances set forth in Recommendations C (financial planning in any of the financial planning practice areas), D (implementation of a financial plan) or E (holding out as a financial planner) exist, professional standards of conduct shall apply to a financial planner in her or his services to a client. In such instances the financial planner shall possess the following five major responsibilities to the client:

- 1. A financial planner shall put the clients’ best interests first;*
- 2. A financial planner shall act with due care and in utmost good faith;*
- 3. A financial planner shall not mislead clients;*
- 4. A financial planner shall provide full and fair disclosure of all material facts; and*
- 5. A financial planner shall disclose and fairly manage all conflicts of interest.*

Conclusion. The foundations of the profession of financial planning were laid at the now-famous December 12, 1969 meeting of thirteen men in Chicago searching for a way to better serve the public interest. Over the years these foundations have been steadily advanced, as our predecessors and contemporaries have uncovered new knowledge, discerned processes, and educated other financial planners. Ever-higher ethical standards have been adopted, and now many (but not all) financial planners practice exclusively under the professional standard of conduct (whether imposed by law or voluntarily assumed) in which the client’s best interests are kept paramount at all times.

Professionals, armed with unique knowledge and experience, are able to bring sound judgment to bear upon the challenges posed to the general public. We request that a very important dimension of the lives of our fellow citizens – that which relates to each person’s own financial security and planning for the achievement of lifetime financial goals – be empowered by consistent professional conduct through the engagement of financial planners held to the highest standards of conduct. We further request that financial planners attain a special place in our society through the adoption of these professional standards. With such adoption will follow the status and prestige accorded to true professionals and the resulting increased demand for their all-important professional services.

The process of assuming true professional status for financial planners will require courage, diligence and persistence by leaders in the financial planning community. Many obstacles will need to be identified and overcome. Resistance by firms and individuals to change is inevitable. Unwillingness to assume a duty to act in the client’s best interests at all times will need to be countered with steady persuasion of the necessity of this standard of conduct, not only for the sake of consumers but also for the sake of the financial planning profession. The FPA[®] Fiduciary Task Force recommends that Financial Planning Association assume the mantra of leadership on this issue and steadfastly work toward the adoption of professional standards of conduct in which the client’s best interests are kept paramount. In so doing, the financial planning community will be transformed into a community of professionals bound together by shared high standards of conduct, service to others, and resulting increased appreciation, respect and loyalty from consumers of financial planning services.

Alternative View Included. Appended to this Final Report is an “Alternative View” propounded by some of the FPA[®] Fiduciary Task Force members. While the Alternative View notes that there is broad consensus regarding the findings and recommendations by the majority of the Task Force’s members, there remains varied views on several specific issues, many of which relate to the method of implementation of the recommendations as to policy initiatives (which the next Task Force, to be convened, is to address in its future deliberations). In order for the FPA Board of Directors be fully aware of these opinions and recommendations, the Alternative View is appended to this Final Report and deserves close scrutiny.

The FPA[®] Fiduciary Task Force

June 1, 2007

GLOSSARY

Broker-dealer (BD). A broker-dealer is a company that trades in securities for customers as well as for its own account. In the United States, a broker-dealer is registered with the U.S. Securities and Exchange Commission pursuant to the Securities and Exchange Act of 1934. When executing trade orders on behalf of a customer, the institution is said to be acting as a broker. When executing trades for its own account, the institution is said to be acting as a dealer. The agents of a broker-dealer are referred to as *registered representatives*.

Compensation methods. *Financial intermediaries* may rely upon only one compensation method or may combine two or more methods. Common methods include:

Commissions. Some *financial intermediaries*, including many *broker dealer* firms and their *registered representatives*, receive their compensation based on commissions clients pay each time they buy or sell a security.

Hourly, fixed or retainer fees. Some *financial intermediaries*, including many financial planners, charge fees for their services which clients pay directly to the provider. They may be hourly fees, a flat fee, a retainer fee, or some combination thereof, for a particular service or range of services.

Percentage of assets under management. Some *financial intermediaries*, including most *registered investment advisers*, charge a fee based on a percentage of the assets in the client's account on which advice is provided.

Dual registrant. The term utilized to describe securities *broker-dealer* firms or their *registered representatives* when they are also registered as a *registered investment adviser* or *investment adviser representatives*.

Fiduciary. Generally, a person who is in a relationship of trust and confidence with a client and who owes the client broad duties of due care, utmost good faith, and loyalty. From the Latin *fiducia*, meaning "trust," a person (or a firm) who has the power and obligation to act for another (often called the beneficiary or entrustor or client) under circumstances which require total trust, good faith and honesty. The most common fiduciary is a trustee of a trust, but fiduciaries can include *registered investment advisers*, *insurance brokers*, attorneys, guardians, or anyone who undertakes to assist someone who places complete confidence and trust in that person or company. As set forth herein, under various circumstances *registered representatives*, *insurance agents*, and *financial planners* may be fiduciaries. Characteristically, the fiduciary has greater knowledge and expertise about the matters being handled.

Financial planner. Unlike the terms *registered investment adviser* (or *investment adviser representative*) and *broker dealer* (or *registered representative*), financial planner is not a legally defined term under federal law. However, it generally refers to providers who undertake the *financial planning process* for clients based upon their long-term goals.

Financial planning process. "Personal financial planning process" or "financial planning process" denotes the process which typically includes, but is not limited to, these six elements: establishing and defining the client-planner relationship; gathering client data including goals; analyzing and evaluating the client's financial status; developing and presenting financial planning recommendations and/or alternatives; implementing the financial planning recommendations; and monitoring the financial planning recommendations.

Financial planning subject areas. "Personal financial planning subject areas" or "financial planning subject areas" denotes the basic subject fields covered in the financial planning process which typically include, but are not limited to: financial statement preparation and analysis (including cash flow analysis/planning and budgeting); investment planning (including portfolio design, i.e., asset allocation and portfolio management); income tax planning; education planning; risk management; retirement planning; and estate planning.

Financial intermediaries. The term utilized to describe various participants in our financial markets which bring together issuers (i.e., corporations issuing stock, and/or governments or corporations issuing debt) and purchasers. While the term generally includes institutions such as commercial banks, savings and loans associations, credit unions, and mutual fund companies, in this Final Report five types of financial intermediaries were examined: *broker dealers* (and their *registered representatives*), *financial planners*, *insurance agents*, *insurance brokers*, and *registered investment advisers* (and their *investment adviser representatives*).

Investment adviser representative (IAR). The representative of a *registered investment adviser* firm. IAR's may use a variety of titles in addition to investment adviser, such as investment manager, investment counsel, asset manager, wealth manager, or portfolio manager.

Life insurance agent. Generally speaking, an individual who is licensed by a state to sell a life insurance product for one or more specific insurance companies. Generally, life insurance agents are deemed to act as the agent of the insurance company or companies he or she represents.

Life insurance broker. Generally speaking, a life insurance broker serves as the agent of his or her customer, acting in the customer's stead in soliciting, negotiating or otherwise obtaining insurance products best suited to the customer's needs

Registered investment adviser (RIA or IA). The term investment adviser is a legal term that describes a firm or individual who is in the business of giving advice about securities (the term "securities" includes stocks, bonds, mutual funds, and annuities) and is registered with either the U.S. Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940 or a state regulatory agency pursuant to state law. Investment advisers provide ongoing management of investments based on the client's objectives. The representative of a registered investment adviser firm is legally referred to as an *investment adviser representative*.

Registered representative (RR). Individual salespeople employed by broker-dealer firms are often called stockbrokers and are officially referred to as registered representatives of the broker-dealer firm.

ABOUT THE FINANCIAL PLANNING ASSOCIATION

The **Financial Planning Association** (FPA[®]) (hereinafter “FPA”) is the community that fosters the value of financial planning and advances the financial planning profession. The financial planning profession exists to help people make those financial decisions and achieve their life goals. Financial planning is the process of wisely managing one’s finances to achieve certain goals and dreams, while at the same time helping negotiate the financial barriers that inevitably arise in every stage of life.

The FPA’s Code of Ethics provides the impetus for the continued advancement of financial planning as a distinct profession. Moreover, the FPA’s Code of Ethics provides a framework for the adoption of appropriate professional standards of care. The seven core principles found in the FPA’s Code of Ethics are:

1. An FPA member shall offer and provide *professional* services with integrity.
2. An FPA member shall be objective in providing *professional* services to clients.
3. An FPA member shall provide services to clients competently and maintain the necessary knowledge and skill to continue to do so in those areas in which the designee is engaged.
4. An FPA member shall perform *professional* services in a manner that is fair and reasonable to clients, principals, partners, and employers and shall disclose conflict(s) of interest(s) in providing such services.
5. An FPA member shall not disclose any confidential client information without the specific consent of the client unless in response to proper legal process, to defend against charges of wrongdoing by the FPA member, or in connection with a civil dispute between the FPA member and client.
6. An FPA member’s conduct in all matters shall reflect credit upon the *profession*.
7. An FPA member shall act diligently in providing *professional* services.

[*Emphasis added.*]

FPA’s individual members include financial planners, accountants, attorneys, bankers, charitable giving specialists, insurance agents, stockbrokers, money managers, investment consultants, broker-dealer and corporate executives, and others who champion the financial planning process. FPA institutional membership connects firms that support the financial planning process to the financial planning community.

FPA believes that everyone is entitled to objective advice from a competent, ethical financial planner in order to make smart financial decisions. FPA members demonstrate and support a professional commitment to education and a client-centered financial planning process.

The FPA, with over 28,000 members, is the nation’s leading not-for-profit organization devoted to connecting those who need, support and deliver financial planning.

FPA® FIDUCIARY TASK FORCE ROSTER

The Fiduciary Task Force appointed by the FPA Board of Directors consists of the following individuals:

CHARLES G. HUGHES JR., CFP® (*Chairman*)

FREDERICK E. "RICK" ADKINS III, CFP®, CLU, ChFC, The Arkansas Financial Group, Inc.

DAVID T. BELLAIRE, ESQ., General Counsel & Director of Government Affairs,
Financial Services Institute, Inc.

BOB BROWN, CFP®, The Tax & Financial Group

MERCER BULLARD, J.D., President, Fund Democracy

HAROLD EVENSKY, Evensky & Katz

DAVID J. GORDON, J.D., CFP®, CIMA, Senior V.P., Investments, Wachovia Securities

STEPHEN D. JOHNSON, CFP®, Johnson Marotta

NANCY JOHNSON JONES, CFP®, BKD Wealth Advisors, LLC

KEITH LOVELAND, J.D., Loveland Consulting

DANIEL B. MOISAND, CFP®, Spraker, Fitzgerald, Tomayo & Moisand

NICHOLAS A. NICOLETTE, CFP®, Sterling Financial Group

TOM L. POTTS, CFP®, Ph.D, Baylor University

BARBARA ROPER, Director of Investor Protection, Consumer Federation of America

MARTIN SIESTA, CFP®, ChFC, MSFS, Compass Wealth Management LLC

(liason to FPA Board of Directors)

NEAL SOLOMON, CFP®, CLU, ChFC, Managing Director, CCO, WealthPro LLC

DAVID O. SPINAR, J.D., CRCP, Senior Vice President and CCO, Securities America, Inc.

DAVID STREGE, CFP®, Syverson, Strege and Company

PATRICIA D. STRUCK, Administrator, Department of Financial Institutions,
Division of Securities, State of Wisconsin

DAVID G. TITTSWORTH, Executive Director, Investment Adviser Association

DONALD B. TRONE, AIFA®, Founder and CEO, Fiduciary 360

MARVIN W. TUTTLE, JR., CAE, Executive Director/CEO, Financial Planning Association

DICK WAGNER, J.D., CFP®, Worth Living, LLC

ROBERT H. NEILL, ESQ., Assistant Director of Government Relations, FPA (*staff liason*)

NEIL A. SIMON, ESQ., Director of Government Relations, FPA (*staff liason*)

RON A. RHOADES, J.D., CFP®, CCO, Joseph Capital Management, LLC (*Reporter*)

FINAL REPORT OF THE FPA[®] FIDUCIARY TASK FORCE TO THE FPA BOARD OF DIRECTORS

I. PREFATORY NOTE

Statement of Purpose. The goal of the FPA[®] Fiduciary Task Force is to examine the word, the meaning, and the concept of the term “fiduciary” in both its present and historical contexts and assess its relevance and applicability to financial planning/financial planners as a complete and all-encompassing standard of conduct. Depending on the results of the assessment, the FPA[®] Fiduciary Task Force may recommend a redefinition of the term and/or a more appropriate application of the term and/or concept, or other words to describe more relevant standards of conduct to which financial planners should adhere.

Developments Leading to the Formation of the FPA[®] Fiduciary Task Force. The formation of the FPA[®] Fiduciary Task Force arose following a series of events.

In April 2002 the Financial Planning Association published a white paper titled “Regulation of Financial Planners.” Written by Yale law professor Jonathan R. Macey, the white paper reviewed the existing regulatory climate for financial planners and examined options for future regulation as a distinct, stand-alone profession. At the time of publication the white paper was publicized to FPA’s membership and was made available on FPA’s website.

In April 2005 the U.S. Securities and Exchange Commission adopted its Final Rule exempting fee-based brokerage accounts from the fiduciary protections afforded to individual investors under the Investment Advisers Act of 1940. The FPA, assisted by other consumer protection and industry groups, challenged the Final Rule in U.S. District Court and oral arguments in the case were heard in early October 2006. As of February 14, 2007 no decision has been handed down in the case.

In response to renewed focus on the issue of whether and when fiduciary duties apply to financial planning activities, the FPA formed the FPA Regulation Task Force in 2005. The FPA Regulation Task Force was charged by then-President James Barnash to examine in detail the regulatory options raised by the 2002 white paper. Its extensive examination of the basic regulatory options led the FPA Regulation Task Force to the following conclusions (as contained in the “Recommendations on Future Regulation Of the Financial Planning Profession,” submitted by the FPA Board of Directors to the FPA membership on behalf of the Regulation Task Force, dated June 12, 2006:

- (1) Financial planning is not widely recognized as a profession, notwithstanding growing recognition of the CFP[®] and Certified Financial Planner[™] marks as a sign of professionalism.
- (2) The public generally does not understand the financial planning process, nor is it able to easily identify a competent, ethical financial planner.
- (3) FPA currently does not have a long-term plan for addressing future regulation of the profession.

- (4) If financial planners are to be eventually recognized as a separate, stand-alone profession, continued subset regulation as investment advisers, brokers, insurance agents, or in banking departments will hinder reaching that goal.
- (5) The financial advisory industry - which straddles the securities, insurance and banking sectors - is highly fractured and, at this stage, disinterested, unwilling, or unable to reach consensus on the best form of regulation and what role financial planning should play in delivering advice to the public.
- (6) FPA must embrace change as inevitable and develop a strategic and opportunistic approach to establishing a framework for professional regulation, either through changes to law or within the legal system.

The FPA Regulation Task Force's recommendations set forth goals and objectives for future regulation that the FPA Regulation Task Force believes the FPA should rely on in crafting meaningful standards for a profession.

- A. Clear identification by the public of a licensed financial planner.
- B. Uniform competency and ethical standards for regulating the financial planning process.
- C. Exemption from duplicate regulation where licensed financial planners meet or exceed existing regulatory standards.
- D. *Fiduciary standard in law for financial planners.*
- E. Peer review process for financial planners.
- F. Statutory authority to censure, discipline or otherwise bar individuals from holding out as financial planners or practicing financial planning.
- G. A governance framework that includes professional representation.
- H. Said regulatory board is ultimately accountable to a public agency and/or legislative entity.

[*Emphasis added.*]

The FPA Regulation Task Force concluded, "Should the Board agree with the (FPA Regulation) Task Force's findings, in particular that the status quo is unacceptable and that a long-term plan is needed to clearly identify and set standards for the profession, then it believes buy-in from membership is critical."

On July 24, 2006 the CFP Board of Standards, Inc. (hereafter "CFP Board") released an exposure draft of proposed changes ("Exposure Draft") to its *Code of Ethics and Professional Responsibility* and *Financial Planning Practice Standards* for a 60-day public comment period. The Exposure Draft contained proposed revisions to CFP Board's ethical standards developed over a period of several years. The most controversial of the proposals was to provide for an "opt-out" from the fiduciary standard of conduct by agreement between the financial planner and the client. The CFP Board subsequently formed an Ethics Task Force to consider more carefully the 336 comments submitted. The CFP Board recently reported: "At the January [2007] Board meeting, the Ethics Task Force also presented a detailed report on the comments about last year's Exposure Draft of proposed revisions to CFP Board's Standards of Professional Conduct. The task force also made several recommendations that incorporate feedback heard from many of CFP Board's stakeholders. The Board has directed the Ethics Task Force to work with staff to prepare a second Exposure Draft that will be released for comment later this year."

On September 26, 2006 the U.S. Securities and Exchange Commission (“SEC”) awarded a contract to the RAND Corporation (“RAND”) to conduct factual research and analysis for a major study comparing how the different regulatory systems that apply to broker-dealers and investment advisers affect investors. Verbal reports suggest that RAND's study will span a 12-month period, culminating in an initial release to which comments will be received before a final report is issued six months thereafter.

As a result of these events, in October 2006 the FPA’s Board of Directors appointed a “Fiduciary Task Force” to further explore the legal and practical issues with regard to identifying and standards of conduct for those involved in the process of financial planning. Because of the strategic implications of the FPA® Fiduciary Task Force’s reports, the FPA® Fiduciary Task Force purposely consisted of various stakeholders in the securities industry, including those with diverse and often competing interests.

The first teleconference of the FPA® Fiduciary Task Force convened in late October 2006. The FPA® Fiduciary Task Force and its Working Groups thereafter met via teleconference, engaging in over sixteen hours of discussions over several months. Additionally, proposals and research were shared through extensive exchanges via a common message board and e-mails. Following the presentation of a Preliminary Report, the FPA Board of Directors met, examined the Preliminary Report, and issued the following resolution on March 1, 2007: “The FPA Board of Directors accepts the work of the Fiduciary Task Force, supports the development of a universal standard of care – based on a client’s best interest – that is unambiguous and without exception, and authorizes the Fiduciary Task Force to proceed with its work to further define that standard of care.”

Subsequently, two additional conference calls were undertaken to take note of the following developments and to discuss the Alternative View in further detail. The recent developments included:

First, the Certified Financial Planner Board of Standards, Inc. issued on March 9, 2007, a *Second Exposure Draft* of proposed revisions to the ethical standards for CFP® certification March 9, 2007 for a period of public comment. CFP Board’s Board of Directors and its Ethics Task Force hosted a Town Hall Meeting on March 30, 2007 regarding the *Second Exposure Draft*. The Second Exposure Draft does say that all CFP® certificants who provide financial planning services will be held to the duty of care of a fiduciary, as defined by CFP Board. The Second Exposure Draft also proposes that CFP® certificants “shall at all times place the interest of the client ahead of his or her own,” regardless of whether financial planning services are provided to the client.

Second, on March 30, 2007, the U.S. Court of Appeals issued its decision in *FPA vs. SEC*, ruling 2-1 that the SEC exceeded its authority in the rule-making leading to the utilization of fee-based brokerage accounts.

Third, additional case law applying common law fiduciary status upon financial planners was obtained through research. This case law will be examined by another FPA Task Force.

This Final Report, including the Alternative View appended hereto, is the culmination of those conferences and interchanges of information and ideas.

FPA® Fiduciary Task Force Working Group 1. The FPA® Fiduciary Task Force formed two initial Working Groups. Working Group 1 (WG1) was charged with exploring the standards of conduct applicable under the current law to five types of financial intermediaries: broker-dealer firms and their registered representatives, financial planners, insurance agents, insurance brokers, and registered investment advisers and their investment adviser representatives. WG1 was also charged with inquiring as to extent of consumer understanding of the fiduciary concept and the varying standards of conduct of different financial intermediaries. WG1 was assisted by the Neil Simon, Esq. and Robert Neill, Esq. of the FPA Government Relations Committee staff, each of whom prepared legal memoranda in support of WG1's efforts and who also actively assisted in the many discussions. Additional legal research was provided to WG1 by Mari-Anne Pisarri, Esq. and Mark D'Arrigo of the Washington law firm of Pickard and Djinis LLP.

FPA® Fiduciary Task Force Working Group 2. Working Group 2 (WG2) was charged with undertaking analysis and policy recommendations by addressing several key questions:

1. What is/are the proper standard(s) of conduct for financial planners?
2. Should uniform standards of conduct for all financial planners exist, or should different standards of conduct apply depending upon the regulatory status and/or function of the financial planner and/or the nature or scope of the financial planning activity?
3. What is a "plain-English" articulation of the identified standard(s) of conduct.
4. What are the ramifications of the identified standards of conduct as to potential legal liability for financial planners?
5. Should the identified standard(s) of conduct apply only to certain activities constituting part of the financial planning process?
6. Should the identified standard(s) of conduct apply to all persons who hold themselves out as financial planners?

FPA® Task Force To Continue Study. A different Task Force, seeking broader representation from FPA's constituencies, will be appointed by the FPA to continue the work of the current Task Force and further explore the fiduciary standard of conduct as it may apply to financial planners, generally, and to FPA members, specifically. This new Task Force is expected to commence meetings within the next few weeks.

This Is A Final Report. This Final Report to the FPA Board of Directors summarizes the work of Working Groups 1 and 2, as then reviewed by the full FPA® Fiduciary Task Force.

An Expression of Gratitude. This Final Report has been greatly aided by the writings and insights provided by many members of the financial planning community over the past 36 years, of whom there are far too many to list in this report. Without their foundational efforts to advance the financial planning profession and their fostering of the value of financial planning in today's complex world, this Final Report would not have been possible. Accordingly, the FPA® Fiduciary Task Force thanks all those many members of the FPA and its predecessor organizations who have devoted their substantial time, energy and expertise to these causes over the years.

II. FINDINGS.

The FPA[®] Fiduciary Task Force examined the current state of the law relating to the standards of conduct applicable to broker-dealer firms and their registered representatives, financial planners, insurance agents, and registered investment adviser firms and their representatives, and examined consumer understanding of the various roles of financial intermediaries.

Appended to this Final Report are memoranda prepared by Mari-Anne Pisarri, Esq. and Mark D'Arrigo, Esq. of the Washington law firm of Pickard and Djinis LLP. These memoranda provide important foundations for the FPA[®] Fiduciary Task Force's analysis and conclusions as to the current state of the law surrounding financial intermediary standards of conduct. These legal memoranda address the following specific topics:

App. A: Dec. 5, 2006: *Fiduciary Responsibilities of Investment Advisers under the Investment Advisers Act of 1940*

App. B: Dec. 21, 2006: *Treatment of Broker-Dealers and Their Associated Persons as Fiduciaries*

App. C: Jan. 22, 2007: *Insurance Agents, Financial Planners and their Common-Law Fiduciary Duties*

An additional legal memorandum relating to the legal issues of professional associations and their members, as they relate to codes of ethics, was prepared by Neil A. Simon, Esq., Director of Government Relations for the Financial Planning Association, and is appended to this Report:

App. D: Jan. 5, 2007 *Legal Issues Relating To Association Code of Ethics*

An additional legal memorandum relating to responsibilities arising under ERISA was prepared by Robert H. Neill, Esq., Asst. Director of Government Relations for the Financial Planning Association, and is appended to this Final Report:

App. E: Jan. 12, 2007 *Duties of a Fiduciary under ERISA*

An additional memorandum was prepared relating to behavioral biases of individual investors, as they relate to the efficacy of disclosures and the ability of consumers to secure informed consent to a change of status from a fiduciary to a non-fiduciary role. This memorandum, prepared by Ron A. Rhoades, J.D., CFP[®], who served as Reporter for the FPA[®] Fiduciary Task Force, is appended to this Final Report:

App. F: Jan. 26, 2007 *Lessons From Behavioral Science: The Effectiveness Of Disclosures Provided to Clients of Financial Intermediaries*

From an extensive examination of the current state of the law regarding the standards of conduct governing various financial intermediaries, and the current practices of financial planners, the FPA[®] Fiduciary Task Force undertakes the following findings:

A. Many financial planners meet the definition of “investment adviser” or “investment adviser representative” under the Investment Advisers Act of 1940 and therefore are subject to the broad fiduciary duties imposed by that law.

Reporter’s Comment. Currently, the title of “financial planner” is largely an unregulated term in the vast majority of countries around the world, including the United States. This has allowed financial services personnel with no restrictive rules to use the title indiscriminately. Financial intermediaries commonly use the title (or related titles) to project a professional image to their clients even when they are not trained in the professional aspects of financial planning. This has often led to abuse and confusion. As a result, consumers may be deceived and may receive financial planning services that are unprofessional or from providers who are unethical.

To promote financial planning as a profession, financial professionals and practitioners in the United States and in some other countries formed trade organizations to provide self-regulation and to maintain some orderliness in the industry. Some organizations, such as the Financial Planning Association, organize high-level continuing education programs. Other trade organizations, such as the Certified Financial Planner Board of Standards, Inc. and organizations under license from the Financial Planning Services Board, certify members as “Certified Financial Planners™.” Other trade organizations provide other designations or certifications. However, the title of “financial planner” continues to be of common usage among individuals in the financial industry in the United States and in many countries where the financial planning concept exists at some level. There are little or no legal barriers to prevent financial services personnel from using the title.

Despite the foregoing general lack of regulatory oversight, in the United States most financial planners (but not all) will be regulated as “investment advisers” (or representatives of an investment adviser firm) pursuant to the federal Investment Advisers Act of 1940 or similar state legislation.

IAA of 1940 and the Capital Gains Decision, Generally. The federal Investment Advisers Act of 1940 does not explicitly impose a fiduciary duty on registered advisers. Section 206 of the Advisers Act does prohibit misstatements or misleading omissions of material facts and other fraudulent acts and practices in connection with the conduct of an investment advisory business. However, it is well-established that investment advisers do in fact bear such fiduciary duties to their clients, as Section 206 has been interpreted to impose such duties. “[T]he 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.” *SEC vs.*

Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), at 191-2. For a further discussion of this landmark decision of the U.S. Supreme Court and of the fiduciary duties applicable to registered investment advisers, please refer to the December 5, 2006 legal memorandum found in Appendix A to this Final Report.

State-Registered Investment Advisers and IARs. State-registered advisers are subject to Section 206 of the Investment Advisers Act of 1940 and its imposition of fiduciary duties. In addition, many state securities laws and/or regulations expressly apply fiduciary duties to state-registered investment advisers. The North American Securities Administrators Association (NASAA) Model Rule 102(a)(4)-1 states in pertinent part: “A person who is an investment adviser, an investment adviser representative [IAR] or a federal covered adviser is a fiduciary and has a duty to act primarily for the benefit of its clients.”

By Rule, The IAA Is Applied To Certain Fee-Based Brokerage Accounts. Under the Investment Advisers Act of 1940, Rule 202(a)(11)-1 applies the heightened investment advisory fiduciary standard to certain other types of conduct deemed not to be “solely incidental” to normal broker-dealer activities. Specifically, the heightened standard is applied where a broker-dealer charges a separate fee for (or separately contracts for) advisory services, or where it provides advice as part of a financial plan or in connection with providing financial planning services and either: (i) holds itself out generally to the public as a financial planner or as providing financial planning services; (ii) delivers a financial plan to the customer; or (iii) represents to the customer that the advice is provided as part of a financial plan or in connection with financial planning services. The FPA[®] Fiduciary Task Force notes that SEC staff’s December 16, 2005 interpretation of the fee-based brokerage account rule, also known as the “Merrill Lynch Rule,” and the rule itself, are highly controversial.

The Effect of Use of Titles, Marketing Materials Describing The Nature of the Relationship; Effect on the Nature of Fee-Based Brokerage Accounts. The financial planner’s title, and description of the relationship between the financial intermediary with the customer or client, whether done either through marketing materials, written disclosures, or contractual terms, may be a significant factor in determining whether fiduciary status is imposed. Recently regulators have increasingly focused on this aspect. For example, it was recently reported that “regulators believe that some broker-dealers market [fee-based accounts] with an invitation to ‘take care of’ the customer’s account ... Registered representatives are commonly referred to as financial advisors or financial consultants, which may lead to confusion by clients with respect to fee-based accounts.” S. Lawrence Polk, “Regulators Discuss the ‘Hot Topics’ for 2007 at Fall New York Compliance Seminar” (Sutherland Asbill & Brennan LLP publication, Dec. 21, 2006). Furthermore, in a Complaint filed on December 12, 2006 against a major broker-dealer firm by N.Y. Attorney General Eliot Spitzer relating to the improper use of fee-based accounts, the Complaint noted: “As part of the promised advisory relationship, each account holder was to be served not by a broker (the word did not appear in [the] brochures), but by a ‘professional Financial Advisor’ – i.e. a professional advisor on financial matters – who gives ‘personalized financial consultation.’ Account holders were not ‘customers,’ which would suggest a sales relationship, but rather ‘clients,’ indicating a confidential relationship like the kind that clients have with their lawyers and accountants ... In sum, [the broker-dealer firm] lured prospective clients to [the fee-based account program] by leading them to believe that a central purpose of

[the fee-based account program] was to provide substantial advice, that clients' fees paid for that advice, that clients should (and would need to) trust and rely on the expert advice of [the fee-based account program's] Financial Advisors, that [the fee-based account program] created an advisory relationship between the Financial Advisors and the clients, and that [the fee-based account program] was much more than just an ordinary brokerage account. Accordingly, [the broker-dealer] owed its [fee-based accounts] clients a fiduciary duty."

The FPA[®] Fiduciary Task Force notes that the Merrill Lynch Rule remains subject to legal challenge by the FPA, and for these reasons the FPA[®] Fiduciary Task Force declines to further expound upon the many issues raised by fee-based brokerage accounts at this time.

B. Financial planning activities that are governed by ERISA fall under similar, if not stricter, fiduciary standards.

Reporter's Comment. As to certain employee benefit plans the federal Employee Retirement Income Security Act (ERISA) imposes upon trustees and sponsors (and nearly any other individual or entity who exercises any form of discretionary control or authority over the management of employee benefit plans) strict fiduciary duties and standards of care. ERISA provides, in relevant part, that a fiduciary shall discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purposes of: (1) providing benefits to participants and their beneficiaries; (2) defraying reasonable expenses of administering the plan with care, skill, loyalty, prudence and diligence; (3) carrying out his or duty to act for the exclusive purpose of providing benefits to plan participants; (4) diversifying the investments of the plan so as to minimize the risk of large losses; and (5) acting in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with applicable law.

Additional information regarding the responsibilities imposed by ERISA can be found in the legal memorandum of Robert H. Neill, Esq., attached hereto as Appendix E. An additional overview of ERISA fiduciary duties can be found in the U.S. Department of Labor's booklet, "Meeting Your Fiduciary Duties."

C. Other statutes may explicitly impose fiduciary duties upon financial planners in specific situations or when practicing in specific geographic regions.

Reporter's Comment.

UPIA. The Uniform Prudent Investor Act, adopted by many of the states, may impose fiduciary duties upon financial planners who act in the capacity as trustee, guardian, executor or personal representative of an estate, attorney-in-fact under a general power of attorney, custodian of an account governed by the Uniform Transfers to Minors Act, and certain other situations.

Maryland Statutory Law. The Maryland Securities Act, Section 11-101(h)(1) defines the term "investment adviser" to mean "a person who, for compensation:

- (i) 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 a part of a regular business, issues or promulgates analyses or reports concerning securities;
or

- (ii) 1. Provides or offers to provide, directly or indirectly, *financial* and investment *counseling or advice*, on a group or individual basis;
- 2. Gathers information relating to investments, *establishes financial goals and objectives, processes and analyzes the information gathered, and recommends a financial plan*; or
- 3. *Holds out as an investment adviser in any way, including indicating by advertisement, card, or letterhead, or in any other manner indicates that the person is, a financial or investment "planner", "counselor", "consultant", or any other similar type of adviser or consultant.*

[*Emphasis added.*] Hence, a person holding himself or herself out as a “financial planner” or “financial consultant,” or who actually provides financial advice for compensation, and who is subject to the laws of the State of Maryland, is an investment adviser and hence is a fiduciary with respect to activities carried on in that state, barring any exclusion as provided by law or regulation.

Washington State Statutory Law. The Securities Act of Washington (state), at RCW 21.20.005(6), defines the term “investment adviser” to mean “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 a part of a regular business, issues or promulgates analyses or reports concerning securities. ‘Investment adviser’ *also includes financial planners* and other persons who, as an integral component of other financially related services, (a) provide the foregoing investment advisory services to others for compensation as part of a business or (b) hold themselves out as providing the foregoing investment advisory services to others for compensation. *Investment adviser shall also include any person who holds himself out as a financial planner.*” [*Emphasis added.*] However, the State of Washington subsequently adopted a regulation (WAC 460-24A-045) which provides: “A person using a term deemed similar to ‘financial planner’ or ‘investment counselor’ ... will not be considered to be holding himself out as a financial planner for purposes of RCW 21.20.005(6) ... under the following circumstances ... (1) The person is not in the business of providing advice relating to the purchase or sale of securities, and would not, but for his use of such a term, be an investment adviser required to register pursuant to RCW 21.20.040; and (2) The person does not directly or indirectly receive a fee for providing investment advice. Receipt of any portion of a “wrap fee,” that is, a fee for some combination of brokerage and investment advisory services, constitutes receipt of a fee for providing investment advice for the purpose of this section; and (3) The person delivers to every customer, at least 48 hours before accepting any compensation, including commissions from the sale of any investment product, a written disclosure including the following information: (a) The person is not registered as an investment adviser or investment adviser salesperson in the state of Washington; (b) The person is not authorized to provide financial planning or investment advisory services and does not provide such services; and (c) A brief description the person's business which description should include a statement of the kind of products offered or services provided (e.g., the person is in the business of selling

securities and insurance products) and of the basis on which the person is compensated for the products sold or services provided; and (4) The person has each customer to whom a disclosure described in subsection (3) of this section is given sign a written dated acknowledgment of receipt of the disclosure” Hence, there are substantial exceptions provided by the regulation to the “holding out” statutory requirement.

Uniform Securities Act. Maryland and Washington laws are substantially different from the Uniform Securities Act (2002), which provides in Section 102(15): “‘Investment adviser’ means a person that, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities. The term includes a financial planner or other person that, as an integral component of other financially related services, provides investment advice to others for compensation as part of a business or that holds itself out as providing investment advice to others for compensation.” The comment to the Uniform Securities Act (2002) further provides: “The second sentence in the term addressing financial planners is new. The purpose of this sentence is to achieve functional regulation of financial planners who satisfy the definition of investment adviser. *Cf.* Investment Advisers Act Release 1092, 39 SEC Dock. 494 (1987) (similar approach in Securities and Exchange Commission interpretative Release). *This reference is not intended to preclude persons who hold a formally recognized financial planning or consulting designation or certification from using this designation. The use by a person of a title, designation or certification as a financial planner or other similar title, designation, or certification alone does not require registration as an investment adviser.*” [Emphasis added.]

It remains to be seen whether the states will move toward either increased or decreased regulation of financial planners, either as investment advisers or under a separate regulatory scheme. Whether increased regulation of financial planners should be encouraged is an issue which Working Group 3 will address when the FPA[®] Fiduciary Task Force reconvenes, and this issue may also be appropriately considered by other committees within the Financial Planning Association.

Other specific statutes may impose fiduciary duties upon financial planners. The foregoing list is not intended to be all-inclusive.

D. Financial planning activities which are not subject to the Investment Advisers Act of 1940, ERISA, or other statutory law which clearly impose fiduciary status, may nevertheless be subject to fiduciary duties under a common law “facts and circumstances” analysis.

Reporter’s Comment. The “common law” forms a major part of the law of those countries of the world with a history as British colonies. In the United States, the common law includes extensive non-statutory law reflecting precedent derived from centuries of court decisions, both in the United States and England.

As stated recently by Lori Richards, the Securities and Exchange Commission's Director of the Office of Compliance, Inspections and Examinations, “[A]ll advisory firms, whatever their size, type or history in the business, owe their advisory clients a fiduciary duty, [a duty which] is the first principle of the investment adviser because the duty comes not from the SEC or another regulator, but from common law.” [Speech by Lori A. Richards, Director, OCIE, SEC, at the Eight Annual Investment Adviser Compliance Summit, Washington, DC, February 27, 2006.]

The common law may impose fiduciary duties not just upon registered investment advisers and their representatives, but also in certain circumstances upon financial planners practicing as registered representatives. See *Merrill Lynch v. Boeck*, 127 Wis. 2d 127, 136, 377 N.W.2d 605 (1985) (“A fiduciary relationship arises from a formal commitment to act for the benefit of another . . . or from special circumstances from which the law will assume an obligation to act for another’s benefit.”).

It is important for financial planners to be aware that, regardless of the statutory scheme under which they may be regulated, they may be fiduciaries to some or many or nearly all of their individual clients under the common law. Through additional research undertaken in March and April 2007, several cases have been found which appear to impose fiduciary duties upon financial planners, applying the common law. These cases, which do not rely upon the Investment Advisers Act of 1940, will be examined by another FPA Task Force. The cases which will be reviewed include: *U.S. v. Williams*, 441 F.3d 716, 724 (9th Cir. 2006); *Hatleberg v. Norwest Bank*, 283 Wis.2d 234, 700 N.W.2d 15, 25 (WI, 2005); *Johnson v. John Hancock Funds*, No. M2005 00356 COA R3 CV (Tenn. App. 6/30/2006) (Tenn. App., 2006); *Koehler v. Pulvers*, 614 F. Supp. 829 (USDC, Cal, 1985); *Cunningham vs. PLI Life Insurance Company*, 42 F.Supp.2d 872, 888-889 (1990); *Sergeants Benevolent Assn. Annuity Fund v. Renck*, 4430 (NY 6/2/2005) (NY, 2005); and *Fraternity Fund v. Beacon Hill Asset*, 376 F.Supp.2d 385 (S.D.N.Y., 2005). Moreover, federal securities law does not appear to preempt state common law which may apply fiduciary status upon certain financial planner – client relationships. *French v. First Union Securities, Inc.*, 209 F.Supp.2d 818, 829 (M.D. Tenn., 2002).

E. There are many factors which may tend to apply common law fiduciary status upon a registered representative. Applying these factors, fiduciary status is found by a court or arbitrator treating the account as “discretionary” in situations where “practical control” over the account has been assumed by the registered representative. These factors include:

- 1. Whether the role of the advisor (registered representative) is one which the consumer would recognize as one to which a fiduciary relationship with the client does not normally attach (such as involving the sale of life insurance, or a banker-customer relationship discussing a bank depository product). In other words, what is the consumer’s reasonable expectation of the role of the financial intermediary?**
- 2. Whether the registered representative holds himself/herself out as an “expert” with regard to the subject matter upon which advice is given.**

- 3. The degree of knowledge, sophistication and experience possessed by the advisor, relative to that of the customer, with regard to the subject matter upon which advice is given, including consideration of the following specific facts: (a) whether there is dependence and inequality based on weakness of age or mental strength; (b) whether there is lack of “intelligence” or “business intelligence” by the customer with respect to the subject matter; (c) whether the customer possesses a lack of education or possesses inferior knowledge as to the material facts surrounding the advice given; (d) the frequency of contact between the registered representative and the customer, as well as the existence of social contacts; and (e) whether other circumstances exist which provide an advantage to one side over the other.**

- 4. The nature of the relationship as “discrete” or “episodic” versus “continuous.”**

Reporter’s Comment. “It may seem curious, but it is common for fiduciaries to be unaware of their fiduciary status, let alone their responsibilities associated with that status.” - Tim Hatton, CFP, CIMA, AIF.

Registered Representatives Do Not Normally Possess A Blanket Fiduciary Duty To Their Customers, But Certain Quasi-Fiduciary Duties Exist. While the Securities and Exchange Act of 1934 has not been held to impose upon broker-dealers and their registered representatives broad or “blanket” fiduciary duties with respect to their customers as to non-discretionary accounts, over the years the Exchange Act’s requirements have been interpreted to impose certain limited or “quasi-fiduciary” duties. These include: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis; (2) the duty to carry out the customer’s orders promptly in a manner best suited to serve the customer’s interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security; (5) the duty not to misrepresent any fact material to the transaction; and (6) the duty to transact business only after receiving prior authorization from the customer. For additional information regarding the duties of broker-dealer firms and their registered representatives, please refer to Appendix B.

However, The Application of a “Facts and Circumstances” Test May Apply a Broad Fiduciary Duty Upon Registered Representatives With Respect To Certain Relationships. The “trap for the unwary” is the extent to which financial planners (other than registered investment advisers and their representatives, and those covered by ERISA or other statutes which expressly impose fiduciary duties or status as a fiduciary) are deemed fiduciaries under the common law. Fiduciary status is determined under the common law by a “facts and circumstances” test specific to each situation. See Donald B. Trone, William R. Allbright, and Philip R. Taylor, *The Management of Investment Decisions* (McGraw Hill, 1997), at p. 22. “Generally speaking, the nature of a broker-dealer’s fiduciary duties to clients, including the duty of care and loyalty, depends on the facts and circumstances of the broker-customer relationship. In this regard, courts which have found broker-dealers to be acting as fiduciaries have recognized that ‘The nature of the fiduciary duty owed will vary, depending on the relationship between the broker

and the investor. Such determination is necessarily particularly fact-based.” [From the legal memorandum included as Appendix B.]

Practical Control Over A Brokerage Account Leads To Finding of Discretion. In determining whether a fiduciary relationship has arisen in the context of a registered representative-customer relationship, as to whether “practical control” of a customer’s account may exist (transforming a non-discretionary account brokerage account into a discretionary one governed by fiduciary standards), the courts consider a variety of factors, including whether there is dependence and inequality based on weakness of age or mental strength, lack of education, lack of intelligence or business intelligence, lack of investment experience, inferior knowledge of facts involved, whether any transactions occurred without the customer’s prior approval, the frequency with which the broker and customer speak regarding the status of the account, the existence of any social or personal involvement between the broker and the customer, or other conditions giving one side an advantage over the other. *See Prod. Credit Ass’n of Lancaster v. Croft*, 143 Wis. 2d 746, 755-56, 423 N.W.2d 544 (Ct. App. 1988), *see also Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 461 F.Supp. 951 (E.D. Mich. 1978). For example, the leading Massachusetts case on the question of whether a fiduciary duty has arisen between a stockbroker and his or her client is *Patsos v. First Albany Corp.*, 433 Mass. 323, 741 N.E.2d 841 (2001). In *Patsos*, the Massachusetts Supreme Judicial Court recognized that the relationship between a stockbroker and a customer may be either a fiduciary one or an ordinary business one, and the court enumerated a number of factual considerations that can determine whether a fiduciary duty has arisen between a stockbroker and a customer. As a preliminary matter, the Supreme Judicial Court noted that “the scope of a stockbroker’s fiduciary duties in a particular case is a factual issue that turns on the manner in which investment decisions have been reached and transactions executed for the account.” *Id.* at 433 Mass. 332, 741 N.E.2d at 849 (citations omitted.) Under *Patsos*, the “degree of discretion a customer entrusts to his broker,” *id.* at 333, 741 N.E.2d at 849, is a principal consideration. In analyzing the extent to which a customer has entrusted “discretion” to his or her stockbroker, *Patsos* notes that trading without the customer’s prior approval suggests an account is discretionary while frequent communications between the customer and the stockbroker about the “prudence” of certain investments suggests that the customer has retained control of the account. *Id.* at 334, 741 N.E.2d at 850. Further, *Patsos* instructs that a fact finder may consider as evidence of a discretionary account whether “a broker has acted as an investment advisor, and particularly if the customer has almost invariably followed the broker’s advice” *Id.* Beyond the question of discretion or control, *Patsos* notes that a “customer’s lack of investment acumen may be an important consideration, where other factors are present” especially when “the broker holds himself out as an expert in a field in which the customer is unsophisticated.” *Patsos* at 334-335, 850-851. Under *Patsos*, whether a stockbroker obtained prior approval is a consideration. But, as noted, *Patsos* also instructs that when the “broker has acted as an investment advisor, and particularly if the customer has almost invariably followed the broker’s advice, the fact finder may consider this as evidence that the relationship is discretionary.” *Id.* at 433, 741 N.E.2d at 850.

F. Insurance agents are deemed under a general agency analysis to bear fiduciary duties to the insurance companies they represent. Insurance agents generally are not deemed to owe fiduciary duties to their customers – unless the facts and circumstances of the individual relationship dictate otherwise.

Reporter's Comment. The general rule is that an insurance agent is not a fiduciary to his or her customer. This general rule may not apply when the insurance agent functions in a capacity other than as an order taker for the insurance company and develops a "special relationship" with the customer. As set forth in the legal memorandum attached hereto as Appendix C:

"in determining that a fiduciary relationship may have existed between a customer and her insurance agent, the court cited factors including the customer's age, lack of education, physical disabilities and lack of sophistication in financial matters; the length and nature of the relationship between the customer and the agent; and the agent's superior knowledge of financial matters"; and

"courts may also look to specific actions or events in the course of dealing between the parties to help determine whether fiduciary duties should attach to a customer relationship. The presence or absence of certain events or interactions between the parties at the inception of the relationship, or in the early stages of a long-term relationship, may be instructive as to the relative positions of strength held by the parties"; and

"courts have held that relationships giving rise to fiduciary duties could exist where, for example, a customer requests that an insurance agent evaluate the customer's options and recommend products suited to the customer's needs, and then relies on the guidance received from the agent in response."

However, the legal memorandum contained in Appendix C also notes that it "is generally not sufficient for a customer merely to believe that he can trust or confide in the agent, or to simply rely on, or pay for, the specialized skill or experience of the agent. Rather, there must typically be some evidence of the insurance agent's acceptance of the customer's trust and confidence and attaining a position of influence or control over the customer."

G. Insurance brokers are generally fiduciaries to their customers under the common law.

Reporter's Comment. As stated in the legal memorandum attached as Appendix C: "An insurance broker ... serves as the agent of his customer, acting in the customer's stead in soliciting, negotiating or otherwise obtaining insurance products best suited to the customer's needs. Therefore, while insurance agents typically bear common-law fiduciary duties to insurance companies, and do not bear such duties to customers unless a 'special' or 'confidential' relationship is present, insurance brokers bear general common-law fiduciary duties to their customers and do not bear such general duties to insurance companies."

H. Financial planners' status as fiduciaries or non-fiduciaries varies under the common law of the various states.

Reporter's Comment. As stated in the legal memorandum attached as Appendix C:

“[A]t least one jurisdiction has stated categorically that ‘[f]inancial planners . . . owe a fiduciary duty to their customers’ ”; and

“Even jurisdictions that have not adopted a bright-line rule regarding the application of common-law fiduciary duties to financial planners have nonetheless given strong indications that holding oneself out as a financial planner may expose one to fiduciary obligations”; and

Other “jurisdictions decline to hold that a relationship between a financial planner and a client is fiduciary in nature absent a finding that one party actually places trust or confidence in the other, and that a disparity of position and influence exists between the parties.”

I. Not everyone who renders “financial advice,” as that term is broadly utilized, is in fact a fiduciary. For example, in most instances a banker, insurance agent and registered representative (not acting as a dual registrant subject to the Investment Advisers Act of 1940) are not fiduciaries.

Reporter’s Comment. Not everyone who renders “financial advice” (as that term is very broadly defined) is in fact a fiduciary. Bankers, for example, enter into arm’s-length transactions with their customers and, along the way, they often give advice. And insurance agents, who sell insurance policies, may offer their customers help with loss control. Yet in each case their customers recognize that the underlying business relationship is not one where the advisors are expected to hold their customer’s interests above their own (absent additional facts or circumstances indicating the contrary). Hence, a significant factor in determining fiduciary status under the common law is the consumer’s reasonable expectation as to the role of the financial intermediary.

J. A financial planner could be found under the common law to be a fiduciary to one particular client without necessarily being a fiduciary for other clients, even though she or he may be performing similar services for each client.

Reporter’s Comment. A financial planner advising an elderly, unsophisticated individual client is more likely to be found to be a fiduciary under the common law than a financial planner providing advice to a sophisticated and wealthy individual client. Additionally, the financial planner may only represent to one or more of his or her clients that he or she is providing specialized or expert services. The “facts and circumstances” test is generally applied to each separate financial planner – client relationship to determine if the financial planner’s status has arisen to that of a fiduciary under the common law.

K. When fiduciary status is imposed, it is imposed by law.

Reporter’s Comment. The law plays a crucial role in the establishment of fiduciary status for a financial planner. To a substantial extent, the law (whether it be statutory law or common law) rather than the parties (and the terms of their contract) determines the entry and exit from the status of the financial planner as a fiduciary. In other words, once the financial planner establishes a relationship with a client, the relationship’s classification as either “fiduciary” or

“arms-length” and its legal consequences are primarily determined by law rather than by the parties.

The greater the knowledge, experience and required degree of expertise of the fiduciary, relative to the knowledge and experience of the client, the more significant the fiduciary association becomes as a protector of the client's interest. For example, clients in receipt of financial planning services will nearly always start off, in their discussions with financial planners, from a position of contractual weakness and, as to the complexities of tax law, financial planning issues, estate planning issues, insurance, risk management issues, and investments, from the position of relative ignorance. Such lack of knowledge results in the consumer being unable to protect himself or herself from the action of the expert advisor without significant agency costs (such as might arise from the engagement of a second expert to monitor the activities of the first expert). The fiduciary duty to act in the best interests of another is thereby imposed by the law upon the party with the greater knowledge and expertise in recognition by the law that the client is in need of protection and care and as a means of reducing agency costs.

Certain statutory laws impose fiduciary status upon the financial planner and in such instances fiduciary status is not waivable by the client. For example, Section 215(a) of the Investment Advisers Act of 1940 provides: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation or order thereunder shall be void." Hence, for financial planners whose activities are governed by the Investment Advisers Act of 1940, the fiduciary status of the financial planner cannot be waived by the client.

L. The parties may contract for fiduciary status to be imposed upon the financial planner.

Reporter's Comment. It is self-evident that if the financial planner enters into a contract with the client under which the financial planner promises to be a fiduciary, the financial planner can be held to that adopted standard of conduct, even in circumstances in which statutory or common law would not impose a fiduciary standard of conduct.

M. There exist various general definitions of the word “fiduciary.” Nonetheless, there is general consensus that "fiduciary" means a person who is in a relationship of trust and confidence with a client and who owes the client broad duties of due care, utmost good faith, and loyalty.

Reporter's Comment.

2006 Speech by Lori Richards. In a speech entitled "Fiduciary Duty: Return to First Principles" at the Eighth Annual Investment Adviser Compliance Summit, Washington, D.C., February 27, 2006, Lori A. Richards, the SEC's Director of Office of Compliance Inspections and Examinations, stated: "I would suggest that an adviser, as that trustworthy fiduciary, has five major responsibilities when it comes to clients. They are:

- to put clients' interests first;
- to act with utmost good faith;
- to provide full and fair disclosure of all material facts;

- not to mislead clients; and
- to expose all conflicts of interest to clients.”

Investment Adviser Association. A similar definition of fiduciary or description of fiduciary status and its major responsibilities can be found in the Investment Adviser Association’s definition, found in its “Standards Of Practice” (as amended February 28, 2006): “An investment adviser stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients. As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients. The parameters of an investment adviser’s duty depend on the scope of the advisory relationship and generally include:

- (1) the duty at all times to place the interests of clients first;
- (2) the duty to have a reasonable basis for its investment advice;
- (3) the duty to seek best execution for client securities transactions where the adviser directs such transactions;
- (4) the duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines and restrictions;
- (5) the duty to treat clients fairly;
- (6) the duty to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest; and
- (7) the duty to respect the confidentiality of client information.”

N. Neither the holding of custody of client securities nor the authority to exercise discretion with regard to the trading of a client’s securities is essential to finding that a fiduciary relationship exists under either statutory or common law.

Reporter’s Comment. While early fiduciary relationships were marked generally by the entrusting of one’s property to another, such as in the instance of a trustee and a beneficiary, the law has clearly evolved to impose fiduciary status in situations in which expert or specialized advice is rendered. One clear example of this situation involves the fiduciary duty an attorney-at-law possesses to his or her client.

The 20th Century brought an enormous explosion of specialization in the area of services providers. Specialization is important because it maximizes the benefits from labor. Specialization is also important because, with the dramatic growth of available knowledge, it has become increasingly difficult for any individual to be proficient – or even competent – in all fields. Relations that stem from specialization are often classified as fiduciary because they pose the problem of abuse of power.

O. Evidence from recent surveys of consumers reveals that:

1. The majority of individual investors do not understand the distinctions between registered representatives, investment advisers, and financial planners.

2. The majority of individual investors do not understand the distinctions in legal responsibilities which different financial services providers may possess with respect to their customer or client.

3. Most investors do not understand the concept of “fiduciary duty,” although they do desire that the same investor protection rules be applied when the same financial services are provided.

Reporter’s Comment. It is clear from recent studies of consumers of financial services that consumers do not understand either the differences between the types of financial services providers nor the different legal standards to which each is generally held.

TD Waterhouse 2004 Survey. In 2004 TD Waterhouse released the results of its survey, conducted by research firm Penn, Schoen & Berland Associates, which indicated:

- 58% of investors incorrectly believe that both stockbrokers and investment advisors have a fiduciary responsibility to act in the investor's best interest in all aspects of the financial relationship.
- 63% of investors incorrectly believe that both stockbrokers and investment advisors are required to disclose all conflicts of interest prior to providing financial advice.
- 85% of investors expect all financial professionals offering fee-based financial advice to provide these protections.
- 86% of investors indicated that their choice of financial professional would be impacted if they understood the different levels of investor protection from stockbrokers and investment advisors offering the same fee-based advisory services.
- When asked about a solution to unequal regulation, 90% of those surveyed expressed support for Congress to enact legislation that creates a clear, uniform standard of investor protection for all stockbrokers and investment advisors who provide investors fee-based financial advice.

Zero Alpha Group / Consumer Federation of America Study. In 2004 the Zero Alpha Group and the Consumer Federation of America released their survey, which was conducted by Opinion Research Corporation (ORC). Key findings from this survey included:

- Nine out of 10 investors (91 percent) believe that the same investor protection rules should apply to both stockbrokers and financial planners when they offer the same kind of investment advice services.
- Two-thirds of investors (65 percent) say they would be much less (36 percent) or somewhat less (28 percent) likely to use a stockbroker providing investment advice if that individual is subject to weaker investor protection rules than a financial planner.

- Greater than a majority of study participants believed “financial advice” was either the primary service of a stockbroker or an equally important service (relative to executing transactions).

The many specific questions and answers contained in the ZAG/CFA survey verified that most individual investors do not know the differences between types of financial services advisers, that individual investors expect to be able to rely upon the recommendations they receive, and that most investors possess a fundamental belief that if financial services industry participants provide the same services then investors should be provided the same protections.

CFP Board's Reference To Wall Street Journal Article and Study. In its Feb. 6, 2005 comment letter to the Securities and Exchange Commission regarding the broker-dealer fee-based accounts exclusion from the Investment Advisers Act of 1940, the CFP Board of Standards, Inc. noted:

[T]he difference [is] between a broker governed by the '34 Act and an investment adviser governed by the '40 Act. Because many investors do not understand the differences between these service providers, they do not understand the different legal standards to which each is generally held. The public doesn't understand the differences between brokers and investment advisers. This point was made vividly in a study just released and reported in the February 2, 2005, edition of *The Wall Street Journal*. The study surveyed wealthy investors—presumably a generally more sophisticated group than average investors. These investors were asked about their levels of satisfaction and trust with their investment ‘advisers.’ The key point of the study for purposes of this rulemaking is this: brokers were included, along with investment advisers and financial planners, in the group considered to be ‘advisers’ to these clients. Thus, neither the surveying company nor the surveyed investors seemed to understand the difference between the investment advising standards applied to brokers and those applied to investment advisers. If this group does not understand the difference, it is easy to imagine how much greater this misunderstanding is among investors generally ... To remedy this situation the Commission would need to require brokers to explain what a broker is. Instead the Commission simply proposes that brokers explain that they are brokers, not investment advisers. This does not address the problem, particularly because brokers can confuse matters more by describing themselves with additional terms with advice-giving connotations. Individuals who go to brokers almost always know they are going to a broker; they simply don't realize they don't understand what that means—and doesn't mean. So having a broker say ‘I'm a broker’ adds nothing to the individual's understanding, and may be undercut by the broker's added descriptions of services that sound, or are, advisory. To be helpful the broker needs to explain not just that he/she is a broker and not an investment adviser, but that this means he/she is held to a different legal standard under which he/she may advise the customer to buy a stock, even if the broker knows that it

is not the best choice for the customer, as long as the stock is a ‘suitable’ selection.

SEC 2005 Focus Group. In connection with its consideration of the rule relating to fee-based brokerage accounts, the U.S. Securities and Exchange Commission commissioned a study to examine how investors differentiate the roles, legal obligations, and compensation among several types of financial services professionals, which resulted in the report, “Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures, Report to the Securities and Exchange Commission,” Siegel & Gale, LLC, Gelb Consulting Group, Inc. (Mar. 10, 2005). The FPA[®] Fiduciary Task Force notes the following key observations from this report:

- Both of the focus groups convened were uncertain about the distinctions between the types of financial services professionals, although these types were identified by the study participants were brokers, financial advisors/financial consultants, investment advisers, and financial planners.
- Universally the study participants indicated that the terms “fiduciary” and “legal obligations” were not meaningful to them.
- The participants thought that brokers provided most types of financial services, including investment advice.
- As to disclosures, the study participants desired “plain English” language, a short and simple explanation of the actual differences between brokerage and advisory accounts, and that any disclosure language be in bold and red ink.

TD AMERITRADE Investor Perception Study 2006. TD AMERITRADE Institutional commissioned a survey of 1,000 U.S. investors as a follow-up to the firm’s 2004 survey. The purpose of the new survey was to gauge whether new disclosure rules have had an impact on investors’ awareness of the differences in investment advice and the protections associated with stockbrokers and Registered Investment Advisors (RIAs). The study showed that 43 percent of investors responding were not aware that stockbrokers and investment advisors offering fee-based advice provide different levels of investor protection (compared to 41 percent in 2004). Moreover, 66% did not believe that the SEC disclosure requirement for fee-based accounts sufficiently informs clients of the level of protection provided to them by brokerage firms. The study also found that 54% of the participants believed that both stockbrokers and investment advisors have a fiduciary responsibility to act in investors’ best interests in all aspects of the financial relationship; just 26% of investors knew that only investment advisors provide this protection. If investors knew that stockbrokers were not required to act in their best interest in all areas of the financial relationship, 70% would not use them.

P. Disclosure and informed consent, when a financial planner desires to change from the role of acting in the client’s best interests to an arms-length transaction with his or her customer, is not adequate for the majority of consumers of financial services and products.

Reporter's Comment. The FPA[®] Fiduciary Task Force explored the effectiveness of disclosure as a means of securing informed consent by a consumer of financial services, when a change from a fiduciary relationship to an arms-length relationship occurs. Given the importance of this issue, extensive discussion and background materials follow.

The FPA[®] Fiduciary Task Force doubts the adequacy of disclosure and/or the adequacy of informed consent by the client, when a financial planner seeks to implement a financial plan in a non-fiduciary role.

- Several members of the FPA[®] Fiduciary Task Force noted that financial planners, investment advisers, and registered representatives are trained to establish close relationships based upon trust and confidence.
 - As one member of the FPA[®] Fiduciary Task Force noted, he has been trained by a wealth management coach to engage a prospective client for several hours of discussions involving the client's personal history, close family relationship, feelings about finances and money, lifetime financial goals, and personal interests. This discussion occurs before any presentation of either advisory services or investment products. Hence, a close and confidential relationship based upon trust is often established with the client prior to the presentation of any written fee agreement.
 - Various books and instructional programs teach financial services providers in these or similar techniques, both in smaller firms and in larger firms.
 - As the FPA Regulation Task Force noted in its June 12, 2006 report, "The marketing and advertising of ... financial conglomerates has steadily shifted to emphasize a relationship based on trust" *Id.* at p.30.
 - "A recent study by Russ Alan Prince and Brett Van Bortel shows clients leave their advisors most of the time because they are unhappy with the service they received (87 percent), not because they are unhappy with the investment returns (13 percent). Research also tells us that advisors who do grasp the enormous importance of building solid client relationships are among the most successful ones in our industry. In fact, advisors who make it a priority to expand their relationships with their clients earn significantly higher incomes than those who do not." Practice consultant John J. Bowen, Jr. of CEG Worldwide, Inc., "Touch and Grow," *Financial Planning* magazine, November 2003.
- "As a general rule, RRs [registered representatives] and their clients are separated by a wide gap of knowledge – knowledge of the technical and financial management aspects of investing. The pace of product innovation in the securities industry has only widened this gap. It is a rare client who truly understands the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many. This knowledge gap

represents a potential source of client abuse, since uninformed investors have no basis for evaluating the merits of the advice they are given.” [Report of the Committee on Compensation Practices (April 10, 1995), also called the "Tully Report," at p. 15.]

- Given the lack of knowledge by many clients of financial planners of even basic concepts (“bond,” “mutual fund,” etc.), it is difficult to imagine any scheme of disclosure which would result in understanding of the complex issues regarding the differing standards of conduct and the details of the financial product, in order that adequate understanding and informed consent by the client could occur.
 - Current disclosures are wholly inadequate to convey the distinctions in the legal standards which apply and the additional facts which consumers should know.
 - When one member of the FPA[®] Fiduciary Task Force attempted to craft a “plain English” disclosure which might be adequate to explain the distinctions in the legal relationships which had governed the parties (under the “bests interests” standard) and a new standard (“arms-length transaction” as modified by “suitability” as to risks), the disclosure document became two pages long. And this document did not include any disclosures relating to any specific investment product.
- Even if a disclosure could be written which would convey all of the information required to enable a smart consumer to provide informed consent, the adequacy of disclosure would still be highly suspect. This is because studies of consumers have revealed that many disclosures of information under current securities law are not even looked at. Moreover, seldom does a consumer subject written disclosures to the high degree of scrutiny which such disclosures deserve.

Arms-Length vs. Fiduciary Relationship. A further understanding of this important finding begins with a description of the two types of relationships between service providers and their customers or clients which are recognized under the common law. In an arms-length relationship no broad fiduciary duty of loyalty is deemed to exist, although there is often implied by law an obligation of good faith. [Additionally, laws may modify to a degree the arms-length relationship through the imposition of certain quasi-fiduciary, or limited, duties (such as the duty of suitability imposed upon registered representatives when undertaking investment product recommendations to clients)]. The other type of relationship is the fiduciary relationship between an advisor and client, in which the advisor is legally required to place the interests of the client before her, his or its own.

Recent Presentation By Law Firm To Broker-Dealer Community. The FPA[®] Fiduciary Task Force notes this language from a September 2006 report presented at a broker-dealer compliance conference relating to fee-based accounts: “Even with clear disclosures and a course of dealing consistent with a broker-dealer acting as ‘adviser’ during the financial planning phase but a ‘broker’ during implementation, the relationship between the customer and the broker-dealer could easily be misunderstood, and may be undermined if the conduct of a registered

representative or other broker-dealer employee suggests, perhaps inadvertently, the continuation of an advisory relationship.” Georgia Bullitt and Steven W. Stone, of Morgan, Lewis & Bockius LLP, “*Fee-based Accounts Rule Forum, How Firms Are Adapting To The Rule And A Look Towards The Future*,” Securities Industry Association, September 21, 2006, New York, NY.

Restatement (Third) of Agency. The Restatement provides in pertinent part:

§ 8.06 Principal's Consent

(1) Conduct by an agent that would otherwise constitute a breach of duty as stated in §§ 8.01, 8.02, 8.03, 8.04, and 8.05 does not constitute a breach of duty if the principal consents to the conduct, *provided that*

(a) in obtaining the *principal's consent*, the agent

(i) acts in good faith,

(ii) *discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and*

(iii) otherwise deals fairly with the principal; and

(b) the principal's consent concerns either a *specific act or transaction*, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship.

[*Emphasis added.*]

Hence, under the law of agency, the principal’s consent to an action by an agent which would otherwise constitute a breach of the agent’s duties is only valid if the agent “discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment.” For example, in the context of implementation of a financial plan, if the agent desires to implement the plan in a manner which is not in the best interests of the financial planning client, there would need to be sufficient adequate disclosure of all material facts, including the differing standards of conduct applicable to the relationships, for the principal’s judgment to be adequately informed. Given the complexity of the securities markets and other factors, the FPA[®] Fiduciary Task Force is highly doubtful such disclosure would be adequate, for the reasons stated in this section.

SEC Discussion, Principal Transactions. In SEC Release No. IA-1732, the Securities and Exchange Commission imposed, prior to engaging in a principal transaction by a broker-dealer with its investment advisory client, several requirements:

- (1) Written disclosure of the capacity in which the adviser is acting;
- (2) Written disclosure of the terms of the transaction sufficient to enable the client to make an informed decision prior to providing consent;
- (3) Disclosure of facts which are necessary to alert the client to the adviser’s potential conflicts of interest;
- (4) Consent by the client to the proposed transaction;
- (5) That the broker-dealer ensure that the client understands that the client is under no obligation to consent to the transaction; and
- (6) Consent is provided by the client prior to the completion of the transaction.

As this SEC Release demonstrates, disclosure must be sufficient for informed consent to be given by the client to the transaction, if the client desires to provide such consent.

The “Economic Costs” Argument Behind Imposition of Fiduciary Status. Law, not the contract between the parties, imposes fiduciary status upon the fiduciary. One theory to explain why persons exercising such power and influence ought to be so burdened with a fiduciary duty of loyalty is that it promotes economic efficiency. Typically, the fiduciary in this instance is a professional with a high degree of knowledge associated with her or his specialty. Specialization of function forces others – the clients – to rely upon the fiduciary advisor. Moreover, the client is ordinarily not able to properly assess the fiduciary’s recommendations and actions, at least not without the significant cost involved in identifying and engaging a third party overseer. Hence, the fiduciary standard is applied to minimize the transaction costs of regulating specialized exchanges. Fiduciary status is designed to prevent the fiduciary advisor from utilizing his or her superior knowledge and skill in a self-interested fashion and at the expense of the client’s best interests. As a result, the fiduciary’s duty of loyalty requires the fiduciary to follow the course of conduct the beneficiary would have chosen if the beneficiary had either the same expertise as the fiduciary or had consulted another fiduciary.

Two Opposing Academic Views As to Fiduciary Duties as “Default Rules.” Despite the fact that fiduciary status is normally imposed by law, not by contractual terms between the parties, there exist two contradictory views in the academic legal community as to the ability of fiduciaries to obtain consent from a client to switch to a non-fiduciary role or to otherwise act in a manner which may not be in the client’s best interests.

Under one of these views fiduciaries are permitted to engage in conduct which would otherwise arise to become a breach of the fiduciary duty of loyalty provided that: (1) the fiduciary undertakes full disclosure of the arrangement and material facts thereto to the client; and (2) the principal (client) provides informed and adequate consent. Under this view fiduciary duties are “contract default terms” that the parties should be free to modify. This view has been applied, to some degree, to the relationships between shareholders and corporate management (through management suggesting changes to the corporate charter, and shareholders approving of such changes). This view has also been applied in trust law, in which the trust document may, by its terms and at its formation, modify a trustee’s duties of due care or loyalty.

Under the opposite view, fiduciary duties are not “default rules” which may be waived by the client of the fiduciary. Rather, fiduciary duties, where they apply, trump the terms of any attempted contract between the parties. The rationale behind this view partly rests in the fact that fiduciary duties reduce the cost of contracting precisely because there is a common consensus about the meaning and scope of the core fiduciary principles. Under this view fiduciary law is a public good, and erosion of fiduciary standards would reduce the value of that public good. It is argued that treating fiduciary duties as freely modifiable by contract will, by introducing uncertainty into fiduciary law, increase the costs of contracting and litigation for all, and will consequently devalue beneficiaries’ interests by increasing agency costs. Professor Tamar Frankel, for decades the leading legal scholar on fiduciary law, adopts this view, stating: “[T]he application of contract to business and financial relationships is irrational; it is grounded in ideology, anchored neither in theory nor in reality. More importantly, a stable financial system

requires the support of fiduciary law principles, judicial enforcement, and monitoring by independent regulatory agencies. The contract model is suitable for simultaneous exchanges among few parties with respect to easily verifiable subject matters. Such transactions usually do not benefit, and do not pose the risks, from trusting. This type of contract model is not suitable to dependent relationships based on future promises and information that is difficult to verify. The model is also not suitable to institutional and social organizations, such as corporations, and institutions that form the financial system. In these contexts trusting is crucial and benefits all parties, while mistrust is corrosive, and disadvantages all.” Tamar Frankel, “Trusting and Non-trusting: Comparing Benefits, Cost and Risk,” Boston University School of Law, Working Paper Series, Law & Economics, Working Paper No. 99-12, at pp.3-4.

Judicial View. It should be noted that most state judges treat fiduciary duties as sacrosanct and recoil from any attempt to loosen them. Benjamin Cardozo immortalized that reverence in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928), with his famous purple prose: “Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior [for fiduciaries]. ... Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. ... [This standard for fiduciaries] will not consciously be lowered by any judgment of this court.”

The Focus Should Be On Whether Consent Can Be Informed and Adequate. Whether fiduciary duties are modifiable (or waivable) by the principal (customer) is an issue the resolution of which would appear to vary with the situation presented to which fiduciary law should be applied. For example, a waiver by a grantor (trustmaker) of a trust of certain of a trustee’s fiduciary duties (such as relieving the trustee with an obligation to diversify trust holdings) may be wholly appropriate, especially since in most instances the grantor (trustmaker) is assisted by legal counsel. In other fiduciary situations, such as a when a guardian is charged with the protection of a ward, the ward’s consent to an action which would otherwise be a violation of the guardian’s duty to the ward would be highly suspect in most instances.

In the setting of a financial services relationship between the financial planner and his or her client, it should be asked: (a) whether there can exist adequate disclosure of the change of relationship from a fiduciary financial planning role to a non-fiduciary implementation role and the resulting change in legal standards applicable to the financial planner; and (b) whether there would likely exist an adequate understanding of that disclosure by the consumer of financial services and hence, whether informed consent would exist.

GAO Report. A 2004 report by the General Accounting Office states in pertinent part: “Generally, the United States relies on markets to promote the efficient allocation of capital throughout the economy so as to best fund the activities of households, business, and government. Financial services are subject to oversight for several reasons that relate to the inability of the market to ensure that the efficient allocation of capital will take place. Essentially, markets cannot ensure that certain kinds of misconduct, including fraud and abuse or market manipulation, will not occur and that consumers/investors will have adequate information to discipline institutions with regard to the amount of risk they take on ... In general, regulators help protect consumers/investors who may not have the information or expertise necessary to

protect themselves from fraud and other deceptive practices, such as predatory lending or insider trading, and that the marketplace may not necessarily provide. Through monitoring activities, examinations, and inspections, regulators oversee the conduct of institutions in an effort to ensure that they do not engage in fraudulent activity and do provide consumers/investors with the information they need to make appropriate decisions of financial institutions in the marketplace. *However, in some areas providing information through disclosure and assuring compliance with laws are still not adequate to allow consumers/investors to influence firm behavior.*" GAO-05-61, "Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure," Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, October 2004.

The Understanding by U.S. Consumers of Financial Planning and Investment Concepts. Even if we were to assume that the individual consumer could overcome the various behavioral biases and impediments to providing informed consent with respect to a change from fiduciary status to non-fiduciary status by his or her financial planner, the vast majority of individual investors do not possess the knowledge to protect themselves. As evidence of the tremendous difficulty consumers of financial services possess in understanding financial planning concepts, and the difficulty in making good decisions even when handed knowledge of investment products, see James J. Choi, David Laibson, Brigitte C. Madrian, "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds." The abstract for this article states: "We report experimental results that shed light on the demand for high-fee mutual funds. Wharton MBA and Harvard College students allocate \$10,000 across four S&P 500 index funds. Subjects are randomized among three information conditions: prospectuses only (control), summary statement of fees and prospectuses, or summary statement of returns since inception and prospectuses. Subjects are randomly selected to be paid for their subsequent portfolio performance. Because payments are made by the experimenters, services like financial advice are unbundled from portfolio returns. Despite this unbundling, subjects overwhelmingly fail to minimize index fund fees. In the control group, over 95% of subjects do not minimize fees. When fees are made salient, fees fall, but 85% of subjects still do not minimize fees. When returns since inception (an irrelevant statistic) are made salient, subjects chase these returns. Interestingly, subjects who choose high-cost funds recognize that they may be making a mistake." This study confirms what every seasoned financial planner knows – that the vast majority of consumers of financial planning services lack the knowledge to undertake sound financial and investment decisions.

Lessons from Behavioral Science. Recent scholarship in behavioral law and economics reveals that behavioral biases substantially inhibit the ability of many individual investors to achieve sufficient knowledge through a disclosure regime. An extensive discussion of these behavioral biases is found in the January 26, 2007 memorandum of Ron A. Rhoades, Esq., "Lessons From Behavioral Science: The Effectiveness Of Disclosures Provided to Clients of Financial Intermediaries," set forth as Appendix F.

IFG Network Securities, Inc. The FPA[®] Fiduciary Task Force's research in this area to date has not revealed any definitive case law on this subject. However, in an administrative proceeding by the SEC, an SEC administrative law judge held that an IFG broker, who was also registered as an investment adviser, differentiated his roles as adviser and broker by being aware

of his fiduciary capacity in developing a financial plan for his customers and then disclosing the change in regulatory status when he offered load products to them, including the fact that in his role as a salesman, he held a self-interest. See *In the Matter of IFG Network Securities, Inc.*, Initial Decision Rel. No. 273 (Feb. 10, 2005), 84 SEC Docket 3287 (Feb. 10, 2005), before Carol Fox Foelak. However, this decision was overturned on appeal by the SEC's Division of Enforcement to the Commission, and a Commission opinion was rendered on July 11, 2006. See *In The Matter Of IFG Network Securities, Inc.*, 1934 Rel. No. 54127, IA Rel. No. 2533, Admin. Proc. File No. 3-11179. The Commission opinion does not address, however, the issue of conversion from an advisory relationship to a non-advisory relationship. Given the fact that the administrative law judge's decision was subsequently overturned, and the lack of discussion of the adequacy of informed consent both in the initial decision and in the Commission's opinion, the FPA[®] Fiduciary Task Force does not believe that this decision establishes any precedent in this area.

Safer v. Nelson Financial Group. A federal court last year considered, albeit indirectly, the issue of when does the advisory part of a financial planning relationship end and a brokerage relationship designed to implement the plan begin. In the investor's suit, *Safer v. Nelson Financial Group*, the Louisiana plaintiffs had entered into various agreements with Nelson, an independent RIA based in Ohio who was affiliated with a broker-dealer. The plaintiffs, who lost 50 percent of their portfolio value over a three-year period, argued the dispute involved the advisory agreement and should be tried in court, while Nelson countered that the claims involved brokerage services and should be submitted to arbitration. The investors responded that they had no problem with the trades, or implementation of the financial plan, but it was the advice, a methodology based on predicting stock market behavior by tracking birth rates, that was flawed. The Fifth Circuit Court of Appeals overturned a lower court decision, and held that the matter should be submitted to arbitration. The advisory agreement, the Appeals Court held, terminated upon delivery of the financial plan. "The district court found that the Advisory Agreement, which pertained to investment advice, was separate and distinct from the New Account Information Forms, which pertained to the execution of that advice. According to the district court, because the parties entered into two separate agreements for two separate services rendered, the arbitration clause found in the New Account Information Forms did not apply to disputes regarding the Advisory Agreement. The Advisory Agreement specifically states that it 'terminates upon the delivery of the Written Financial Plan.' Nelson allegedly provided the Safers with this written financial plan on the weekend of the investment seminar in June 100. Any allegations in the complaint relating to events occurring after April of 2000 (i.e., investments made through an affiliated broker-dealer), therefore, would not be covered by the terms of the Advisory Agreement. The Plaintiffs, however, clearly allege in their complaint that they were harmed by actions taken by the Defendants long after June 100." However, there is no significant discussion in the case as to the fiduciary duties which arise under the Investment Advisers Act of 1940 or the common law, the adequacy of disclosure and informed consent, and when and whether such fiduciary duties can be terminated. Given such, and the unique facts of the case (as to the facts which were pled by the plaintiff), this decision should not be relied upon as authoritatively addressing the issue of adequacy of informed consent.

The CFP Board of Standards Disclosure. The CFP Board of Standards, Inc. provides the following “CFP® Certificant Disclosure Form (Form OPS) For Use When Providing Other Professional Services”:

PART I. MATERIAL INFORMATION RELEVANT TO THE PROFESSIONAL RELATIONSHIP

(Disclosures required to be provided at the time of entering into a client relationship)
(Code reference - Rule 401)

- A. Material information relevant to the professional relationship:
- B. Conflict(s) of interest:
- C. Information required by all laws applicable to the relationship (e.g., if the CFP® certificant is a registered investment adviser, the disclosure document required by laws applicable to such registration):

PART II. SUBSEQUENT DISCLOSURES

(Disclosures required to be provided subsequent to entering into a client relationship)
Changes in any of the following information since entering into a client relationship:
(Code reference - Rule 401)

- 1. Business affiliation:
- 2. Address:
- 3. Telephone number:
- 4. Credentials:
- 5. Qualifications:
- 6. Licenses:
- 7. Compensation structure:
- 8. Agency relationships:
- 9. Scope of the CFP® certificant’s authority in any agency relationship:

I hereby acknowledge receipt of this required disclosure.

_____/_____
Client’s Signature Date Client’s Signature Date

The foregoing form of disclosure does not appear to be adequate to advise financial planners of the specific disclosures which may be required, such as a specific discussion of the distinctions between a relationship governed by a “best interests” standard of conduct vis-à-vis a relationship governed by “arms-length” negotiations. Financial planners are seldom trained sufficiently to complete such a form with the level of detail required to effect a disclosure of all material conflicts of interest and the necessary explanation of the differences in the legal standards governing the different relationships with the client. Moreover, even if a detailed disclosure regimen were to be formulated, the burden of the adequacy of the disclosure and ensuring its understanding by the customer still falls upon the financial intermediary undertaking the disclosure.

The Continuation of Financial Planning: Monitoring, References to The Financial Plan, Revisions to the Plan. The financial planning process, by necessity, will require frequent references back to the financial plan, monitoring of the financial plan, and possibly future revisions. This would lead to a “switching of hats,” over and over, if the financial plan information-gathering, development and presentation were subject to a fiduciary standard of conduct while implementation occurred under a lesser arms-length standard of conduct (as modified by specific prohibition under various federal and state laws). It would be difficult, if

not impossible, for an individual investor to discern when the advisor was acting in a fiduciary capacity or in a non-fiduciary capacity.

Given the intertwining of financial plan development and presentation with financial plan implementation activities and monitoring, the following additional conditions would be necessary if disclosure were to be deemed adequate and effective so as to enable informed consent by the customer:

- The compensation model adopted by the broker-dealer firm or insurance agent must not appear to the customer to be one in which continual advice is to be provided. Only transactions should be permitted in which discrete compensation is paid. Hence, the receipt of ongoing 12b-1 fees, broker-dealer fee-based account fees, and other continual forms of compensation would be inconsistent with arms-length transactions not involving the provision of continued advice.
- The disclosure of change of status (fiduciary vs. non-fiduciary status) must be clear and unequivocal each and every time such change of status occurs.
- Financial plan analysis and plan presentation must be kept totally separate and apart from implementation.
- The course of conduct of the broker-dealer firm and its employee must be consistent with its non-financial planner role. Even with clear disclosures and a course of dealing consistent with a firm acting as a “financial planner” during the financial planning analysis and preparation phase but a “broker” during implementation, the relationship between the customer and the broker-dealer could easily be misunderstood. If the conduct of a registered representative or other broker-dealer employee suggests, even inadvertently, the continuation of the financial planner relationship while brokerage services are being provided, then the broker-dealer and its registered representative could still be found to be a financial planner and fiduciary under the law as to the brokerage activities.

It is highly unlikely that all of these additional conditions could be met. As a practical matter, the implementation of a financial plan is likely to involve frequent references back to the financial plan and continued explanation of elements of the financial plan. Moreover, as the circumstances of the client or of the financial markets change, monitoring of the financial plan, which is a continuous activity, should occur, along with additional data gathering and modification to the financial plan as appropriate.

Conclusion. Given the inherent complexity of financial products and services, the necessity of continued explanation of and references back to the financial plan during implementation and following its presentation to the client, and the inherent limitations upon disclosure once a close and confidential relationship has been established (given the existence of behavioral bias of individual investors, which are often known by and taken advantage of by financial services intermediaries), it would be impractical to expect that consumers will understand any disclosures which may be presented to them with regard to a change from the “best interests” standard applicable to advisory relationships to the “buyer beware” standard

applicable to arms-length transactions. Hence, the availability of informed consent is highly suspect for the majority of consumers of financial planning services.

- Q. The current separate regulatory scheme for broker-dealers (and their registered representatives), registered investment advisers (and their representatives) and insurance companies (and their brokers and/or agents) lacks clarity with regard to its application to financial planners, is inappropriate for the regulation of financial planning services, and fails to adequately protect consumers of financial planning services.**

Reporter's Comment For additional information on the various regulatory schemes, please refer to FPA Regulation Task Force report and the legal memoranda attached hereto as Appendices A, B and C.

The FPA Regulation Task Force, in its June 12, 2006 "Recommendations on Future Regulation Of the Financial Planning Profession," previously addressed this issue, finding:

"If financial planners are to be eventually recognized as a separate, stand-alone profession, continued subset regulation as investment advisers, brokers, insurance agents, or in banking departments will hinder reaching that goal." (p.8.)

"The Task Force believes relying on current regulation of financial planners through subset regulation will not eventually lead to widespread public acceptance of financial planning as a profession until those who violate the standards or are otherwise unqualified are barred from the business. This, they believe, can be done only through changes to the law explicitly licensing planners and enforcing rules that lead to disbarment. Education in the marketplace of the value of financial planning, or by private, voluntary certification alone will not be enough to help the public recognize ethical, competent planners." (p.18.)

- R. A professional organization can serve several important purposes, including enhancing the reputation of a profession for fair and honest service by establishing standards for doing business and by disciplining those who do not abide by those standards.**
- S. Professional associations often may assume or be granted certain control regarding access to professional privileges and/or the use of certain titles or designations. In such instances proceedings relating to the admission, suspension and termination of membership in a profession must be rationally and consistently applied given the potential for judicial review.**
- T. An association's code of ethics or standards of practice does not give rise to an independent cause of action for negligence or malpractice, but it may be evidence of the appropriate standard of care to be followed by the association's member. Additionally, a professional code may be advantageous or disadvantageous to a professional in civil proceedings, as professionals may seek to have the code**

admitted as evidence that the professional has in fact complied with the applicable standard of care.

U. There should be a reasonable expectation among clients of professionals that the professional association's code of ethics or rules of conduct will be followed.

V. If a professional association's codes are not actually enforced, or are just aspirational in nature, the primary rationale for using the code as evidence of a standard of care would not exist.

W. A professional association's decisions relating to expulsion or other discipline of a member is subject to legal challenge, even when the association's action would not substantially preclude the member in question from competing in the marketplace.

Reporter's Comment. See legal memorandum of Neil Simon, Esq., attached hereto as Appendix D, for more detailed discussion of the points set forth above.

In conclusion, as to the Findings of the FPA[®] Fiduciary Task Force:

- The activities of financial planners are regulated under different regulatory regimes – registered representative, insurance agent, and registered investment adviser – which have lead to the application of different standards of conduct to their activities.
- The current regulatory structure does not provide adequate and consistent regulation of financial planning activities, and current marketing materials and disclosure materials do not adequately inform consumers of the distinctions in the different legal duties of various financial intermediaries.
- These exist many confused consumers of services which are termed “financial planning” (or similar language), and poor protection of consumers of services from all those who hold themselves out as “financial planners” (or similar terms).
- The development of financial planning has served to elevate the understanding by all financial intermediaries of the many financial needs of consumers and how best to serve them.
- Financial planning is, and should be regarded as, a separate and distinct professional discipline.

III. RECOMMENDATIONS

The FPA[®] Fiduciary Task Force addressed the initial policy questions relating to the appropriate standards of conduct for financial planners. FPA[®] Fiduciary Task Force's recommendations are intended to be statements of what the law relating to financial planners should be, rather than what the law is currently.

A. The six-part financial planning process as it currently exists is adequately set forth in the July 2003 CFP Board's *Financial Planning Practice Standards*.

Reporter's Comment. As a foundation to the FPA[®] Fiduciary Task Force's later conclusions, a reaffirmation of the financial planning process as consisting of six parts was undertaken. The six-part financial planning process is set forth by the practice standards from several major regulatory bodies which affect the financial planning profession.

CFP Board Definition. The CFP Board of Standards, Inc. current "Financial Planning Practice Standards" applies to "CFP Board designees in performing the tasks of financial planning regardless of the person's title, job position, type of employment or method of compensation." Compliance with the Financial Planning Practice Standards "is mandatory for CFP Board designees." [It should be noted that all individual members of the Financial Planning Association "who are not CFP certificants and who hold themselves out to the public as financial planners shall abide by the principles of the CFP Board's Code of Ethics and Professional Responsibility and by the CFP Board's practice standards, as a condition of membership." Section 4.1, FPA's Bylaws.] The "terminology" section of the *Financial Planning Practice Standards* (July 2003) states:

"Personal financial planning process" or "financial planning process" denotes the process which typically includes, but is not limited to, these six elements: establishing and defining the client-planner relationship, gathering client data including goals, analyzing and evaluating the client's financial status, developing and presenting financial planning recommendations and/or alternatives, implementing the financial planning recommendations and monitoring the financial planning recommendations.

FPSB Practice Standard. FPSB's "Professional Financial Planning Standards" provides:

Each Professional Standard is a statement regarding an element of the six-step personal financial planning process.

- Step #1: Establish And Define The Relationship With The Client
- Step #2: Gather Client Data
- Step #3: Analyse And Evaluate The Client's Financial Status.
- Step #4: Develop And Present Financial Planning Recommendations.
- Step #5: Implement The Financial Planning Recommendation(s)
- Step #6: Monitor The Financial Planning Recommendation(s)

International Standards. The International Organization for Standardization's ISO 22222 provides the following in its practice standards:

Personal financial planning process. As provided by a personal financial planner, the personal financial planning process shall include, but is not limited to, six steps that can be repeated throughout the client and personal financial planner relationship. The client can decide to end the process before having completed all of the steps ... Establishing and defining the client and personal financial planner relationship; ... Gathering client data and determining goals and expectations; ... Analysing and evaluating the client's financial status; ... Developing and presenting the financial plan ... Implementing the financial planning recommendations ... Monitoring the financial plan and the financial planning relationship.

B. The definition of “personal financial planning subject areas” contained in the terminology section of the July 2003 CFP Board’s *Financial Planning Practice Standards* is reaffirmed.

Reporter’s Comment. The reaffirmation of the “personal financial planning subject areas” definition served as another foundation to the FPA[®] Fiduciary Task Force’s later recommendations.

CFP Board Definition. The CFP Board of Standards, Inc. July 2003 *Financial Planning Practice Standards* in its “Terminology” section provides:

“Personal financial planning subject areas” or “financial planning subject areas” denotes the basic subject fields covered in the financial planning process which typically include, but are not limited to, financial statement preparation and analysis (including cash flow analysis/planning and budgeting), investment planning (including portfolio design, i.e., asset allocation and portfolio management), income tax planning, education planning, risk management, retirement planning and estate planning.

International Standard. ISO 22222 provides that a “personal financial planner” is defined to be an “individual who provides a service of personal financial planning to clients and who meets all of the ethics, competence and experience requirements contained in this International Standard.” “Personal financial planning” is defined as a “process designed to enable a consumer to achieve his/her/their personal financial goals.” A “financial goal” is defined to be a “quantifiable financial outcome or target which is intended to be met at some future point in time or over a period of time.” A “personal goal” is defined as “outcome which a consumer wishes to achieve that may be quantitative or qualitative in nature.” Lastly, a “personal financial plan” is defined to be a “document that specifies how a consumer should organize and manage his/her/their personal financial affairs, in whole or in part, so as to satisfy present and future personal goals, needs and priorities.”

- C. **“Financial planning” shall include activities which relate to “retirement planning,” “estate planning,” “risk management planning,” and other portions of a comprehensive financial planning process, and the “best interests of the client” standard shall apply in each of those instances.**

Reporter’s Comment. Very early on in the Fiduciary Task Force’s discussion there was consensus that financial planning encompasses many different subject areas and that providing services in any one or more of those subject areas should be subject to uniform standards of professional conduct.

The SEC No-Action Dec. 16, 2005 No-Action Letter. Under the SEC’s interpretation of the Merrill Lynch Rule, as expressed in the SEC staff’s Dec. 16, 2005 no-action letter, “modular” financial planning (when not called a “financial plan”) would not be subject to fiduciary duties imposed by statute under the Investment Advisers Act of 1940. It was noted that in a recent educational seminar presentation by securities law attorneys recently recommended that firms seeking to avoid the imposition of fiduciary duties undertake such actions as “trimming planning modules” and “provide 3 (or less than half) modules versus a full fledged plan” and “draft plans that linger while the firm shifts into” a non-fiduciary mode.

Fiduciary Task Force’s Observations Regarding The SEC’s No-Action Letter. The Fiduciary Task Force was unanimous in its opinion that such a misuse of the English vocabulary should not be followed. Simply calling “financial planning” something else does not make it so. Using a “financial tool” does not mean that the output of that tool, especially when it is presented to the client, is not a financial plan of some form. Moreover, consumers possess no ability to discern between a “financial tool” and a “financial plan” – if there even exists any distinction. The convolution of the English language engaged in by the SEC Staff in its Dec. 16, 2005 no-action letter follows from the ill-advised adoption of the Merrill Lynch Rule. Both of these actions strayed far from earlier positions of the Commission regarding the nature of financial planning, including the following text from a prior SEC Release:

Financial planning typically involves providing a *variety* of services, principally advisory in nature, to individuals or families regarding the management of their financial resources based upon an analysis of individual client needs. Generally, financial planning services involve preparing a financial program for a client based on the client's financial circumstances and objectives. This information normally would cover present and anticipated assets and liabilities, including insurance, savings, investments, and anticipated retirement or other employee benefits. The program developed for the client usually includes general recommendations for a course of activity, *or specific actions*, to be taken by the client. For example, recommendations may be made that the client obtain insurance or revise existing coverage, establish an individual retirement account, increase or decrease funds held in savings accounts, *or* invest funds in securities. A financial planner may develop tax or estate plans for clients or refer clients to an accountant or attorney for these services. [*Emphasis added.*]

SEC Release No. IA-1092 (October 8, 1987).

The subject fields covered in the financial planning process include, but are not limited to, financial statement preparation and analysis (including cash flow analysis, planning and budgeting), investment planning (including portfolio design, i.e., asset allocation and portfolio management), income tax planning, education planning, risk management, retirement planning and estate planning. Any one or more of these areas may be addressed by undertaking financial planning for a client.

Professional standards of conduct serve to draw a line between professional and unprofessional conduct. If professional standards of conduct are to exist for financial planners, and if financial planners are to be regarded as professionals, all those persons who are engaged in providing personalized financial planning advice to clients must act in the “best interests of the client” whenever engaged in financial planning activities – whether such planning is undertaken comprehensively and all at one time, or whether it addresses just one key aspect of a client’s financial planning needs.

Moreover, those who practice in the area of financial planning realize that all planning areas – whether they be called “retirement planning” or “risk management planning” or “estate planning” or “tax planning.” – interrelate in some fashion. This is revealed when looking more closely at definitions of each of the six major subject areas of financial planning:

“Asset Management”: strategies and techniques to maximize returns on assets in consideration of a client’s requirements and constraints.

“Estate Planning”: strategies and techniques for the maximization, preservation and distribution of accumulated assets.

“Financial Management”: strategies and techniques to optimize short- and mid-term cash flows, assets and liabilities.

“Retirement Planning”: strategies and techniques for the accumulation of wealth to meet needs and goals in retirement years.

“Risk Management”: strategies and techniques to control financial exposure to personal risk.

“Tax Planning”: strategies and techniques to maximize the present value of after-tax net worth by minimizing taxation.

As each subject area definition alludes to, in each instance a client’s *financial* needs are addressed – whether these relate to “return on assets” or “maximization ... of accumulated assets” or “cash flows” or “accumulation of wealth” or “control financial exposure” or “maximize ... after tax net worth.” Moreover, in each instance the client’s overall financial planning goals are assessed prior to providing recommendations. As stated in the explanation to

the CFP Board’s Financial Planning Practice Standards, Practice Standard 200-1: “Prior to making recommendations to the client, the financial planning practitioner and the client shall mutually define the client’s personal and financial goals, needs and priorities. In order to arrive at such a definition, the practitioner will need to explore the client’s values, attitudes, expectations, and time horizons as they affect the client’s goals, needs and priorities.”

Accordingly, whenever a financial planner is presenting a recommendation to the client involving any of the financial planning subject fields, this should be regarded as part of a financial planning engagement and the “best interests of the client” professional standard of conduct should apply.

The FPA[®] Fiduciary Task Force notes that nothing stated herein prevents in any way a registered representative from fulfilling his or her obligations to the client, such as the requirement that a specific transaction be suitable for the client. However, documentation of a client’s risk tolerance and/or financial circumstances for purposes of an internal compliance-related document is distinct from the provision of a financial plan to a client, whether it be in writing or orally presented.

D. The “best interests of the client” standard shall apply when a financial planner implements any portion or element of a financial plan presented by that financial planner to the client.

Reporter’s Comment. This key recommendation was proposed very early on in the FPA[®] Fiduciary Task Force’s deliberations, and the many aspects of this recommendation were subjected to intense scrutiny. It should be noted that the FPA[®] Fiduciary Task Force’s research into and discussion of this issue was extensive, leading to the finding as to inadequacy of disclosure. There was much discussion in the FPA[®] Fiduciary Task Force as to whether the “best interests of the client” standard should always be applicable to the fifth part of the financial planning process – “implementation” – following the development and presentation of a financial plan of any type. The FPA[®] Fiduciary Task Force concluded that implementation of a financial plan is an indistinct part of the process of financial planning, and accordingly that the “best interests of the client” standard of conduct should apply during all implementation activities.

While some members of the financial planning community may feel that implementation of a financial plan, which may involve the sale of a product, is separate and distinct from financial planning, the FPA[®] Fiduciary Task Force undertakes the following observations:

- The idea that implementation is a separate, distinct activity is counter to the definition of “personal financial planning process” found in the Terminology section of the Certified Financial Planner Board of Standards, Inc.’s *Financial Planning Practice Standards*, which definition was reaffirmed by the FPA[®] Fiduciary Task Force.
- The idea that product recommendations should be segregated from other parts of the financial planning process does not hold merit in the real world. The tax, financial and risk management world of today is extraordinarily complex. For example, a

financial planner may advise a client to fund a 401(k) account which has limited investment options, as well as fund a Roth IRA account, and taxable personal or trust accounts. The financial planner may concurrently recommend a strategic asset allocation for the client. The placement of specific investments in each account may then be substantially driven by both tax and liquidity considerations, as they intertwine with the client's unique financial and tax circumstances both presently and as projected into the future. Additionally, implementation of the financial plan may well involve the necessity of selling various assets which are no longer optimal for the client, and significant tax considerations (such as securing long term capital gains treatment while avoiding alternative minimum tax liability) may come into play. Certain investment products may be inappropriate fits for the client's estate planning desires, such as might occur should nonqualified variable annuities name trusts as beneficiaries (given the compressed income tax brackets for trusts, and the lack of any stepped-up basis for annuities under current tax law). Alternatively, tax-deferred investments may prove in some instances to be superior over the long run, such as when the client possesses estate planning desires involving the provision of benefits to qualified charities. The use of an investment with return guarantees may be appropriate to meet a need, but that need could have already been met through life insurance or a client's other resources. In summation as to this paragraph, there exists a very close interrelationship for all aspects of financial planning – including the core six areas of Financial Management, Tax Planning, Asset Management, Risk Management, Retirement Planning and Estate Planning.

- Implementation of a financial plan will, by necessity, involve frequent references back to the financial plan. Despite lengthy explanations which may have been frequently provided, clients of financial planners will often request during the implementation process further explanations of the financial plan as they relate to the investment decisions undertaken. Additionally, during the implementation process new facts may arise that have previously not been revealed by the client, leading to a reevaluation to, and possible modification of, key portions of the client's financial plan.
- Financial planners are often called upon to monitor the financial plan. As stated in the explanation of the CFP Board's *Financial Planning Practice Standards*, Standard 600-1, the "monitoring process may reveal the need to reinitiate steps of the financial planning process ... This *Practice Standard* promotes awareness that financial planning is a dynamic process rather than a single action." To suggest that either implementation and/or monitoring are distinct activities, given the ever-changing financial circumstances, needs and goals of a client and changes in the financial markets, is contrary to the correct view that financial planning is an integrated process. Otherwise a financial planner would be constantly "switching hats" – from one standard of professional conduct governed by the best interests standard – to a different non-professional standard of conduct governed by a far lesser standard. The blending of these roles would not only be confusing for the client but could also lead to increased liability for the financial planner – as statements made by the financial planner could be assumed by the financial planner to have been made under a lower

standard of conduct when the client possessed a reasonable expectation that the higher professional standard of conduct in fact applied to such statements.

- The client may specify that implementation and monitoring of a financial plan could be undertaken separately (either by the client acting alone and without any advisor, or by the client choosing to act through a separate and distinct financial services intermediary firm). However, it is not the province of the financial planner, once a financial plan has been developed and presented to the client, to abdicate from his or her duty to act in the best interests of the client during the implementation and monitoring stages of the dynamic process of financial planning. The duty to act in the best interests of the client is a function of the close and personal relationship which necessarily follows from a financial planning engagement; this duty is imposed by law and is not, in the context of the provision of financial services, capable of being waived by informed consent of the client (as discussed at length in the “findings” section of this Final Report).

While observers would be correct in stating that implementation of a financial plan is not always required by current federal law (and the law of most states) to be undertaken under the “best interests of the client,” and hence they might desire to conclude that an organization should not advocate same, the Fiduciary Task Force believes the better approach is for some organization of financial planners to formally adopt and enforce the “best interests of the client” standard.

- This is an instance where, in the view of the FPA[®] Fiduciary Task Force and many other commentators with regard to recent rule-making, the Securities and Exchange Commission has retreated from proper application of the Investment Advisers Act of 1940, and hence retreated from the “best interests of the client” standard to all those who provide investment advice. As stated in the January 2005 SEC’s issuing release relating to the proposed Merrill Lynch Rule, “The advisory services provided by financial planners and the context in which they are provided may extend beyond what Congress, in 1940, reasonably could have understood broker-dealers to have provided as an advisory service ancillary to their brokerage business. We are concerned that some broker-dealers have promoted ‘financial planning’ as a way of acquiring the confidence of customers to promote their brokerage services without actually providing any meaningful financial planning.” While the FPA[®] Fiduciary Task Force could provide additional commentary on this issue, given the pending litigation between the FPA and the SEC with regard to the Merrill Lynch Rule, the FPA[®] Fiduciary Task Force believes further discussion of the Merrill Lynch Rule in this Final Report should be deferred.
- Moreover, should “implementation” of a financial plan be excluded from the financial planning process, this could easily lead to the fraudulent activity known as “bait and switch.” For example, in the early case of *In the Matter of Haight & Co., Inc.* (Securities Exchange Act Rel. No. 9082, Feb. 19, 1971), the SEC held that a broker or dealer and its associated persons defrauded its customers in the offer and sale of securities by holding themselves out as financial planners who would, as financial planners, give comprehensive and expert planning advice and choose the best

investments for their clients from all available securities, when in fact they were not expert in planning and made their decisions based on the receipt of commissions and upon their inventory of securities. Regardless of any position taken by regulators, the FPA[®] Fiduciary Task Force concludes that the use of financial planning as a means to entice potential customers to a firm should only be undertaken when the firm and its representatives are required to adhere to the professional standards of conduct, which includes the duty to keep the client's best interests paramount at all times during the relationship.

- The importance of the issue presented is, from a standpoint of public policy, cannot be overlooked. There exists a looming crisis that faces so many Americans. As stated nearly five years ago, “[E]ffective financial planning is important to the success of a free-market economy. If people do not make careful, rational decisions about how to self-regulate the patterns of consumption and savings and investment over their life cycles, government will have to step in to save people from the consequences of their poor planning. Indeed the entire concept of government-sponsored, forced withholding for retirement (Social Security) is based on the assumption that people lack the foresight or the discipline, or the expertise to plan for themselves. The weaknesses in government-sponsored social security and retirement systems places increased importance on the ability of people to secure for themselves adequate financial planning.” “Regulation of Financial Planners,” white paper prepared for the Financial Planning Association by Jonathan R. Macey, June 102, at p.2.
- Additionally, the importance of this issue to financial planning, as a profession, cannot be overlooked. To be effective in the financial planning profession, financial planners are called upon to possess a breadth and quality of knowledge and experience which requires substantial time and effort to possess, and which many people cannot achieve. As stated by Professor Robert G. Kennedy, “a professional professes his commitment to address problems according to the principles and accepted practices of the discipline.” (From “The Professionalization of Work,” an article provided to the FPA[®] Fiduciary Task Force courtesy of Don Trone). While financial planners can be well compensated for the specialized knowledge which they possess, first and foremost the profession of financial planning involves service to others and placing the client's best interests ahead of their own. Financial planning cannot, and will not, arise to the level of a respected profession if financial planners can negate their duty to act in the client's best interests during the all-important implementation stage of the financial planning process.
- The benefit of the assumption of potential legal liability which may arise from the high “best interests of the client” standard is the increased marketability of financial planners and the financial planning process. If financial planners are endowed by a reputation for honesty backed by strict adherence to professional standards of conduct and rigid enforcement of those professional standards, financial planners (whether also regulated as registered investment advisers, registered representatives, and/or insurance agents) will possess a greater ability to promote and market their

professional services. However, should implementation of a financial plan be excluded from these professional standards of conduct, substantially the same services will be provided by those who choose to continue to adhere to the professional standard of conduct as those who choose a lesser standard of conduct. As a result, the increased marketability of the professional financial planner is thwarted. This in turn leads to a degenerative cycle in which:

- The financial planner does not desire to enter into the profession of financial planning, as substantially the same services can be performed under lesser standards of conduct (i.e., with greater freedom of action, and with less risk exposure) under a functionally similar occupation. There is no clear benefit to the financial planner in terms of increased marketability of services, which might otherwise arise from the assumption of the duty to act in the best interests of the client at all times.
- The consumer of financial planning services, who does not possess the knowledge and skill to discern the functional distinctions between implementation under a professional standard of conduct and implementation under a lesser standard, and confronted with two persons which functionally provide the same, is unable to distinguish any increased benefit from those who commit to the professional standard of conduct at all times. As made clear in the *findings* contained in this Final Report, even detailed and prominent written disclosures cannot overcome the consumer's lack of knowledge, given the wide gap of knowledge which exists between the financial planning expert and the consumer. Often the consumer perceives that the expert (who is implementing financial plans under a lesser standard) is supposed to act objectively and in the client's best interest (i.e., under the "best interests of the client" standard), when in fact this does not occur (when not required by law). Instead, the implementation is undertaken in the presence of multiple conflicts of interest, the nature and effect of which are seldom understood by the client until after harm results.
- The foregoing interplay leads to a downward spiral which results in the erosion of the reputation enjoyed by the financial planning profession. Consumers become wary of financial planning services, less likely to turn to true financial planning professionals for advice, and less likely to utilize the professional services public policy should promote.
- The potential legal liability of a financial planner is not necessarily greater, in actual practice, under a "best interests of the client" standard. First, with clearer and more detailed standards of professional practice and "best practices" (including a review of prudent processes which can be followed, it should be easier for financial planners to comply with the "best interests of the client" standard. Second, a focus on doing what is right for the client, instead of not doing something which is prohibited by various regulations, will result in overall conduct which is likely to be more favorable for the client and less likely to be challenged at a later time. In other words, when

motivations are directed at doing what is best for someone the conduct is more likely to be positive in nature and the actor is much less likely to be concerned with fears of legal liability. Third, close relationships with clients are more likely to develop in relationships based upon trust. In trusting relationships, when misunderstandings occur they are more likely to be dealt with through candid discussions between the financial planner and the client, rather than by arbitration or litigation.

Another key question relating to the “implementation of a financial plan” issue is whether broker-dealer firms will permit their registered representatives to establish and maintain the client’s best interests as paramount, even above the duties owed by the registered representative to the broker-dealer firm (or, in a related example, even above the duties owed by an insurance agent or broker to insurance company). The FPA[®] Fiduciary Task Force carefully considered this issue and concluded that the current institutional reluctance to adopt a “best interests of the client” standard – whether it be due to past industry practice or legal liability concerns – is not sufficient reason to permit a wholesale casting away of the duty to act in the client’s best interest at the time of implementation of a financial plan. The FPA[®] Fiduciary Task Force notes that the duties of loyalty under agency law can easily, by agreement between the institution and the financial planner, be given various priorities, with the best interests of the client mutually agreed to be first and paramount, then the interests of the institution second. While adjustments may be necessary in the policies and procedures of many financial services intermediaries, the greater benefits to the profession of financial planning and to the consumer of financial services from the adoption of the “best interests of the client” standard for the entire financial planning process are both real and substantial, and far outweigh any disruption to established institutional practices.

Finally, it should be emphasized that neither the FPA[®] Fiduciary Task Force nor the Financial Planning Association have stated that fee-only registered investment adviser practices are the only or best method by which to implement a financial plan. To the contrary, there are situations where brokerage-provided services, under our current regulatory and tax system, may be better than relationships governed only by the Investment Advisers Act of 1940. As but one example, investment products which compensate the financial services intermediary on the basis of 12b-1 fees may be much more tax-efficient in taxable accounts than no-load, no 12b-1 fee products suggested by investment advisers (who receive investment advisory fees which may not be fully deductible due to various provisions in federal and state income tax laws). It should further be noted that the FPA[®] Fiduciary Task Force has discerned no restriction in any federal or state law or regulation which would prohibit registered representatives and insurance brokers/agents from adhering to the professional standard of conduct which places the best interests of the client paramount.

D.1. The “best interests of the client” standard arises out of an advisory relationship. An advisory relationship exists between an individual and a client when one or more of the following facts and circumstances are present:

- Either existing law (including both statutory and common law) or regulation dictate that the individual possesses a fiduciary duty to the client with regard to the advice provided to the client;

- **The nature of the services provided is financial planning, or one or more of the material elements of financial planning;**
- **The terms and conditions of the contract between the individual and the client include an express assumption of the individual's duty to act in the best interests of the client;**
- **The individual "holds out" as a financial planner (or similar terms), thereby creating the rightful expectation that an advisory relationship exists.**

Reporter's Comments.

Recommendation D.1. was adopted by the Task Force following the issuance of its Preliminary Report. This recommendation seeks to further define the manner in which advisory relationships are created. There are three ways in which advisory relationships may be created under the law. First, such relationships may be created by statutory law, such as those advisory relationships which fall within the ambit of the Investment Advisers Act of 1940. Second, advisory relationships may exist by virtue of the terms of the agreement between the parties (i.e., an express promise to put the client's best interest forward, or to provide advisory services). Third, facts and circumstances may exist, either by actions of the parties and/or due to holding out as a financial planner, under which the common law would dictate that an advisory relationship has been entered into. Please note that the common law application of fiduciary duties to financial planners will be further explored in a subsequent task force.

It is recommended that individuals who perform a variety of roles – i.e., product sales or advisory relationships – with different clients, be permitted to hold themselves out as financial planners. However, prior to the entry into any relationship with the customer, the individual must clearly and strongly counter any understanding the customer may possess that the individual is providing services which are advisory in nature or under a relationship based upon trust. For example, a comprehensive, distinct written disclosure should be provided which specifies that the individual's proposed engagement with the customer is not an advisory relationship but one in which the sale of a product shall be undertaken, that the individual does not possess any fiduciary duty with respect to the client (including but not limited to the duty to keep the client's best interests paramount at all times), and that the individual will be compensated based upon the sale of a product by means of a commission or other third-party payment and not through the payment of advisory fees by the client.

It should be noted that neither Recommendation D.1. nor the foregoing comments relating thereto were unanimously adopted by the Task Force. Further consideration of Recommendation D.1. is urged by the subsequent Task Force.

E. The “best interests of the client” standard shall apply to persons holding out as financial planners or who otherwise create a reasonable expectation regarding an advisory relationship.

Reporter’s Comments.

The FPA[®] Fiduciary Task Force anticipates that it will re-address the particulars of this issue during Working Group 3 discussions, to be undertaken. In the interim, it should be noted that in research undertaken by Neil Simon, Esq. and Robert Neil, Esq. it was discerned that two states have, at the present time, adopted laws and/or regulations to the effect that “holding out” triggers the application of fiduciary standards of conduct under the Investment Advisers Act of 1940.

Washington State. Washington includes anyone who holds himself out as a financial planner within the definition of investment adviser. However, administrative rules then specify when anyone using a term deemed similar to “financial planner” or “investment counselor” will not be considered to be holding out as a financial planner for purposes of registration as an investment adviser when certain conditions are met. See discussion under “Findings.”

Maryland. Maryland includes within the definition of “Investment Adviser” any person who “holds out as an investment adviser in any way, including indicating by advertisement, card, or letterhead, or in any other manner indicates that the person is, a financial or investment “planner”, “counselor”, “consultant”, or any other similar type of adviser or consultant.” Maryland Securities Act § 11-101(h)3.

Diminishment of the Value of Being a Professional. Should others be permitted to hold themselves out as financial planners but then engage the consumer as a financial intermediary not governed by the professional standard of conduct to put the client’s best interests first, the increased marketability of the financial planner would be thwarted. As the 2002 FPA White Paper by Professor Macey observed:

Each financial planner has incentive to develop and maintain a reputation for honesty and competence in order to increase the demand for his services. All financial planners suffer when the reputation of the profession suffers because consumers are unable to distinguish between high-quality services of ethical or competent financial planners and low-quality services of unethical or incompetent financial planners. This, in turn, reduces the market’s demand and willingness to pay for financial planners. The practical implications of this basic problem, described by economists as “information asymmetry” because of the fact that consumers have less information than producers (and therefore the distribution of information between the sellers of services and the buyers of services is asymmetric) are important for the future of any industry or profession ... The general problem was first described in a famous article by George Akerloff, in which he showed what would happen to an industry if consumers were unable to distinguish between high quality producers and low quality producers [citing George A. Akerlof, *The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON.488 (1970)]. The consequences of this problem are far more severe than may appear at first blush. The structure of the problem can be described with reference to the financial planning

profession as follows: suppose, for the sake of clarity and simplicity, there are only three types of financial planners, excellent quality planners, whose work is worth \$900 per hour, medium quality financial planners, whose work is worth \$300 per hour, and low quality financial planners, whose work is worth minus \$300 per hour because of the costs that such planners impose on their clients through incompetence and fraud. Imagine further that consumers are unable to differentiate among these various types of financial planners until after they have received their services. They don't know whether the advice they are getting is of high, medium or low quality until they have purchased the advice. Where this is true, economists have shown that the products all will sell for the same price, because consumers who pay more than the standard market price still will be unable to increase the probability that they are receiving high quality advice.

Avoid Bait and Switch Arrangements. In addition, if a person were to hold himself or herself out as a financial planner, but then engage the client in a role which is not subject to the high professional standards of conduct adopted by financial planners, that person could be guilty of “baiting and switching.” This fraudulent practice could easily become widespread and would demean the integrity of the profession, as well as lead to abuse of consumers of financial planning services. While some industry participants might argue that disclosures are adequate, as previously discussed disclosures would be inadequate in this instance, since it is likely that such disclosures would only be handed out for signature after the holding out and much of the initial relationship-building has taken place. Even if clients were to carefully read and study the disclosures provided by financial planners, consumers would not likely seek advice from a third party in most instances, due to the high costs of attempting to even find independent advice on this issue. Even if consumers overcome the agency costs and find such independent advice as to whether to accept a relationship based upon (or not based upon) a “best interests” standard of conduct, nearly always the advice from good legal (or other) counsel would be to seek out the financial planner held to the “best interests” standard in all aspects of the relationship.

F. When the circumstances set forth in Recommendations C (financial planning in any of the financial planning practice areas), D (implementation of a financial plan) or E (holding out as a financial planner) exist, professional standards of conduct shall apply to a financial planner in her or his services to a client. In such instances the financial planner shall possess the following five major responsibilities to the client:

- 1. A financial planner shall put the clients’ best interests first;**
- 2. A financial planner shall act with due care and in utmost good faith;**
- 3. A financial planner shall not mislead clients;**
- 4. A financial planner shall provide full and fair disclosure of all material facts; and**
- 5. A financial planners shall disclose and fairly manage material conflicts of interest.**

Reporter's Comment. Additional major or minor responsibilities of fiduciary financial planners may be added later. For example, in developing “practice standards” the FPA[®] Fiduciary Task Force may desire to address responsibilities relating to diligence, achieving and maintaining competency, conflicts which may exist in the representation of multiple clients, confidentiality of client information, and other issues. In the interim, the foregoing “English-language” formulation of the major fiduciary duties of financial planners is recommended.

Generally, this list of five major responsibilities was initially derived from a speech entitled “Fiduciary Duty: Return to First Principles,” given by Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, at the Eighth Annual Investment Adviser Compliance Summit in Washington, D.C., February 27, 2006, in which Ms. Richards stated: “Many different types of professions owe a fiduciary duty to someone — for example, lawyers to their clients, trustees to beneficiaries, and corporate officers to shareholders. Fiduciary duty is the first principle of the investment adviser — because the duty comes not from the SEC or another regulator, but from common law. Some people think ‘fiduciary’ is a vague word that's hard to define, but it's 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 whom he owes fiduciary duties, to the exclusion of any contrary interest ... 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' interests 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.”

This listing of responsibilities was modified following much discussion and a comparison of this list with other foundational codes and rules of professional conduct for financial planners and related professions, including those which are explored in further detail in the commentary which follows.

F.1. A financial planner shall put the clients’ best interests first.

Generally, the duty of a financial planner to place the client’s best interests first, or paramount, is a “plain English” statement of the financial planner’s fiduciary duty of loyalty. Fiduciaries have a duty, created by undertaking certain types of acts, to act primarily for the benefit of another in matters connected with such undertaking. The term “fiduciary” is utilized to mark certain relationships where a party with superior knowledge and information acts on behalf of one who usually does not possess such knowledge and information. Financial planning is such a relationship. Furthermore, learning the personal details of a client’s financial affairs, their hopes, dreams, and aspirations cultivates a confidential and intimate relationship. In these relationships the person with the dominant position (the “fiduciary”) acts as if the interests of the other party (the “entrustor” or “client”) were the fiduciary’s own.

The duty to act in the best interests of the client is an expression of the general fiduciary duty of loyalty. The duty of loyalty is often said to reflect what a fiduciary should not do, as opposed to what a fiduciary should do. For example, the Restatement (Second) of Trusts states that the fiduciary “is under a duty *not* to profit at the expense of the beneficiary and *not* to enter into competition with him without his consent, unless authorized to do so.” [*Emphasis added.*]

Financial planners must take only those actions that are within the best interests of the clients. The financial planner should not act in his or her own interest. Engaging in self-dealing, misappropriating a client's assets or opportunities, or otherwise profiting in a transaction that is not substantively or "entirely fair" to the client may give rise breaches of the duty of loyalty. High standards of conduct are required when advising on other people's money and plans for the achievement of their lifetime financial goals.

The financial planning professional must recognize that the client is often a participant in the capital markets. Hence, the financial planning professional possesses the duty to maintain the perception and reality that the market is a fair game and thus encourage the widest possible participation in the capital allocation process. The premise of the U.S. capital markets is that the widest possible participation in the market will result in the most efficient allocation of financial resources and, therefore, will lead to the best operation of the world-wide economy. Putting the client first actually protects and promotes the best interests of the entire financial community, and, therefore, society as a whole. This concept is operationalized by requiring that financial planners place the interests of their clients ahead of all other concerns. Responsibilities to employers, colleagues and selves are all placed in a descending order of importance so that the financial markets can be best served.

CFP Board Code of Ethics Rule 202. The CFP Board of Standards Inc.’s *Code of Ethics and Professional Responsibility* (hereafter “CFP Board Code of Ethics”) was adopted by the Certified Financial Planner Board of Standards Inc. (hereafter “CFP Board”) to provide principles and rules to all persons whom it has recognized and certified to use the CFP® and related marks. As stated by the CFP Board, “[i]mplicit in the acceptance of [the] authorization [to use the marks] is an obligation not only to comply with the mandates and requirements of all applicable laws and regulations but also to take responsibility to act in an ethical and professionally responsible manner in all professional services and activities.” The CFP Board Code of Ethics “applies to CFP Board designees actively involved in the practice of personal financial planning, in other areas of financial services, in industry, in related professions, in government, in education or in any other professional activity in which the marks are used in the performance of professional responsibilities.” CFP Board Code of Ethics Rule 202 states: “A *financial planning practitioner shall act in the interest of the client.*” While this is similar to the Fiduciary Task Force’s adopted statement of responsibility, the word “best” is curiously omitted. However, it should be noted that Professor Austin Scott, who for many years was the leading American scholar in the field of trust law, early on defined the term “fiduciary” to mean “a person who undertakes to act in the interest of another person.” [Austin Scott, “The Fiduciary Principle,” CAL. L. REV. 37 (1949): 539, 540.] Hence, it could be concluded that the omission of the word “best” should *not* be construed as lessening the responsibility of a CFP Board designee. Again, it should be noted that under the FPA’s Bylaws, Section 4.1, it states that “All

individual members who are not CFP certificants and who hold themselves out to the public as financial planners shall abide by the principles of the CFP Board’s Code of Ethics and Professional Responsibility and by the CFP Board’s practice standards, as a condition of membership.”

FPSB Code of Ethics. The mission of the Financial Planning Standards Board Ltd. (FPSB) is to manage, develop and operate certification, education and related programs for financial planning organizations so that they may benefit the global community by establishing, upholding and promoting worldwide professional standards in financial planning. In essence, the FPSB licenses the CFP and related marks to organizations which operate outside the United States. The FPSB promulgated its own *Code of Ethics and Professional Responsibility* (hereafter “FPSB Code of Ethics”) intended to be localized by FPSB Affiliates “to comply with the practice requirements and regulations of the country or region.” By adhering to the FPSB Code of Ethics, as localized, “CFP professionals agree to provide personal financial planning in the *best interests of clients* and to act in accordance with the highest ethical and *professional standards* for the practice of personal financial planning.” [*Emphasis added.*]

International Standard (ISO 22222), Section 5.2.1. The ISO (the International Organization for Standardization), a worldwide federation of national standards bodies, promulgated in December 2005 its ISO 22222, “Personal financial planning - Requirements for personal financial planners.” The ISO states that the purpose of this International Standard is “the objective of achieving and promoting a globally accepted benchmark for individuals who provide the professional service of personal financial planning. Personal financial planning is a process designed to enable consumers to achieve their personal financial goals. The service of personal financial planning is provided by a personal financial planner to assist clients with their personal financial planning. Consumers need to have confidence in their personal financial planner. This International Standard specifies the ethical behaviour, competences and experience required of a professional personal financial planner.” Furthermore, the ISO states that the “International Standard is applicable to all personal financial planners regardless of their employment status” and the term “client” refers to any person who has accepted the written terms of engagement, which are required in every engagement. Section 5.2.1 of ISO 22222 states: “*Personal financial planners shall make the legitimate interests of the client paramount.*” WG2 contrasted this language with the adopted language of “a financial planner shall put the client’s interests first” and concluded that, while the ISO language is more precise, the adopted language is more commonly recognized and is in plain English. WG2 emphasizes that either version of this statement of responsibility would be acceptable.

IAA Standard of Practice I-1. The Investment Adviser Association Standards Of Practice (hereafter “IAA Standards of Practice”), as amended February 28, 2006, “emphasize an investment adviser’s core fiduciary duty,” and state in pertinent part:

I. Fiduciary Duty and Professional Responsibility

An investment adviser stands in a special relationship of trust and confidence with, and therefore is a fiduciary to, its clients. As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith *to act in the best interests of its clients*. The parameters of an investment adviser’s duty depend on the scope of the advisory relationship and generally include:

(1) the duty at all times to place the interests of clients first
[*Emphasis added.*]

Restatement (Third) of Agency. The Restatement (Third) of Agency (2006) (published by the American Law Institute) sets forth similar duties for an agent and provides in pertinent part:

§8.01 General Fiduciary Principle. An agent has a fiduciary duty to *act loyally for the principal's benefit in all matters connected with the agency relationship.*

§8.02 Material Benefit Arising Out Of Position. An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position.

§8.03 Acting As Or On Behalf Of An Adverse Party. An agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship.

§8.04 Competition. Throughout the duration of an agency relationship, an agent has a duty to refrain from competing with the principal and from taking action on behalf of or otherwise assisting the principal's competitors ...

§8.05 Use Of Principal's Property; Use Of Confidential Information. An agent has a duty: (1) not to use property of the principal for the agent's own purposes or those of a third party; and (2) not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party.

[*Emphasis added.*]

F.2. A financial planner shall act with due care and in utmost good faith.

Reporter's Comment. In the United States, the 'triad' of fiduciary duties is most commonly referred to as the duties of due care, good faith and loyalty. The statement of responsibility set forth immediately above incorporates the first two of those three general fiduciary duties.

The Duty of Due Care: Process vs. Substance. The fiduciary duty of care has been considered to involve both process and substance. That is, in reviewing the conduct of a fiduciary in adherence to the person's fiduciary duty of due care, a court would likely review whether the decision made by the fiduciary was informed (procedural due care) as well as the substance of the transaction or advice given (substantive due care). Procedural due care is often met through the application of an appropriate decision-making process, and judged under the standard, not (necessarily) by the end result. Substantive due care pertains to the standard of care and the standard of culpability for the imposition of liability for a breach of the duty of care.

Procedural Aspect of the Duty of Due Care. One must evaluate the duty of care by the process the fiduciary undertakes in performing his functions and not the outcome achieved. The very word “care” connotes a process. Procedural due care is often met through the application of an appropriate decision-making process, and judged under the standard, not (necessarily) by the end result. Given the expertise fiduciaries possess within their fields and due to the difficulty of evaluating the behavior of fiduciaries as to the soundness of their judgment, most often courts turn to an analysis not of the advice that was given but rather to the process by which the advice was derived.

Substantive Aspect of the Duty of Due Care. While adherence to a proper process is necessary, at each step along the process the financial planner is required to act prudently with the care of the prudent financial planner. In other words, the financial planner must at all times exercise good judgment, applying his or her education, skills, and expertise to the financial planning issue before the financial planner. Simply following a prudent process is not enough if prudent good judgment and the financial planner’s requisite knowledge, expertise and experience are not applied as well. However, the courts recognize that it is simply not possible for a fiduciary to be aware of every piece of relevant information before making a decision on behalf of the client, and a financial planner cannot guarantee that a correct judgment will be made in all cases.

The Duty of Due Care Is Relational. The standard of care for professionals is that of prudent professionals; for amateurs, it is the standard of prudent amateurs. The Restatement (Third) of Agency at §8.08 states: “Special skills or knowledge possessed by an agent are circumstances to be taken into account in determining whether the agent acted with due care and diligence. If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.” Hence, the financial planner is obligated to act under a duty to utilize the knowledge, skill and expertise which should be possessed by all financial planners.

The Duty of Good Faith. Traditionally, the duty of good faith has been closely related to the concept of loyalty. However, reckless, irresponsible or irrational conduct – but not necessarily self-dealing conduct – will implicate concepts of good faith and cause a financial planner to be in breach of this standard.

F.3. A financial planner shall not mislead clients.

Reporter’s Comment. Honesty is fundamental to the role of the financial planner. The Fiduciary Task Force concluded that a clear statement of the financial planner’s duty to not mislead clients was necessary, given the importance of this issue in arbitration and litigation proceedings and the necessity for clear guidance to financial planners on this issue. The responsibilities of financial planners overlap in many ways. If a financial planner is putting clients’ interests first, then the financial planner will not mislead clients. And, if the financial planner is not misleading clients, then it is providing full and fair disclosure, including disclosure of any conflicts of interest.

CFP Board's Code of Ethics Rules 101 and 102. The CFP Board applies this general statement of responsibility – to not mislead clients – through its first aspirational “principle,” stating that a “CFP Board designee shall offer and provide professional services with integrity,” and through two Rules contained in its current “Code of Ethics and Professional Responsibility”:

Rule 101. A CFP Board designee shall not solicit clients through false or *misleading* communications or advertisements.

Rule 102. In the course of professional activities, a CFP Board designee shall not engage in conduct involving dishonesty, fraud, deceit or misrepresentation, or knowingly make a false or *misleading* statement to a client, employer, employee, professional colleague, governmental or other regulatory body or official, or any other person or entity.

[*Emphasis added.*]

FPSB Code of Ethics. While FPSB’s Code of Ethics does not utilize the word “mislead,” it does provide the following statement in explanation of its first ethical principal: “A CFP professional will always act with integrity. CFP professionals may be placed by clients in positions of trust and confidence. The ultimate source of such public trust is the CFP professional's personal integrity. In deciding what is right and just, a CFP professional should rely on his or her integrity as the appropriate touchstone. Integrity demands honesty and candor that must not be subordinated to personal gain and advantage.”

International Standards. While ISO 22222 does not use the word “mislead,” the Standards do include the following relating to the ethical principal of integrity: “Personal financial planners shall be open, honest, responsive, accountable and committed to acting competently, responsibly, reliably, fairly and with respect in all professional relationships.”

F.4. A financial planner shall provide full and fair disclosure of all material facts.

Reporter's Comment. Disclosure of material facts to the client is essential when acting in the client’s best interest. As stated by the recent case of *Zastrow v. Journal Communications, Inc.*, Wisconsin Supreme Court No. 2004AP276, the Court stated: “A fiduciary agrees to assume a position of authority in regard to the affairs of another in which position the fiduciary may have access to confidential information or to property of the object of the fiduciary’s obligation. Therefore, if a trustee does not make a full disclosure of material facts to a beneficiary, that conduct is a breach of the trustee’s duty of loyalty.”

Various organizational codes from which this duty of disclosure of material facts is derived follow.

CFP Code of Ethics, Rule 401. This Rule states:

Rule 401. In rendering professional services, a CFP Board designee shall disclose to the client: (a) Material information relevant to the professional relationship, including, conflict(s) of interest, the CFP Board designee's business affiliation, address, telephone number, credentials, qualifications, licenses, compensation structure and any agency relationships, and the

scope of the CFP Board designee's authority in that capacity; and (b) The information required by all laws applicable to the relationship in a manner complying with such laws.

International Standards. ISO 22222 provides:

5.2.9 Disclosure. Personal financial planners shall provide accurate and relevant information, including statements of qualifications, credentials and type of conformity assessment with this International Standard.

F.5. A financial planners shall disclose and fairly manage material conflicts of interest.

Reporter's Comment. All financial planners receiving any type of fee for their services, regardless of the statutory or other scheme of regulation in which they fall, possess conflicts of interest relating to their own compensation, and may possess other conflicts of interest. The duty of loyalty requires disclosure of material conflicts of interest by the financial planner. A conflict of interest is material if an ordinary person would take it into account in making a decision.

It should be emphasized that disclosure of a conflict of interest does not negate the financial planner's duty to act in the best interests of the client with respect to the scope of the engagement. As stated in *Regulation of Financial Planners*, a white paper prepared for the Financial Planning Association by Professor Jonathan R. Macey (June 102): "Even with written disclosure and consent, though, the adviser must reasonably believe that the transactions are in the best interests of the clients – that is, the adviser's fiduciary obligation is not discharged after disclosure and consent." Hence, fair management of conflicts of interest is required of the financial planner.

Various current ethical codes also address the disclosure and management of material conflicts of interest:

CFP Board Code of Ethics, Principle 4. This ethical principle states:

Principle 4 – Fairness. A CFP Board designee shall perform professional services in a manner that is fair and reasonable to clients, principals, partners and employers, and shall disclose conflict(s) of interest in providing such services.

CFP Board Code of Ethics, Rules 402 and 403. These Rules state:

Rule 402. A CFP Board designee in a financial planning engagement shall make timely written disclosure of all material information relative to the professional relationship. In all circumstances and prior to the engagement, a CFP Board designee shall, in writing: (a) Disclose conflict(s) of interest and sources of compensation; and (b) Inform the client or prospective client of his/her right to ask at any time for information about the compensation of the CFP Board designee.

In its explanation of Rule 402, the CFP Board provides the following guidelines for compliance with the Rule, in pertinent part:

- A statement that in reasonable detail discloses (as applicable) conflict(s) of interest and source(s) of, and any contingencies or other aspects material to, the CFP Board designee's compensation; and
- A statement describing material agency or employment relationships a CFP Board designee (or firm) has with third parties and the nature of compensation resulting from such relationships

Rule 403. Upon request by a client or prospective client, the CFP Board designee in a financial planning engagement shall communicate in reasonable detail the requested compensation information related to the financial planning engagement, including compensation derived from implementation. The disclosure may express compensation as an approximate dollar amount or percentage or as a range of dollar amounts or percentages. The disclosure shall be made at a time and to the extent that the requested compensation information can be reasonably ascertained. Any estimates shall be clearly identified as such and based on reasonable assumptions. If a CFP Board designee becomes aware that a compensation disclosure provided pursuant to this rule has become significantly inaccurate, he/she shall provide the client with corrected information in a timely manner.

FPSB Code of Ethics. The Financial Planning Standards Board's Code of Ethics provides:

Principle 4: Fairness. A CFP professional will perform personal financial planning in a manner that is fair and reasonable to clients, principals, partners, and employers and shall disclose conflicts of interest in providing such services. Fairness requires impartiality, intellectual honesty, and disclosure of conflicts of interest. It involves a person's subordination of his or her own feelings, prejudices, and desires to achieve a proper balance of conflicting interests. Fairness is treating others in the same fashion that one would want to be treated and is an essential trait of any professional.

FPSB Professional Financial Planning Standard 100-1. This standard requires that the "CFP Professional [shall provide] [d]etails about each party's responsibilities, the time frames of the engagement, compensation, and conflicts of interest should be set out in writing in a formal engagement letter or letter of understanding, signed by both parties."

International Standards. ISO 22222 requires:

4.2.3 The personal financial planner shall provide written terms of engagement for services that disclose:

- a) the basis of remuneration,
- b) any known conflicts of interest,
- c) service deliverables and timeframes,
- d) duration of the agreement,
- e) frequency of contact, and
- f) confidentiality provisions.

5.2.5 Conflicts of interests. Personal financial planners shall disclose and fairly manage all conflicts of interest.

IV. INITIAL CONCLUSIONS.

The FPA[®] Fiduciary Task Force requests that the financial security of our fellow citizens be empowered by consistent professional conduct through the engagement of financial planners held to the highest standards of conduct. We further request that financial planners attain a special place in our society through the adoption of professional standards of conduct. With such adoption will follow the status and prestige accorded to true professionals and the resulting increased demand for their all-important professional services.

The FPA[®] Fiduciary Task Force recommends that Financial Planning Association assume the mantra of leadership on this issue and steadfastly work toward the adoption of professional standards of conduct in which the client's best interests are kept paramount. In so doing, the financial planning community will be transformed into a community of professionals bound together by shared high standards of conduct, service to others, and resulting increased appreciation, respect and loyalty from consumers of financial planning services.

The FPA[®] Fiduciary Task Force recognizes the controversial nature of the recommendations contained in this Final Report, and that the Board of Directors and FPA members who have not had the opportunity or time to examine the issue in-depth as has the FPA[®] Fiduciary Task Force, may require time and effort to achieve consensus.

The FPA[®] Fiduciary Task Force's work is complete, but not complete. In the coming weeks and months another task force, appointed by the FPA's Board of Directors, will continue to explore the issues set forth in this Final Report, particularly as they relate to FPA's members. In addition other task forces and committees of the FPA continue to explore specific facets of fiduciary duties. The task ahead will be affected by additional events, both expected and unexpected. The FPA[®] Fiduciary Task Force applauds the FPA's efforts, through its various task forces, committees, and comments received from its members through varied means, to address the issues surrounding fiduciary status for financial planners and its implications for consumers, the emerging profession of financial planning, the FPA, and the FPA's members.

We wish to thank the FPA Board of Directors for their foresight and interest in looking to advance financial planning as a true profession. We greatly appreciate the continued opportunity to serve on what we consider to be one of the most important volunteer works groups ever appointed by the Financial Planning Association. We are pleased to submit this Final Report as evidence of our careful consideration of the issues relating to the fiduciary issues surrounding the practice of financial planning.

We look forward to responding to any questions or comments.

Sincerely,

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The FPA[®] Fiduciary Task Force

June 1, 2007

Reporter's Comment: This legal memorandum, while believed to be authoritative as to the current general state of the law as of the date of its publication, is intended for the use and benefit of the Financial Planning Association only. Accordingly, this legal memorandum is not intended to be, and shall not be, relied upon by any member of the Financial Planning Association nor any other person or entity in connection with his or her activities as a financial planner, registered representative, registered investment adviser representative, insurance agent, or otherwise.

APPENDIX A

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Memorandum

Via Electronic Mail and Regular Mail

To: Mr. Neil Simon
Mr. Robert Neill
From: Mari-Anne Pisarri
Mark D'Arrigo
Date: December 5, 2006
RE: Fiduciary Responsibilities of Investment Advisers
under the Investment Advisers Act of 1940

Pursuant to your request, this memorandum provides an overview of the fiduciary duty imposed on investment advisers by the Investment Advisers Act of 1940 (the "Advisers Act"). While certain aspects of the fiduciary duty borne by advisers are imposed by other sources of law and corresponding regulatory regimes, such as certain responsibilities imposed upon advisers to registered investment companies under the Investment Company Act of 1940 (the "Company Act"), this memorandum is generally limited to a discussion of those issues raised under the Advisers Act. Issues raised under sources of law such as the Company Act will be discussed in subsequent memoranda.

I. General Nature of Fiduciary Duty Borne by Advisers

The Advisers Act does not explicitly impose a fiduciary duty on registered advisers. However, it is well-established that investment advisers do in fact bear such fiduciary duties to their clients. In the landmark case of *SEC v. Capital Gains Research Bureau, Inc.*,¹ the Supreme Court found that a fiduciary duty is imposed upon advisers by Section 206 of the Advisers Act. Among other

¹ 375 U.S. 180 (1963).

things, Section 206 prohibits an adviser from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client.² In *Capital Gains*, the Court examined the legislative history of the Advisers Act and determined that Section 206 reflects a Congressional recognition of the fiduciary nature of advisory relationships.³ In this regard, the Court referred to an SEC report commissioned by Congress which in part discussed the notion that

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.⁴

The *Capital Gains* Court also highlighted certain affirmative duties and obligations traditionally imposed on fiduciaries, including the duty of “utmost good faith, and full and fair disclosure of all material facts,” as well as fiduciaries’ obligation to use reasonable care to avoid misleading their clients.⁵

The Supreme Court has since reaffirmed the existence of the fiduciary duty imposed by the Advisers Act and elaborated on its interpretation of Congress’ intent with regard to the general nature of this duty. For example, in *Santa Fe Industries, Inc. v. Green*, the Court observed that “Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers.”⁶ Additionally, in *Transamerica Mortgage Advisors, Inc. v. Lewis*,⁷ the Court reaffirmed the enforceability of these fiduciary obligations under Section 206, although the *Transamerica* Court declined to establish a private right of action beyond rescission of an advisory contract for breaches of this fiduciary duty.

Accordingly, the Advisers Act is deemed to impose upon advisers a fiduciary duty, which includes a duty of care and a duty of loyalty and which is enforceable under Section 206 of the Advisers Act. As a fiduciary, an adviser must act in the best interests of its client at all times.⁸ The SEC has repeatedly reaffirmed the existence of this fiduciary duty, and the discussion below highlights certain aspects of investment advisers’ fiduciary duty as set forth in the Advisers Act, the rules promulgated thereunder and in other Commission guidance.

² 15 U.S.C. § 80b-6.

³ 375 U.S. 180, 191.

⁴ *Id.* at 188.

⁵ *Id.* at 194.

⁶ 430 U.S. 462, 471 at note 11 (1977).

⁷ 444 U.S. 11 (1979).

⁸ See, e.g., Commissioner Annette L. Nazareth, Remarks Before the *IA Week* Sixth Annual Fall Conference (Sept. 25, 2006), available at <http://www.sec.gov/news/speech/2006/spch092506aln.htm>.

II. Specific Requirements Derived from the Adviser’s Fiduciary Duty

As noted above, the foundation for the treatment of registered investment advisers as fiduciaries was laid by the Supreme Court through its examination of the legislative history of the Advisers Act. The SEC has on a number of occasions elaborated on the general fiduciary principles described by the Supreme Court. Whether through the promulgation of formal rules or through general interpretive guidance, these SEC pronouncements provide helpful insight regarding a number of specific contexts in which the fiduciary duty imposed by the Advisers Act entails specific responsibilities or prohibits specific conduct.

A. Disclosure Responsibilities

A key aspect of an adviser’s fiduciary duty concerns the adviser’s general responsibility to fully disclose all material conflicts of interest to clients. This disclosure obligation is commonly cited as one of the primary driving forces behind the enactment of the Advisers Act. In this regard, the Supreme Court in *Capital Gains* noted that in enacting the Advisers Act, Congress intended

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.⁹

An adviser’s duty to disclose relevant facts pertaining to conflicts of interest and to other matters relating to the adviser’s activities on behalf of its clients permeates both the Advisers Act and the rules promulgated thereunder. For example:

- Rule 204-3 requires advisers to give clients a comprehensive written disclosure statement at the outset of the adviser/client relationship and to offer a new statement to clients at least once a year. Special disclosure brochures apply in the case of wrap fee programs. In each case, the required disclosure covers a range of factors relating to the nature of the advisory services provided, the fees charged, the nature of any conflicts of interest the adviser will face in rendering services to clients, and how those conflicts will be mitigated.
- Rule 204A-1 requires advisers to describe their codes of ethics to clients and to offer to furnish the codes to clients upon request.
- Section 206(3) forbids advisers from engaging in principal transactions with or agency-cross transactions on behalf of clients without first notifying clients and obtaining their informed consent.¹⁰

⁹ 375 U.S. 180, 191.

¹⁰ The Commission liberalized the notice and consent requirements somewhat for agency-cross transactions by adopting Rule 206(3)-2. The Commission addressed the scope of the disclosure required in the context of principal trades in *In the Matter of Kidder, Peabody & Co., Inc., Edward B. Goodnow* (“*Kidder*”), SEC Release No. IA-232 (Oct. 16, 1968).

- Rule 206(4)-3 under the Advisers Act prohibits an adviser from paying cash referral fees in connection with the solicitation of clients except under certain prescribed conditions, which in most cases require the delivery of a special disclosure statement to prospective clients. In promulgating this rule, the SEC noted that referral arrangements are “fraught with possible abuses inconsistent with the fiduciary relationships which frequently exist in the investment advisory community.”¹¹
- Rule 206(4)-4 under the Advisers Act imposes substantial disclosure obligations on advisers with regard to certain financial and disciplinary information.
- Rule 206(4)-6 requires advisers to disclose information regarding their proxy voting policies and procedures (about which more guidance is discussed below), as well as information related to how the adviser voted its clients’ proxies.
- Regulation S-P requires advisers to disclose their privacy policies to clients.

B. Codes of Ethics

Advisers Act Rule 204A-1 requires federally registered advisers to establish, maintain and enforce written codes of ethics. Among other things, these codes must describe the standards of conduct expected of all advisory personnel and must address the personal trading activities of those supervised persons who have access to sensitive client information. In adopting this requirement, the SEC stressed that the chosen standards of business conduct must reflect the adviser’s fiduciary obligations and those of its supervised persons.¹²

C. Proxy Voting Responsibilities

Another context in which an adviser’s fiduciary obligations may arise concerns the adviser’s voting of proxies on behalf of clients. In addition to the disclosure obligations noted above, Rule 206(4)-6 requires advisers who exercise voting authority with respect to client securities to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interests of clients and that describe the manner in which the adviser addresses material conflicts of interest.

The proposing and adopting releases to Rule 206(4)-6 set forth the SEC’s views regarding the manner in which an adviser’s proxy voting activities implicate its general fiduciary duty, as the Commission has generally taken the position that an adviser must carefully consider such duties when it undertakes to vote proxies on behalf of clients. Specifically, the SEC opined that the duty of care requires an adviser to monitor corporate events and exercise its proxy voting rights

¹¹ See SEC Release No. IA-615 (Feb. 2, 1978).

¹² See SEC Release No. IA-2256 (July 2, 2004).

when given such authority. The SEC has also taken the position that the duty of loyalty requires advisers to vote proxies in a manner consistent with the best interest of the client and precludes advisers from subrogating the client's interest to its own.¹³

With regard to these responsibilities, the SEC has noted that an adviser does not necessarily violate its fiduciary obligations to its client when it fails to vote a particular proxy. The Commission has recognized that an adviser may have good reason to refrain from voting a proxy, such as where the cost of voting a proxy exceeds the expected benefit. The Commission has also observed that advisers need not necessarily become "shareholder activists" pursuant to their proxy-voting responsibilities, noting that the scope of the adviser's proxy responsibilities are ordinarily determined by the advisory contract and the investment objectives and policies of the client. The SEC has made clear, however, that an adviser may not ignore a proxy voting obligation it has assumed or be negligent in fulfilling such obligation.

D. Suitability Obligations

In 1994, the SEC proposed a rule under the Advisers Act which would have expressly prohibited investment advisers from making unsuitable recommendations to clients.¹⁴ Proposed Rule 206(4)-5 would have prohibited an investment adviser from providing personalized investment advice to clients unless the adviser made a reasonable inquiry into the financial situation, investment experience, and investment objectives of the client and reached a reasonable determination that the advice was suitable for the client. This requirement would have applied to advice given to institutional clients as well as individual clients, and the extent of the inquiry required under the rule would have been determined by what could have been considered reasonable under the circumstances. Advisers would also have been required to maintain records of the information obtained from clients and to update such information on a periodic basis.

While proposed Rule 206(4)-5 was never adopted, the SEC framed the proposal as reflecting the Commission's interpretation of advisers' suitability obligations under the Advisers Act. Because the Commission related these suitability obligations to an adviser's fiduciary duty,¹⁵ it would seem to follow that despite the non-adoption of Rule 206(4)-5, the suitability obligations set forth in the proposal are nevertheless binding on advisers. Accordingly, advisers bear a fiduciary duty to provide only suitable investment advice to their clients. When giving personalized advice to a client, advisers must make a reasonable inquiry into the client's financial situation, investment experience and investment objectives and make a reasonable suitability determination. This suitability obligation entails both "know the client" and "know the product" considerations.

¹³ See SEC Release No. IA-2059 (Sept. 20, 2002); see also SEC Release No. IA-2016 (Jan. 31, 2003).

¹⁴ See SEC Release No. IA-1406 (March 22, 1994).

¹⁵ In this regard, the Rule 206(4)-5 proposing release noted that "Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice."

In considering its suitability obligations under the Advisers Act, advisers should note that the Commission observed in the Rule 206(4)-5 proposing release that the inquiries conducted by most advisers at initial client meetings would in most cases satisfy the inquiry requirement, as clients are typically asked for information about their current financial situation, financial goals and risk tolerance, among other things. Additionally, with regard to the suitability determination required by the rule, the Commission noted that

A reasonable determination of an investment's suitability for a client would require, for example, that certain kinds of particularly risky investment products be recommended only to those clients who can and are willing to tolerate the risks and for whom the potential benefits justify the risks.¹⁶

The SEC noted that suitability should be evaluated in the context of the client's full portfolio. Accordingly, the inclusion of risky investments in the portfolio of a generally risk-averse client may not necessarily be violation of the adviser's suitability obligations where, for example, the risky investments have a valid hedging function.

E. Best Execution

The SEC has taken the position that among the basic duties of a fiduciary is the duty to execute securities transactions for clients in such a manner that the client's total costs or proceeds are as favorable as possible under the circumstances. This duty, as the SEC has noted, requires an adviser to obtain best execution in the marketplace.¹⁷

The Director of the SEC's Division of Investment Management, Andrew J. Donohue, indicated in a recent speech before the Securities Industry Association's Institutional Brokerage Conference that in his view, an adviser's best execution considerations require the adviser to ask the threshold question of whether he is using a particular broker-dealer because it is best for the client, or because it is best for the adviser.¹⁸ Donohue noted that an adviser may not be able to simplify a best execution analysis to a single question, however. In many cases, for example, a client may direct an adviser to send trades to a particular broker-dealer, in which case Donohue noted that it is the adviser's responsibility to act in accordance with the client's instructions. However, where a client makes such a request "subject to best execution," the adviser's best execution analysis is again changed. In sum, Donohue stressed two key points: that personal benefits or considerations should not be motivating factors in advisers' execution considerations, and that advisers should bear in mind that commission dollars and other execution-related charges are client assets rather than belonging to the adviser.

¹⁶ SEC Release No. IA-1406, text accompanying note 11.

¹⁷ See, e.g., *Kidder*, note 10 supra; SEC Release No. IA-1406.

¹⁸ See Andrew J. Donohue, Keynote Luncheon Address Before the SIA Institutional Brokerage Conference (Oct. 30, 2006), available at <http://www.sec.gov/news/speech/2006/spch103006ajd.htm>.

With regard to an adviser's best execution considerations, we note that Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act") provides a safe harbor for persons such as advisers who exercise investment discretion with respect to accounts and who use commission dollars to obtain investment research and brokerage services. Under Section 28(e), such persons are not deemed to have breached their fiduciary duties or to have violated the federal securities laws where (i) the products and services received are eligible brokerage and research under the statute; (ii) the products and services received provide lawful and appropriate assistance to the adviser in carrying out its investment management duties; and (iii) the adviser makes a good-faith determination that the amount of the commission paid is reasonable in relation to the value of the brokerage and research services provided. Full and fair disclosure of the adviser's soft-dollar practices must be made as well.

The SEC has also opined that in addition to obtaining best execution in the marketplace, an adviser's fiduciary duty requires the adviser to execute transactions on an agency rather than a principal basis where similar transactions for non-advisory clients normally would be executed on an agency basis at a commission less than the mark-up which would be imposed if the transaction were executed on a principal basis.¹⁹ As a general matter, the Commission noted that an 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."²⁰

F. Duty to Monitor Personal Trading Activity

Because investment advisers are hired to make investment decisions for their clients, potential conflicts of interest arise whenever advisers or their staffs also trade for their own accounts. The SEC takes such conflicts very seriously. Over the past several years, the agency has brought a number of enforcement actions against advisers and their employees in connection with personal trading activities that were deemed to violate the adviser's fiduciary duties as reflected in the antifraud, reporting and other provisions of the federal securities laws. The conduct that has led to sanctions includes:

- Allowing portfolio managers to buy and sell for themselves the same securities they buy and sell for clients in such a way that the adviser's independent judgment is compromised.²¹
- Diverting trading opportunities away from managed accounts in favor of an adviser's proprietary accounts or the accounts of its associated persons.²²
- Improper allocation of trades after execution.²³

¹⁹ *Kidder* at 11.

²⁰ *Id.*

²¹ See *In the Matter of Roger W. Honour*, SEC Release No. IA-1527 (Sept. 29, 1995).

²² See *In the Matter of Joan Conan*, SEC Release No. IA-1446 (Sept. 30, 1994); *In the Matter of Kemper Financial Services, Inc., et al.*, SEC Release No. IA-1494 (June 6, 1995); *In the Matter of Ronald V. Speaker and Janus Capital Management*, SEC Release No. IA-1605 (Jan. 13, 1997).

- Insider trading. Section 204A of the Advisers Act requires advisers to have written policies and procedures designed to prevent violations in this area.
- Inadequate disclosure of the conflicts of interest arising from portfolio managers' personal shareholdings.²⁴

As noted above, Advisers Act Rule 204A-1 requires the adoption of codes of ethics that, among other things, address personal trading by certain advisory personnel. In this regard, advisers must require their "access persons"²⁵ to pre-clear trades in IPOs and private placements (*i.e.*, investments of limited opportunity) and to periodically report information regarding their personal securities transactions and holdings. In the adopting release to this rule, the SEC identified a range of other prophylactic measures an adviser might include in its code of ethics to avoid problems in the personal trading area.²⁶

G. Prohibition on Assigning Contracts Without Client Consent

Section 205 of the Advisers Act requires that advisory agreements provide that the adviser will not assign its duties under the contract without the client's consent. Where the adviser is a partnership, this section requires that the contract provide, in substance, that the adviser will notify the client of any change in the membership of the partnership within a reasonable time after such change. These requirements derive from the common-law rule that a fiduciary may not delegate the duties it owes its beneficiaries unless otherwise agreed.

H. Duty to Protect Clients in the Event of a Business Disruption

In adopting Rule 206(4)-7 under the Advisers Act to require advisers to adopt and maintain written policies and procedures reasonably designed to prevent violation of the federal securities laws and regulations thereunder, the SEC indicated that it considers the maintenance of business continuity plans to fall within the scope of an adviser's fiduciary duty. Specifically, the SEC stated its belief that an adviser's fiduciary duty

includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel.²⁷

²³ See *In the Matter of Nicholas-Applegate Capital Management*, SEC Release No. IA-1741 (Aug. 12, 1998).

²⁴ See *In the Matter of Chancellor Capital Management, Inc.*, SEC Release No. IA-1447 (Oct. 18, 1994).

²⁵ An "access person" is one who is involved in making recommendations to clients or who has access to those recommendations before they are public.

²⁶ See SEC Release No. IA-2256.

²⁷ See SEC Release No. IA-2204 (Dec. 24, 2003).

In indicating that it expects advisers' required policies and procedures to include such plans, the SEC noted that the clients of an adviser who actively manages assets would generally be placed at risk if the adviser were to cease operations.

III. Views of Advisers' Fiduciary Duties from a Compliance Examination Perspective

In a recent speech before the Eighth Annual Investment Adviser Compliance Summit, SEC Office of Compliance Inspections and Examinations (OCIE) Director Lori A. Richards expressed her personal views regarding the scope of the fiduciary duty imposed by the Advisers Act and provided an overview of deficiencies commonly found by OCIE during examinations of registered advisers.²⁸ While Richards' characterization of an adviser's major responsibilities is consistent with the guidance discussed above,²⁹ her discussion of the deficiencies commonly noted in OCIE examinations may provide more practical insight into the SEC staff's current views regarding an adviser's fiduciary duty from a compliance perspective. These deficiencies involved advisers' practices with regard to disclosure, portfolio management, employee personal trading, performance calculations and brokerage arrangements and execution.

Richards noted that an adviser's fiduciary duty was implicated by each of these types of common deficiency. Specifically, Richards noted that advisers must identify and disclose all material conflicts of interest and ensure that they have accurately described in their Form ADV how their business is conducted. With regard to deficiencies in portfolio management, Richards indicated that advisers must ensure that they manage their clients' money in a manner consistent with clients' direction. Advisers must also implement controls, codes of ethics and monitoring procedures to ensure that their employees refrain from placing their own interests ahead of those of their clients when trading for their personal accounts, as is dictated by the fiduciary duty of utmost good faith. With regard to performance calculations, Richards noted that advisers must calculate and describe their past performance honestly and must provide information that is not misleading. Finally, she observed that because brokerage money belongs to the client and not the adviser, the adviser must ensure that such funds are used appropriately and that the client is aware of how such money is and will be spent.

While Richards' statements describing how these common deficiencies implicate an adviser's fiduciary duty are not binding on the Commission or other members of the staff, they provide a degree of insight into OCIE's current construction of an adviser's fiduciary duty from the standpoint of those members of the SEC staff who examine advisers for compliance with the requirements of the Advisers Act. Accordingly, it may be helpful for advisers to bear these comments in mind when assessing their own compliance with their fiduciary responsibilities.

²⁸ See Lori A. Richards, *Fiduciary Duty: Return to First Principles*, Address at the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), available at <http://www.sec.gov/news/speech/spch022706lar.htm>.

²⁹ Specifically, Richards opined that an adviser's five major responsibilities as a fiduciary are "to put clients' interests first; to act with utmost good faith; to provide full and fair disclosure of all material facts; not to mislead clients; and to expose all conflicts of interest to clients."

Reporter's Comment: This legal memorandum, while believed to be authoritative as to the current general state of the law as of the date of its publication, is intended for the use and benefit of the Financial Planning Association only. Accordingly, this legal memorandum is not intended to be, and shall not be, relied upon by any member of the Financial Planning Association nor any other person or entity in connection with his or her activities as a financial planner, registered representative, registered investment adviser representative, insurance agent, or otherwise.

APPENDIX B

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Memorandum

Via Electronic Mail and Regular Mail

To: Mr. Neil Simon
Mr. Robert Neill
From: Mari-Anne Pisarri
Mark D'Arrigo
Date: December 21, 2006
RE: Treatment of Broker-Dealers and Their Associated Persons as Fiduciaries

Pursuant to your request, this memorandum provides an overview of the circumstances in which a fiduciary duty is imposed on registered broker-dealers by the Securities Exchange Act of 1934 (the "Exchange Act") and regulations thereunder and highlights certain aspects of the nature of such duties. This memorandum also addresses similar fiduciary issues which arise under the regulations of self-regulatory organizations ("SROs") such as the NASD and New York Stock Exchange ("NYSE").

I. General Application of Fiduciary Duty to Broker-Dealers

Our previous memorandum discussed the fiduciary duty imposed on registered investment advisers by the Investment Advisers Act of 1940 (the "Advisers Act"). In that memorandum, we noted that the Advisers Act does not explicitly articulate a fiduciary standard for registered advisers. However, in light of the legislative history behind the statute, the Supreme Court has deemed Section 206 of the Advisers Act, which prohibits an adviser from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client, to impose a general fiduciary duty on advisers.¹

¹ See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

Like the Advisers Act, the Exchange Act does not explicitly impose a fiduciary duty on registered broker-dealers, although the Exchange Act does include the kind of general antifraud provision found in Advisers Act Section 206. In this regard, Section 10(b) of the Exchange Act prohibits the use of any manipulative or deceptive device or contrivance in connection with the purchase or sale of any security in contravention of rules and regulations promulgated by the SEC. Rule 10b-5 thereunder prohibits any person from (a) employing any device, scheme, or artifice to defraud, (b) making any untrue statement of material fact or failing to state any material fact necessary to make any statement made not misleading, or (c) engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of a security. Unlike Section 206 of the Advisers Act, however, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder have not been deemed to impose a general fiduciary duty upon registered broker-dealers. Accordingly, registered broker-dealers and registered advisers do not typically bear the same fiduciary duties to their clients under all circumstances.²

Generally speaking, the nature of a broker-dealer's fiduciary duties to clients, including the duty of care and loyalty, depends on the facts and circumstances of the broker-customer relationship. In this regard, courts which have found broker-dealers to be acting as fiduciaries have recognized that

The nature of the fiduciary duty owed will vary, depending on the relationship between the broker and the investor. Such determination is necessarily particularly fact-based.³

Broker-dealers are traditionally held to higher fiduciary standards where they assume positions of trust and confidence with their customers similar to those held by advisers, or where a high degree of reliance on the broker is evident on the part of the customer. Such relationships are typically found where a brokerage account is discretionary rather than nondiscretionary or where a broker-dealer otherwise provides ongoing investment advice, as discussed in greater detail below.⁴

The scope of a broker-dealer's fiduciary duty to customers in the context of a discretionary account was described in *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*⁵ Specifically, the *Leib* court asserted that a broker-dealer's duty in such cases encompasses the following responsibilities:

² See generally, e.g., SEC Release No. 34-50980 (January 6, 2005)(reproposing Rule 202(a)(11)-1 under the Advisers Act to require in advertisements and other documents with regard to certain accounts that, due to the status of the account as a brokerage rather than an advisory account, the scope of the firm's fiduciary obligations to the client may differ)(the "Rule 202(a)(11)-1 Reproposing Release"). Additionally, please note that while Section 10(b) and Rule 10b-5 are deemed to impose upon the management of public companies a fiduciary duty to shareholders, see, e.g., *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), such matters are beyond the scope of this memorandum, which is limited to a discussion of the fiduciary duties borne by broker-dealers.

³ See *Romano v. Merrill Lynch, Pierce, Fenner & Smith, et al.*, 834 F. 2d 523, 530 (5th Cir. 1987)("Romano").

⁴ See, e.g., Rule 202(a)(11)-1 Reproposing Release at Note 54; SEC Release No. 34-51523 (Apr. 12, 2005), 70 Fed. Reg. 20424, 20433 at Note 98 (Apr. 19, 2005).

⁵ 461 F.Supp. 951 (E.D. Mich. 1978).

- The duty to manage the account in a manner directly comports 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;
- The duty to keep informed regarding the changes in the market which affect the customer's interest and act responsively to protect those interests;
- The duty to keep the customer informed as to each completed transaction; and
- The duty to explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.⁶

Courts have also recognized that there may be circumstances under which a type of hybrid discretionary-nondiscretionary account relationship may exist, such as where a broker assumes or usurps control of a non-discretionary account, which would also carry increased fiduciary responsibilities for a broker-dealer.⁷ In this regard, the Colorado Supreme Court has held that

Proof of practical control of a customer's account by a broker will establish that the broker owes fiduciary duties to the customer with regard to the broker's handling of the customer's account. Evidence that the customer has placed trust and confidence in the broker, with the broker's knowledge, to manage the customer's account for the customer's benefit will be indicative of the existence of a fiduciary relationship but will not, by itself, establish that relationship."⁸

Among the factors to be considered in a determination of whether a broker-dealer has assumed such control are the age, education, intelligence and investment experience of the customer; the existence of any social or personal involvement between the broker and the customer; whether any transactions occurred without the customer's prior approval; and the frequency with which the broker and customer speak regarding the status of the account.⁹

The courts' traditional views on fiduciary duties in the discretionary account context have recently been incorporated into SEC Rule 202(a)(11)-1 under the Advisers Act. This rule allows broker-dealers to treat customers of asset-based or fixed fee brokerage services as brokerage clients and not advisory clients so long as any investment advice rendered to such clients is "solely incidental" to the brokerage services supplied to them. The rule provides that investment advice is not "solely incidental" to brokerage services if, among other things, the broker-dealer exercises discretion over client accounts, except on a temporary or limited basis. Since the adoption of Rule 202(a)(11)-1, therefore, a discretionary brokerage account must be treated as an

⁶ *Id* at 953.

⁷ *See, e.g., Leib*.

⁸ *See Paine, Webber, Jackson & Curtis, Inc. v. Adams*, 718 P.2d 508, 517-518 (Colo. 1986).

⁹ *See Leib* at 954.

investment advisory account, subject to all the fiduciary duties described in our previous memorandum to you regarding the Advisers Act.

Rule 202(a)(11)-1 also applies the heightened investment advisory fiduciary standard to certain other types of conduct deemed not to be “solely incidental” to normal broker-dealer activities. Specifically, the heightened standard is applied where a broker-dealer charges a separate fee for (or separately contracts for) advisory services, or where it provides advice as part of a financial plan or in connection with providing financial planning services and either (i) holds itself out generally to the public as a financial planner or as providing financial planning services, (ii) delivers a financial plan to the customer, or (iii) represents to the customer that the advice is provided as part of a financial plan or in connection with financial planning services.

We note that while the predominant view is that a broker-dealer does not owe its customers a fiduciary duty in the absence of a discretionary relationship or one of special trust and confidence (assuming that Rule 202(a)(11)-1 is not otherwise implicated),¹⁰ not everyone adopts this view. Instead, some courts hold that broker-dealers always owe at least some degree of fiduciary duty to their clients.¹¹ But even these courts view the nature of the broker-customer relationship as “a factor to be considered” in addressing the scope of the broker-dealer’s fiduciary duty.¹²

The nature of a broker-dealer’s fiduciary obligation in the case of a non-discretionary account is generally thought to be limited, or transactional. In explaining this concept, the *Leib* court noted that

[t]he broker is bound to act in the customer’s interest when transacting business for the account; however, all duties to the customer cease when the transaction is closed.¹³

In such cases, a broker does not bear a continuing duty to monitor financial information which may affect a customer’s portfolio or to keep the customer informed of developments which may influence his investments.¹⁴ Other courts which have asserted that only narrow fiduciary duties apply to brokers in connection with non-discretionary accounts have characterized these duties as being confined merely to the execution of orders, potentially encompassing no more than a duty not to make unauthorized trades.¹⁵ However, on the trade execution front, the duty of best

¹⁰ See, e.g., *In the Matter of Arleen W. Hughes d.b.a. E.W. Hughes & Co.*, 27 S.E.C. 629 (Feb. 18, 1948)(“Hughes”).

¹¹ See *Romano*; see also *Davis v. Merrill Lynch, Pierce, Fenner & Smith*, 906 F.2d 1206 (8th Cir. 1990).

¹² *Romano* at 530. In reaching its conclusion that Merrill Lynch had not breached a fiduciary duty to Mr. Romano, the *Romano* court also noted that Romano maintained control over his non-discretionary account and was an “alert and vigilant businessman” who had the ability to make his own investment decisions.

¹³ *Id* at 952-3.

¹⁴ *Id* at 953.

¹⁵ See *Hill v. Bache Halsey Stuart Shields, Inc.*, 790 F.2d 817 (10th Cir. 1986). We note that the *Hill* court attributed the existence of this duty to the agency relationship that exists between a customer and a broker who executes a trade for the customer’s account under state law. *Id* at 824.

execution is generally regarded as a basic component of a transactional fiduciary duty in connection with a nondiscretionary account.¹⁶

The *Leib* court itemized the fiduciary duties owed by a broker-dealer in the context of a non-discretionary account as follows:

- The duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis;
- The duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests;
- The duty to inform the customer of the risks involved in purchasing or selling a particular security;
- The duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security;
- The duty not to misrepresent any fact material to the transaction; and
- The duty to transact business only after receiving prior authorization from the customer.

The discussion below highlights certain additional aspects of common fiduciary responsibilities that may apply to broker-dealers in connection with either nondiscretionary or discretionary accounts, as well as certain relevant NASD and NYSE rules which may be regarded as encompassing aspects of a broker-dealer's fiduciary duty. You will see that the fiduciary standards to which broker-dealers may be held are similar to those applicable to advisers under the Advisers Act, although they may not apply in all circumstances, as discussed above. Note, too, that the SEC has emphasized that even absent a statutory fiduciary responsibility to clients, broker-dealers are still subject to an extensive regulatory regime that in some cases provides customer protections beyond those provided under the Advisers Act.¹⁷

II. Specific Considerations and SRO Rules Relevant to Broker-Dealers Which Relate to Fiduciary Obligations

NASD and NYSE member firms are subject to broad disclosure and customer protection obligations under the rules maintained by each of these SROs. NASD and NYSE rules, like the Exchange Act, generally do not explicitly impose fiduciary duties upon member firms. Certain rules, however, could be read as imposing a sort of transactional fiduciary duty in light of the considerations discussed above. The discussion below examines some of these SRO rules which can be read as relating to the fiduciary obligations to which a broker-dealer may be subject.

¹⁶ See *Hughes*, note 10 *supra* and the discussion at pages 8-9 *infra*.

¹⁷ See, e.g., Rule 202(a)(11)-1 Reproposing Release, 70 Fed. Reg. 2716, 2721.

A. SRO Rules of Fair Practice

The NASD and NYSE maintain expansive rules requiring members to behave fairly. NASD Rule 2110 requires members to “observe high standards of commercial honor and just and equitable principles of trade” in the conduct of their business. Similarly, NYSE Rule 401 requires members to “at all times adhere to the principles of good business practice in the conduct of . . . business affairs.”¹⁸ These rules may generally be regarded as imposing fiduciary-like obligations on SRO members even where a specific fiduciary duty is not imposed by law.¹⁹

The NASD and NYSE also have each adopted interpretations to these rules which clarify the nature of the duties the rules impose on broker-dealers. For example, the NASD has opined that its Rule 2110 prohibits a member firm from trading ahead of a customer limit order unless the firm immediately thereafter executes the limit order.²⁰ Specifically, a member firm that accepts and holds an unexecuted limit order in an exchange-listed security from a customer and continues to trade the security for its own account at prices that would satisfy the customer’s limit order without executing the limit order is deemed to violate just and equitable principles of trade.

This interpretation, known as the “Manning Rule,” originates from an NASD disciplinary action taken against a member firm for engaging in such conduct. In its affirmation of the NASD’s decision, the SEC asserted that in accepting the customer’s limit order and agreeing to act on his behalf in obtaining execution, the NASD member firm had assumed certain fiduciary obligations to the customer.²¹ In finding that the broker bore such obligations, however, we note that the SEC found that such obligations were based on the agency relationship created by the firm’s acceptance of the limit order, and did not depend on the existence of a relationship of trust and confidence. Accordingly, such obligations should be merely transactional and should not in this case be seen as extending to the entire relationship between the firm and its customer. The NASD has also adopted a separate rule, Rule 2111, which similarly prohibits a member firm from trading ahead of customer market orders. Among other things, Rule 2111 requires a member to make every effort to execute a customer market order fully and promptly, and provides that a member that accepts and holds a market order in a Nasdaq or other exchange-listed security from a customer without immediately executing such order may not trade that security on the same side of the market for its own account unless it immediately thereafter executes the customer market order up to the size and at the same or better price at which the firm traded for its own account.

¹⁸ Additionally, NYSE Rule 401 requires members to maintain written policies and procedures regarding customer transmittals of funds or securities, customer changes of addresses and customer changes of investment objectives.

¹⁹ See, e.g., Letter dated April 4, 2005 from Mary L. Schapiro and Elisse B. Walter, NASD Regulatory Policy and Oversight, to Annette L. Nazareth, SEC Division of Market Regulation and Meyer Eisenberg, SEC Division of Investment Management.

²⁰ See NASD IM-2110-2.

²¹ See *In the Matter of the Application of E.F. Hutton & Company, Inc.*, SEC Release No. 34-25887 (July 6, 1988).

Another NASD interpretation of Rule 2110—NASD IM-2110-3, the NASD’s front-running policy—appears to implicate transactional fiduciary duties as well as the broader fiduciary duties borne by broker-dealers in connection with discretionary accounts. This policy prohibits member firms from executing an order to buy or sell an option or security future (or an underlying security) where the member or an associated person is in possession of material non-public market information concerning an imminent block transaction in a security (or an overlying option or future) or where a customer has been provided such information by the member or any associated person thereof. These restrictions apply to any account in which a member or associated person has an interest, any account for which a member or associated person exercises investment discretion, and certain other customer accounts, but do not apply to situations in which a member or associated person receives a customer order of block size relating to both an option or future and the underlying security.

Likewise, interpretive guidance adopted by the NYSE with regard to Rule 401 implicates an NYSE member broker’s fiduciary responsibilities. Specifically, NYSE Rule 401/01—Trading Against Firm Recommendations—prohibits NYSE members from taking any action in contemplation of firm recommendations. Noting that transactions in a security shortly before a member issues a purchase or sale recommendation regarding the security “raise[s] questions of motive,” Rule 401/01 provides that firm personnel having pre-publication knowledge of a recommendation should refrain from entering into a transaction in any account in which they have an interest or exercise discretion, or from passing on advance information to persons outside the firm, in contemplation of the report. The interpretation further specifies that most personnel of the member are free to act for unaffiliated discretionary accounts once customers have generally learned of the recommendation, but should still refrain from acting for accounts in which they have an interest until the market has absorbed the effect of the recommendation.

B. Best Execution Considerations

As noted above and in our previous memorandum regarding fiduciary duties imposed by the Advisers Act, the SEC has taken the position that the duty of best execution, that is, the duty to execute securities transactions for clients in such a manner that the client’s total costs or proceeds are as favorable as possible under the circumstances, is among the most basic duties of a fiduciary.²² The SEC has on a number of occasions reiterated that the duty of best execution imposes upon broker-dealers an obligation to obtain the best price for its customers, stating that such obligation “is basic and vital to the broker-customer relationship.”²³ In the broker-dealer context, the SEC has specified that the duty of best execution is compromised where a broker-dealer interposes another broker-dealer between himself and a third broker-dealer.²⁴ In such cases, the broker-dealer bears the burden of showing that the customer’s total cost of or proceeds from the transaction are as favorable as possible under the circumstances.

²² See, e.g., *In the Matter of Kidder, Peabody & Co., Inc., Edward Goodnow*, SEC Release No. 34-8426 (Oct. 16, 1968).

²³ See, e.g., *In the Matter of Thomson & McKinnon, Walter T. O’Hara*, 43 S.E.C. 785, 788-9 (June 1, 1968).

²⁴ *Id.* at 789.

The NASD has addressed member firms' best execution obligations in Rule 2320. Rule 2320(a) requires a member and its associated persons to use "reasonable diligence" in any transaction with or for a customer or a customer of another broker-dealer to ascertain the best market for a subject security, and to buy or sell in such market in order to obtain as favorable a price to the customer as possible under prevailing market conditions. Rule 2320(a) further provides that in determining whether a member has used "reasonable diligence," the NASD will consider the character of the market for the security, *e.g.*, price, volatility, relative liquidity, and pressure on available communications; the size and type of transaction; the number of markets checked; accessibility of the quotation; and the terms and conditions of the order resulting in the transaction, as communicated to the member and persons associated with the member.

In addition, under Rule 2320(b), in any transaction for or with a customer, no member or associated person thereof may interject a third party between the member firm and the best available market, unless the member can demonstrate that to its knowledge at the time of the transaction, the total cost or proceeds of the transaction, as confirmed to the member, were better than the prevailing inter-dealer market for the security. The rule further provides that a member's best-execution obligations generally are not fulfilled when the member channels transactions through another broker-dealer, unless he can show that doing so reduced the transaction cost for the customer.

The SEC has also promulgated certain rules relevant to a broker-dealer's best-execution obligations. For example, Rule 11Ac1-1 under the Exchange Act (the "quote rule") requires national securities exchanges to establish procedures for collecting from their members and making available to quotation vendors, bids, offers and quotation sizes with respect to reported securities. It also requires that quotation information be "firm" for the disseminated size, subject to certain exceptions. Additionally, Rule 11Ac1-4 (the "display rule") requires market makers to display the full price and size of qualifying limit orders in their quotes, subject to certain exceptions. Customer limit orders subject to the rule must generally be displayed as soon as practicable after receipt of the order, which under normal market conditions is generally regarded as being no later than 30 seconds after receipt.

C. Disclosure Obligations

In addition to implicating a broker-dealer's best-execution responsibilities, rules such as the quote rule and display rule also implicate a broker-dealer's disclosure responsibilities. The SEC has asserted that, consistent with the duty of loyalty, a fiduciary must "disclose all material circumstances fully and completely."²⁵ With regard to a broker-dealer bearing transactional fiduciary duties, this responsibility encompasses disclosure of the current market price of a security involved in a transaction, among other things.²⁶ With regard to a broker-dealer bearing more widespread fiduciary responsibilities in connection with a discretionary account or in the case of other circumstances giving rise to a relationship of trust and confidence, a broker-dealer's disclosure obligations are more comprehensive. As a general matter, however, as the SEC has

²⁵ See, *e.g.*, *Hughes*, note 10 *supra*, at 636.

²⁶ *Id.*

noted, broker-dealers are generally subject to extensive disclosure requirements and a robust customer protection regime.²⁷

For example, Rule 10b-10 under the Exchange Act requires broker-dealers to provide customers with a written transaction confirmation disclosing certain specified information prior to, or at the time of, completion of a transaction. In addition to specifying fundamental information such as the date and time of the transaction, the identity, price and number of shares purchased or sold, compensation received by the broker and the capacity (principal or agent) in which the broker-dealer is acting, the confirmation must provide certain other details, such as information regarding odd-lot differential or equivalent fees, disclosures regarding redemption of debt securities before maturity, information regarding the yield of debt securities, and the broker-dealer's participation in SIPC, among other things.

The NASD also imposes disclosure requirements on members in connection with transactions in particular securities. For example, under the NASD Rules of Fair Practice, members must disclose all material facts when recommending the purchase or sale of a mutual fund to a customer.²⁸ Members are also required to ensure that all communications with the public, both oral and written, contain accurate and complete disclosure with regard to mutual funds offered for sale by the member, including information relating to SIPC coverage, breakpoints and switching.²⁹ In addition, we note that all NASD member communications with the public are subject to the requirements of NASD Rule 2210, which provides that such communications must be based on principles of fair dealing and good faith, must be fair and balanced, must provide a sound basis for evaluating the facts with regard to any particular security or type of security, industry or service, among other things. Such communications also may not omit any material fact or qualification if such fact or qualification would be necessary to make the communication not misleading.

While not explicitly tied to members' fiduciary obligations, both the NASD (Rule 2340) and NYSE (Rule 409) require member firms to provide account statements to customers on at least a quarterly basis. Such statements must generally provide a statement or description of a customer's securities positions, money balances and account activity for the period covered by the statement. Additionally, NASD Rule 2341 requires the delivery of a disclosure statement to any non-institutional customer for whom the member opens a margin account prior to the opening of such account, and requires the delivery of a separate disclosure statement to holders of such accounts on an annual basis. Rule 2361 similarly requires the delivery of a disclosure statement to any non-institutional customer by any member who promotes a day-trading strategy.

Disclosure obligations also arise in the context of broker-dealer research reports. In order to address concerns that investment banking relationships and certain compensation arrangements may adversely affect the objectivity of research produced by full-service firms, NYSE Rules 351 and 472 and NASD Rule 2711 impose a number of prophylactic measures on members' research

²⁷ See, e.g., Rule 202(a)(11)-1 Reproposing Release at 2721; see also *Id.* at 2731, note 131.

²⁸ See NASD Notice to Members 94-16.

²⁹ See *Id.*; see also NASD Notice to Members 95-80.

activities. Among these are a requirement to disclose publicly information about conflicts of interest as well as specific information about a firm's rating system.

Note, however, that although broker-dealers are subject to a host of transaction-related and other specific disclosure requirements, they have no general obligation to provide information to clients and potential clients about the nature of their operations, the conflicts of interest those operations entail or the scope of the services to be rendered to the client. In this regard, broker-dealers' disclosure obligations are less extensive than those of registered investment advisers who, in accordance with Advisers Act Rule 204-3, must distribute comprehensive disclosure brochures to their clients.

D. Suitability Obligations

The suitability obligations borne by broker-dealers when making recommendations to customers are well-established. However, as an initial matter we note that there is no bright-line determination of where a broker-dealer's suitability obligation ends and a fiduciary obligation begins. In this regard, the SEC noted in the Rule 202(a)(11)-1 adopting release that

Elements of financial planning have been, are, and should be a part of every broker-dealer's considerations as to the suitability of their recommendations . . . it would be unwise for us to attempt to distinguish when a suitability analysis ends and financial planning begins, and we do not want to interfere in any way with a broker-dealer's fulfillment of its suitability obligations.³⁰

In light of this consideration, it may be helpful to regard a broker's suitability obligation as a transactional, or product-focused obligation, wherein the broker attempts to distinguish himself through the quality of his research and knowledge of a particular product, and the particular circumstances of the customer become relevant only at the point at which the customer is matched with a broker-dealer's product research or recommendation. By contrast, the fiduciary duty borne in an advisory or financial planning relationship focuses more on the customer's objectives, as an adviser or financial planner fleshes out his customer's goals over time, and individual financial products or transactions become relevant only insofar as they advance the client's objectives.

Notwithstanding these considerations, the SEC has previously observed a connection between a broker's suitability obligations and his fiduciary duty to customers, such as it did in the *Hughes* decision. In that case, the SEC noted that Hughes had in part created the relationship of trust and confidence that gave rise to her heightened fiduciary duties by "representing that she would act solely in the best interests of her clients and that she would make only such recommendations as would serve their interests."³¹

A broker-dealer's suitability obligations do not, however, merely extend to situations in which a relationship of trust and confidence has been established. Rather, broker-dealers bear such

³⁰ See SEC Release No. 34-51523, 70 Fed. Reg. 20424, 20439.

³¹ 27 S.E.C. at 638.

obligations whenever they make recommendations to customers, regardless of the presence or absence of such a special relationship. In this regard, NASD Rule 2310 sets forth NASD member firms' suitability obligations when making recommendations, providing in part that a member must have reasonable grounds for believing that the recommendation of a purchase, sale or exchange of a security is suitable for the customer upon the basis of the facts disclosed by the customer as to his other security holdings and his financial situation and needs. Members must also make reasonable efforts to obtain information concerning the customer's financial status, tax status and investment objectives, as well as other relevant information, before making recommendations to non-institutional customers.

The NASD sets forth its general policy regarding fair dealing with customers on the part of member firms in the interpretive material to Rule 2310. In IM-2310-2, the NASD asserts that the fundamental responsibility for fair dealing is implicit in all member and registered representative relationships with customers, declining to limit such responsibility only to cases where a relationship of trust and confidence has been established. Accordingly, the NASD espouses the view that sales efforts may be undertaken only on a basis that falls within the ethical standards of NASD rules, with particular emphasis on the duty to deal fairly with the public.

Similarly, NYSE Rule 405 (Diligence as to Accounts) imposes "know your customer" obligations on NYSE member firms. Among other things, the rule requires members to conduct due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by the member and every person holding power of attorney over any account accepted or carried by the member.

III. SRO Enforcement Considerations

The NASD Department of Enforcement has on a number of occasions instituted enforcement proceedings under Rule 2110 against member firms and their associated persons for breaches of fiduciary duty.³² Such breaches may arise in a number of different contexts, including the following:

Registered Representative's Fiduciary Duty to His Employer

In a settled 2000 enforcement action against a registered representative of a member firm, the NASD found that the representative had breached a fiduciary duty to his firm by engaging in a course of trading that led the representative's personal accounts, and those of his customers, to profit at the expense of the firm.³³ In particular, the NASD found that the representative executed trades against the firm's account wherein the representative or his customer purchased securities from the firm at, around or below the market bid price and subsequently sold the same

³² In addition, we also note that customers of NASD member firms may bring claims for breach of fiduciary duty against firms or associated persons through the NASD Dispute Resolution forum. SRO arbitration decisions are not publicly reported; however, it is the experience of Pickard and Djinis that broker-dealers frequently deny that they have the type of relationship of trust and confidence with their clients that would give rise to a general fiduciary duty.

³³ See *Peter John Quartararo*, NASD Disciplinary Actions Reported for February 2000.

securities back to the firm at, around or above the market ask price. Under the terms of the settlement, the representative was fined and barred from association with an NASD member in any capacity, with a right to reapply after two years.

Fiduciary Duty to Customers

In another settled enforcement action, the NASD found that, among other things, a representative breached a fiduciary duty to a public customer through his conduct in settling a dispute with the customer.³⁴ In arriving at this conclusion, the NASD found that the member had breached his fiduciary duty by behaving in a manipulative, deceptive and intimidating manner during settlement discussions, exploiting his superior knowledge of the securities industry and the customer's age, reliance on and trust in the representative, and relative lack of knowledge. Pursuant to the terms of the settlement, the representative was censured, fined and suspended for six months. This particular enforcement action provides a good illustration of the type of conduct which may constitute a breach of the enhanced fiduciary duties broker-dealers bear where a relationship of trust and confidence has been established with a customer.

In a case involving the NYSE's rules regarding just and equitable principles of trade, the NYSE instituted an enforcement action against a registered representative of a member firm for, among other things, breaching a fiduciary duty to a customer by improperly obtaining funds from a customer trust account.³⁵ Accordingly, even in the absence of a fiduciary duty imposed on broker-dealers by statute or regulation, broker-dealers must be mindful of the fact that they remain subject to SRO enforcement action for breaches of practically imposed fiduciary duties under general rules of member conduct.

Likelihood of Future Fiduciary Misconduct

SRO enforcement actions relating to members' fiduciary duties are not limited to cases in which a member has breached an existing duty. For example, the NASD has taken the position that it may institute enforcement proceedings against members or their associated persons for conduct which carries implications for such parties' anticipated future compliance with fiduciary responsibilities. For example, in a June 2000 action which found that a registered representative violated Rule 2110 by making unauthorized charges on a co-worker's credit card, an NASD Hearing Panel noted that

The presence of an antecedent fiduciary responsibility is not essential to liability under Rule 2110. The focus instead is on the implications of the misconduct for future fiduciary responsibility.³⁶

In pursuing enforcement proceedings of this nature, the NASD has indicated that it regards not only breaches of existing fiduciary duty, but also any conduct that reflects on a member's ability to uphold its fiduciary duty as very serious matters.

³⁴ See *Dale Fuller Jackson*, NASD Disciplinary Actions Reported for August 1998.

³⁵ See *In the Matter of Robert Owen Bruce Tonnesen, Sr.*, Exchange Hearing Panel Decision 03-58 (April 29, 2003).

³⁶ See *Department of Enforcement v. Daniel D. Manoff*, Hearing Panel Decision No. C9A990007 (June 6, 2000).

Reporter's Comment: This legal memorandum, while believed to be authoritative as to the current general state of the law as of the date of its publication, is intended for the use and benefit of the Financial Planning Association only. Accordingly, this legal memorandum is not intended to be, and shall not be, relied upon by any member of the Financial Planning Association nor any other person or entity in connection with his or her activities as a financial planner, registered representative, registered investment adviser representative, insurance agent, or otherwise.

APPENDIX C

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Memorandum

Via Electronic Mail and Regular Mail

To: Mr. Neil Simon
Mr. Robert Neill

From: Mari-Anne Pisarri
Mark D'Arrigo

Date: January 22, 2007

RE: Insurance Agents, Financial Planners and their Common-Law Fiduciary Duties

Pursuant to your request, this memorandum provides an overview of the fiduciary duties which may be imposed on insurance agents and financial planners under common law. This is the third and final in a series of memoranda describing the treatment of fiduciaries in various contexts. Our first memorandum, dated December 5, 2006, provided an overview of the fiduciary duties imposed on investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). Our second memorandum, dated December 21, 2006, provided an overview of the circumstances under which a fiduciary duty is imposed on registered broker-dealers by the Securities Exchange Act of 1934, by the rules of self-regulatory organizations, and under common law.

Under the common law theory of agency, an agent bears a fiduciary obligation to his principal with regard to matters within the scope of the agency relationship. This memorandum explores this concept with a particular focus on its application to insurance agents and financial planners. The memorandum also addresses certain other common-law fiduciary duties that courts have applied in the insurance and financial planning context.

I. Common Law of Agency Generally

One of the most basic considerations under the common law of agency is the principle that the relationship between an agent and his principal is fiduciary in nature. In this regard, the Second Restatement of Agency describes the agency relationship generally as

the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other to so act.¹

Whether or not an agency relationship will be deemed to exist turns on the presence or absence of certain factual elements. The existence of such a relationship does not, by contrast, depend on either the parties' intent or what the parties call the relationship. The relevant factual elements include:

the manifestation by the principal that the agent shall act for him, the agent's acceptance of the undertaking and the understanding of the parties that the principal is to be in control of the undertaking.²

An agent's fiduciary duties typically attach at the inception of the relationship, rather than at the time at which the agent first acts on behalf of his principal.³ And those duties extend to all matters within the scope of the agency relationship.⁴ As a fiduciary, an agent holds a position of trust and confidence with respect to his principal, a position the agent may not use for his own personal gain.⁵ The fiduciary nature of an agent's position also imposes a host of specific duties upon him. Like the fiduciary duties borne by investment advisers and broker-dealers discussed in our previous memoranda, an agent's fiduciary duties include the duty of care, the duty of loyalty and the duty to act in good faith. Other specific duties which are deemed to arise out of an agent's fiduciary obligation may include the duty to account for profits arising out of the agency relationship; the duty not to act as, or on account of, an adverse party without the principal's consent; the duty not to compete with the principal on the agent's own account or for another in matters relating to the subject matter of the agency; and the duty to deal fairly with the principal in all transactions with him.⁶ Additionally, because agency is a consensual relationship, typically founded in a contract or other agreement between two parties, an agent's

¹ Restatement (Second) of Agency § 1.

² *Id.*, comment (b). Please note that while many jurisdictions include the basic elements summarized in the Restatement in their interpretations of what constitutes a fiduciary relationship, individual jurisdictions may also include other considerations. See, e.g., *A.G. Edwards & Sons, Inc. v. Drew et al.*, 978 S.W.2d 386 (Mo. Ct. App. 1998)(under Missouri law, the elements of a fiduciary relationship include certain characteristics consistent with those articulated by the Restatement, but also include additional elements specific to Missouri).

³ *Id.* §1, comment (c).

⁴ *Id.* § 13. See also, e.g., *Harts v. Farmers Insurance Exchange et al.*, 597 N.W.2d 47 (Mich. 1999)(holding that an insurance agent, acting on behalf of an insurance company, bore common-law fiduciary duties to the company).

⁵ *Id.* § 387, comment (b).

⁶ *Id.* § 13, comment (a).

duties under common law also include the performance of any obligations specified in the contract or agreement.⁷

It is important to note that not every party who agrees to act on behalf of another party is an agent. Whether such a situation rises to the level of an agency depends on whether one party (the principal) controls or has the right to control the other party's (the agent's) physical conduct in the performance of his duties.⁸ For this reason, courts sometimes decline to impose fiduciary duties under a theory of agency where the agreement between the parties indicates that a party is merely acting in the capacity of an independent contractor.⁹

II. Judicial Imposition of Common-Law Fiduciary Duties

A. General Concepts

As a general matter, there is no body of federal common law relevant to the question of whether an insurance agent or financial planner owes a fiduciary duty to another person. Accordingly, such matters are questions of state law, and the specific circumstances under which a person may bear such a fiduciary duty often differ depending on the jurisdiction in which the insurance agent or financial planner conducts business. Although courts sometimes find fiduciary duties in state statutes governing particular relationships,¹⁰ for the most part, judicial analyses are based on common law, which is the focus of the following discussion.

As explained more fully below, courts impose fiduciary duties on insurance agents where they find such persons to be acting in an agency capacity or where such persons are otherwise in positions of trust and confidence with others (*e.g.*, clients). In this regard, the application of common-law fiduciary duties to insurance agents is similar to that which applies to registered broker-dealers.¹¹ While some states address the application of fiduciary duties to financial planners in a similar fashion, a number of other jurisdictions appear to impose common-law fiduciary duties on any person holding himself out as a financial planner. The treatment afforded financial planners in these latter jurisdictions is similar to that afforded registered investment advisers, which reflects the frequent overlap between financial planning and investment advisory functions.

⁷ *Id.*, introductory note to Chapter 13. *See also State Security Insurance Co. v. Frank B. Hall & Co.*, 630 N.E.2d 940, 947 (Ill. App. Ct. 1994)(noting that an agent's duties to his principal are determined by the agreement between the parties as interpreted in light of the surrounding circumstances).

⁸ *Id.* §2(3).

⁹ *See, e.g., Consolidated Insured Benefits, Inc. et al. v. Consec Medical Insurance Company*, 206 U.S. Dist. LEXIS 85755 (D.S.C. 2006).

¹⁰ *See, e.g., U.S. v. Schwab*, 88 F.Supp. 2d 1275, 1285-6 (D.Wyo. 2000)(noting that the Wyoming Statutes specify that any premiums received by an insurance agent are trust funds received in a fiduciary capacity and concluding that the relationship between an insurer and its agent is therefore fiduciary by statute).

¹¹ Please refer to our memorandum dated December 21, 2006 for further discussion of the application of common-law fiduciary duties to broker-dealers.

In reading the following discussion, please note that because duties of disclosure and due care can exist in economic transactions even where no fiduciary relationship exists,¹² insurance agents and financial planners may still have obligations to their customers regardless of whether those agents and planners are acting as fiduciaries.

B. Imposition of Common-Law Fiduciary Duties on Insurance Agents

In the insurance arena, there are two kinds of relationships that may implicate fiduciary duties: the relationship between an insurance agent and his insurance company, and the relationship between the insurance agent and his customer. Generally speaking, insurance agents are deemed under a general agency analysis to bear fiduciary duties to the insurance companies they represent.¹³ Thus, an insurance agent typically may not act on behalf of an adverse party without his company's (*i.e.*, principal's) consent and may not act in competition with his company in matters relating to the subject of his agency.¹⁴ By contrast, insurance agents generally are not deemed to owe fiduciary duties to their customers unless the facts and circumstances of the individual relationship dictate otherwise.¹⁵

1. General Rules Regarding Facts and Circumstances Analysis

Fiduciary responsibilities may be imposed where the facts and circumstances of the customer-insurance agent relationship indicate that a state of trust and confidence exists such that one party is placed in a position of superiority or influence over the other.¹⁶ Such a relationship is often

¹² *Cf. Consolidated Insured Benefits, Inc.*, note 9 *supra* (finding that defendant insurance carrier owed duties of disclosure and due care to plaintiff insurance brokers in connection with the non-renewal of insurance policies sold by the plaintiffs).

¹³ *See Schwab*, note 10 *supra* (Wyoming case law also supports the notion that the relationship between an insurance agent and the company on behalf of which the agent acts is that of principal and agent and accordingly gives rise to fiduciary duties). *See also Harts*, note 4 *supra*; *Schrader v. Prudential Insurance Company of America*, 280 F.2d 355, 363 (5th Cir. 1960) (“an insurance agent is under a duty to exercise good faith and loyalty toward his company, to make full disclosure to the company, and to obey instructions”).

¹⁴ *See Bennett v. Allstate Insurance Company et al.*, 753 F.Supp. 299, 303 (N.D. Cal. 1990) (noting that California law follows the general rule that an agent may not act as the agent for another person whose interests conflict with those of the principal).

¹⁵ *See Sipes v. The Equitable Life Assurance Society of the United States et al.*, 1996 U.S. Dist. LEXIS 12325 (N.D. Cal. 1996) (noting that the relationship between an insurance agent and the insured is generally not fiduciary in nature, but rather comes under a traditional standard of reasonable care in California); *see also Nash v. Ohio National Life Insurance Company*, 597 S.E.2d 512, 518 (Ga. Ct. App. 2004) (“It is well settled that ‘there is no fiduciary relationship between the insured and the insurer or the insurer’s agent’” (*quoting Fowler v. Prudential Property & Cas. Ins. Co.*, 449 S.E.2d 157 (Ga. App. 1994))); *Bennett*, note 14 *supra* at 303 (“Despite considerable opportunities to do so, the California Supreme Court has been unwilling to find the existence of fiduciary duty between insurers and insureds”).

¹⁶ *See In re Jackson National Life Insurance Company Premium Litigation*, 107 F. Supp. 2d 841 (W.D. Mich. 2000) (“fiduciary responsibilities may arise from an informal confidential relationship where ‘special confidence and trust is [sic] reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this special trust’” (*quoting Craggett v. Adell Ins. Agency*, 635 N.E.2d 1326, 1331 (Ohio App. 1993)) under Ohio law; such a relationship may arise “where one party places trust in another so that the

referred to as a “special” or “confidential” relationship under common law. The fiduciary duty that attaches where a party has attained such a position of superiority or influence addresses the fact that one person has the power to exploit his position of superiority or influence to his advantage and to the detriment of the other. By contrast, where no position of superiority or influence exists, such considerations do not come into play, and fiduciary duties generally do not attach. In this regard, for example, some courts have suggested that an arm’s-length dealing between the parties to a transaction or relationship generally does not support a finding of a “special” relationship or other fiduciary responsibility.¹⁷

This general notion that a “special” or “confidential” relationship must exist for fiduciary duties to attach to an agent-customer relationship under common law has been expressed by a number of courts. For example, the court in the *Harts* case opined that a person who serves as the agent of an insurance carrier generally does not bear fiduciary duties to customers, such as the duty to advise a customer regarding the adequacy of his coverage.¹⁸ However, the court subsequently clarified that the general rule against an insurance agent’s bearing fiduciary duties to customers does not apply under all circumstances, explaining that

as with most general rules, the general no-duty-to-advise rule, where the agent functions as simply an order taker for the insurance company, is subject to change when an event occurs that alters the nature of the relationship between the agent and the insured. This alteration of the ordinary relationship between an agent and an insured has been described by our Court of Appeals as a “special relationship” that gives rise to a duty to advise on the part of the agent.¹⁹

2. Relevant Factors

Courts have identified a number of factors that may be considered in determining whether a relationship between an insurance agent and a customer is a “special” or “confidential” relationship involving a position of superiority or influence. Many of these factors relate to the sophistication or capabilities of the customer involved. For example, in *Amendolia v. Rothman et al.*,²⁰ in determining that a fiduciary relationship may have existed between a customer and her insurance agent, the court cited factors including the customer’s age, lack of education, physical disabilities and lack of sophistication in financial matters; the length and nature of the relationship between the customer and the agent; and the agent’s superior knowledge of financial

latter gains superiority and influence over the former” (*quoting Ransom v. A.B. Dick Co.*, 682 N.E.2d 314, 321 (Ill. App. 1997)) under Illinois law).

¹⁷ See generally, e.g., *Consolidated Insured Benefits, Inc.*, note 9 *supra*; see also *Pitts v. Jackson National Life Insurance Company*, 574 S.E.2d 502 (S.C. Ct. App. 2002).

¹⁸ *Harts*, note 4 *supra*, 597 N.W.2d at 50.

¹⁹ *Id.* at 51. The court went on to hold that a specific duty to advise may apply where the agent misrepresents the nature or extent of the coverage offered or provided, an ambiguous request is made that requires a clarification, an inquiry is made that may require advice and the agent (though he need not provide such advice) gives inaccurate advice, or the agent assumes an additional duty by either express agreement with or promise to the insured. *Id.* at 52.

²⁰ 2003 U.S. Dist. LEXIS 22719 (E.D. Pa. 2003).

matters. Similarly, in *Sorrano et al. v. New York Life Insurance Co. et al.*,²¹ the court suggested that factors such as a customer's age, health, education and business experience could be used to support a determination that an insurer or insurance agent had attained a position of dominance or control in a relationship with a customer.

In addition to considering these types of factors, courts may also look to specific actions or events in the course of dealing between the parties to help determine whether fiduciary duties should attach to a customer relationship. The presence or absence of certain events or interactions between the parties at the inception of the relationship, or in the early stages of a long-term relationship, may be instructive as to the relative positions of strength held by the parties. For example, in addition to considering the level of sophistication of the customer, the *Amendolia* court observed that the customer had insisted that her insurance agent attend meetings with her investment adviser. Other courts have held that relationships giving rise to fiduciary duties could exist where, for example, a customer requests that an insurance agent evaluate the customer's options and recommend products suited to the customer's needs, and then relies on the guidance received from the agent in response.²²

It is important to bear in mind that the question of whether a relationship between an insurance agent and his customer has the requisite degree of trust and confidence coupled with a position of influence or control necessary to support the existence of a fiduciary duty requires consideration of the actions or positions of both parties to the relationship. Typically, such a relationship cannot be established unilaterally. It is generally not sufficient for a customer merely to believe that he can trust or confide in the agent, or to simply rely on, or pay for, the specialized skill or experience of the agent. Rather, there must typically be some evidence of the insurance agent's acceptance of the customer's trust and confidence and attaining a position of influence or control over the customer.²³ In this regard, some courts have declined to impose upon insurance agents a fiduciary duty to customers where the customer is unable to establish that the agent accepted the trust and confidence the customer extended.²⁴

3. Exceptions to General Rule for Applicants for Insurance Coverage

Notwithstanding the general rule that an insurance agent does not bear fiduciary duties to his client absent a relationship of trust and confidence or position of superiority or influence, some courts have come to the opposite conclusion where the client is applying for insurance

²¹ 2000 U.S. Dist. LEXIS 7540 (N.D. Ill. 2000).

²² See *Prieto et al. v. John Hancock Mutual Life Insurance Company et al.*, 1998 U.S. Dist. LEXIS 6642 (N.D. Tex. 1998).

²³ See *Amendolia*, note 20 *supra*. See also *Consolidated Insured Benefits, Inc.*, note 9 *supra*, quoting *Williams-Garrett v. Murphy*, 106 F.Supp.2d 834, 840-41 (D.S.C. 2000) ("The facts and circumstances must indicate that the one reposing the trust *has foundation* for his belief that the one giving advice . . . is acting not in his own behalf, but in the interests of the other party")(emphasis added). Compare this concept to the general description of agency provided by the Restatement as a fiduciary relation that results from one party's request that the other act on his behalf, "consent by the other to so act," and understanding by the parties that the principal is in control.

²⁴ See, e.g., *In re Jackson*, 107 F.Supp. 2d 841, 863, note 16 *supra*.

coverage.²⁵ In so doing, the courts have opined that an insurance agent owes a duty of loyalty to a prospective purchaser of insurance akin to the duty owed by an attorney to his client.²⁶ While this type of judicial finding appears to be the exception rather than the rule,²⁷ we note that some courts have also suggested that the relationship between an insurance agent and an applicant for insurance may be a principal-agent relationship giving rise to a fiduciary duty where the insurance agent is not currently acting in a principal-agent relationship with the insurance provider in question.²⁸ An insurance agent bearing no fiduciary duty to an insurance company under general agency theory would, of course, not be subject to the general prohibition against acting in competition with the company in matters relating to the subject of the relationship between the company and the agent.

4. Distinction Between Insurance Agents and Insurance Brokers

An important distinction highlighted by a number of jurisdictions concerns the difference between relationships involving a customer and an insurance *agent* and those involving a customer and an insurance *broker*. Generally speaking, as noted above, an insurance agent is deemed to act as the agent of the insurance company he represents. An insurance broker, by contrast, serves as the agent of his customer, acting in the customer's stead in soliciting, negotiating or otherwise obtaining insurance products best suited to the customer's needs.²⁹ Therefore, while insurance agents typically bear common-law fiduciary duties to insurance companies, and do not bear such duties to customers unless a "special" or "confidential" relationship is present, insurance brokers bear general common-law fiduciary duties to their customers and do not bear such general duties to insurance companies.³⁰ Notwithstanding this general rule, courts have held that insurance brokers may still owe limited fiduciary duties to insurance companies with regard to handling funds received from the customer in connection with the purchase or maintenance of insurance coverage.³¹

C. Imposition of Fiduciary Duties on Financial Planners

As noted above, courts are quicker to impose fiduciary obligations on financial planners than they are to impose such duties on insurance agents. In this regard, at least one jurisdiction has

²⁵ See *Forgione v. State Farm Mutual Automobile Insurance Company et al.*, 1995 U.S. Dist. LEXIS 22378 (S.D. Fla. 1995).

²⁶ *Id.* at p. 13.

²⁷ See *Consolidated Insured Benefits, Inc.*, note 9 *supra* (noting that South Carolina courts have refused to find fiduciary relationships between an insured individual and the insurance provider at the application stage).

²⁸ See *Stewart v. Boykin*, 303 S.E.2d 50 (Ga. Ct. App. 1983). We note, however, that in holding that a jury could find the existence of a fiduciary relationship between the applicant and the insurance agent in this case, the court noted that the applicant had allegedly been unable to read the insurance application. This may have been a contributing factor in the court's decision regarding the possible existence of a fiduciary relationship.

²⁹ See *Highlands Insurance Co. v. PRG Brokerage, Inc. et al.*, 2004 U.S. Dist. LEXIS 83 (S.D.N.Y. 2004).

³⁰ See *A.G. Edwards & Sons*, note 2 *supra* at 394 ("other jurisdictions have held that the relationship between an insured and an insurance broker is a fiduciary one").

³¹ See *Highlands*, note 29 *supra*.

stated categorically that “[f]inancial planners . . . owe a fiduciary duty to their customers.”³² This approach is consistent with the well-established treatment of investment advisers as fiduciaries, which we discussed in our December 5, 2006 memorandum, and is logical in light of the frequency with which financial planners delve into the investment advisory arena. It is also consistent with the heightened fiduciary standard that applies to persons who hold themselves out as financial planners, by virtue of Advisers Act Rule 202(a)(11)-1, as discussed in our December 21, 2006 memorandum.

Even jurisdictions that have not adopted a bright-line rule regarding the application of common-law fiduciary duties to financial planners have nonetheless given strong indications that holding oneself out as a financial planner may expose one to fiduciary obligations. For example, in *Murphy v. Northwest Mutual Insurance Company et al.*,³³ the court noted that an insurance agent who allegedly held himself out as an expert in securities and financial planning could owe his customers a duty akin to that owed to customers of an investment adviser. While the *Murphy* court did not establish the actual nature of the duty owed by the financial planning “expert” in question, the court’s suggestion that such a duty could rise to the level of that owed by an investment adviser illustrates a general acceptance of the idea that financial planners should be regarded as fiduciaries under common law. The court in *Koehler v. Pulvers*³⁴ took a similar approach in finding that a group of real estate developers stood in a fiduciary relationship with purchasers of limited partnership interests by virtue of, among other things, the developers’ “purported disinterested financial planner status.”³⁵

Other jurisdictions, however, do not appear to have embraced the trend toward imposing fiduciary duties on financial planners. These jurisdictions decline to hold that a relationship between a financial planner and a client is fiduciary in nature absent a finding that one party actually places trust or confidence in the other, and that a disparity of position and influence exists between the parties.³⁶

* * * * *

We hope that the three memoranda we have provided you assist the Task Force in understanding the circumstances under which investment advisers, broker-dealers, insurance agents and financial planners may be considered fiduciaries, and the consequences that a fiduciary status may have for these parties. If we can assist you further in any way, please do not hesitate to ask.

Best regards.

³² *Johnston et al. v. CIGNA Corporation et al.*, 916 P.2d 643, 647 (Colo. Ct. App. 1996).

³³ 2005 U.S. Dist. LEXIS 43627 (W.D. Mo. 2005).

³⁴ 614 F. Supp. 829 (S.D. Cal. 1985).

³⁵ *Id.* at 849.

³⁶ *Fleet National Bank v. Mayeux*, 2005 Me. Super. LEXIS 193 (2005). *See also Serrano*, 2000 U.S. Dist. LEXIS 7540, note 21 *supra* (an insurance company’s holding its agent out as an expert in financial matters would not be sufficient to create a fiduciary relationship between the insurance company and the insured absent other indicia of a relationship of trust and confidence involving one party’s influence over the other).

Reporter's Comment: This legal memorandum, while believed to be authoritative as to the current general state of the law as of the date of its publication, is intended for the use and benefit of the Financial Planning Association only. Accordingly, this legal memorandum is not intended to be, and shall not be, relied upon by any member of the Financial Planning Association nor any other person or entity in connection with his or her activities as a financial planner, registered representative, registered investment adviser representative, insurance agent, or otherwise.

APPENDIX D

TO: Fiduciary Task Force Working Group I
FROM: Neil A. Simon, Esq.
DATE: January 5, 2007
RE: Legal Issues Related to Association Codes of Ethics

Introduction¹

Associations have a “sacred right to make, interpret, and enforce rules governing the ethical conduct of their own members.”² So-called industry or professional “self-regulation” is a fundamental function of associations and has numerous benefits and legitimate purposes.³ For example, self-regulation:

- a. can enhance the reputation of an industry or profession for fair and honest service by establishing standards for doing business and disciplining those who do not abide by those standards;
- b. may deter conduct that is generally considered undesirable, but that may not be prohibited by law;
- c. often is more prompt, flexible, and/or effective than government regulation; it also can bring the accumulated judgment and experience of an industry or profession to bear on issues that are sometimes difficult for government to define with bright line rules;
- d. can be an effective response to business practices that, while not illegal, may nevertheless be ethically questionable and threaten to tarnish the image of an entire industry or profession;
- e. may deter governmental interference in an industry or profession by demonstrating that such intrusion is not necessary, as the industry or profession can police itself; and
- f. instills loyalty and pride in those who are part of an industry or profession through heightened professionalism and acceptance of common values.

¹ This memorandum is based primarily upon materials from *The Law of Associations: An Operating Legal Manual for Executives and Counsel*, George D. Webster and Hugh K. Webster (Matthew Bender & Co., rev. 2d edition 1975).

² E.g., *Plummer v. AICPA*, 97 F.3d 220 (7th Cir. 1996).

³ *Consolidated Metal Products, Inc. v. American Petroleum Institute*, 846 F.2d 284 (5th Cir. 1988) (“It has long been recognized that the establishment and monitoring of trade standards is a legitimate and beneficial function of trade associations.”).

By joining an association, members are presumed to have agreed to abide by any code of ethics, rules of conduct, disciplinary procedures, etc. required by the association.⁴

Legal Issues

There are two basic reasons that self-regulation of an industry or profession through an association raises significant legal issues.

- Antitrust

The first is that self-regulation can be anti-competitive. Many ethical rules or other standards of practice are, in effect, agreements among the association members as to how to do business. If those agreements restrain trade, e.g., agreements as to advertising, pricing, use of vendors, etc., then they will be in violation of the antitrust laws.

- Member Discipline

The second circumstance under which self-regulation raises legal issues is when the rules or regulations are enforced against members who have violated them. Such punishment, including but not limited to expulsion, can have a devastating impact on the member in question and cannot be undertaken without sufficient safeguards.

Associations can, to a large degree, control access to business and professional privileges and thereby thwart a member's ability to successfully pursue a trade, business or profession. Very simply, the right to practice a lawful trade or profession is sufficiently fundamental, such that the association has significant liability if that right is abridged improperly.⁵

Courts may take jurisdiction over a challenge to an association enforcement action even when expulsion or other discipline would not substantially preclude the member in question from competing in the marketplace:

Professional associations, although voluntary in nature, often attain a quasi-public significance. In public view, membership in such organizations may appear to be a tangible demonstration of professional competence and skill, professional responsibility, and acceptance by one's professional peers. The fact that an individual member expelled from membership may not be prohibited from practicing his [or her] chosen occupation or profession is not a sufficient test to determine whether he needs and is entitled to judicial protection from unfair proceedings or arbitrary actions.⁶

⁴ E.g., *Gaston Board of Realtors v. Harrison*, 306 S.E.2d 809 (N.C. App. 1983).

⁵ E.g., *Ezekial v. Winkley*, 572 P.2d 32 (Cal. 1977).

⁶ *McCune v. Wilson*, 237 So.2d 169 (Fl. 1970).

Negligence/Malpractice Claims Against Members by Clients/Customers

A third legal issue implicated by self-regulation – and the one most relevant to the Fiduciary Task Force’s inquiry – involves the impact a code of ethics or standards of practice may have on the liability of members to customers, clients, or other third parties. That is, if a member is sued by a customer or client for negligence or other reason, can the customer cite the failure of the member to adhere to the association’s code of ethics as evidence of the member’s wrongful conduct?

Courts have almost universally held that such codes may be admissible as evidence of the applicable standard of care. For example, in *The Post Office v. Portec, Inc.*,⁷ two professional codes for engineers were held to have been correctly admitted by the trial court in a negligence suit “as relevant to show at least a related industry standard of conduct....[T]he codes provide some guidance in determining what conduct is appropriate for unlicensed engineers.”

It should be emphasized that professional codes are not considered conclusive proof of the standard of care in a given instance, but, instead, as one piece of evidence of such a standard. Thus in *Pittman v. Upjohn Co.*,⁸ it was held that standards of practice promulgated by the Board of Pharmacy “do not necessarily establish the duty of care owed by the pharmacy in this case...[but nevertheless]...they are relevant to the issue and may provide guidance in determining if there is a duty of care under the circumstances.” Similarly, another court referred to the code of ethics of the American Pharmaceutical Association solely as “a potential source of guidance on a pharmacist’s duty of care generally.”⁹

It is important to bear in mind that use of a professional code in a civil proceeding can have advantages to professionals as well. Specifically, if their conduct conformed to an association code of ethics, they might seek to have the code admitted as evidence that they in fact complied with the applicable standard of care.¹⁰

Finally, there is one other important consideration with respect to the ability of a litigant to use an association code against a member. The fundamental rationale used for admitting association codes as evidence of a standard of care is that if a particular set of rules actually regulates a profession or industry (such as through the threat of expulsion by an association), there should be a reasonable expectation among members of the profession or industry that those same rules may be enforced against them by their customers or clients. Likewise, there should be a reasonable expectation among customers or clients that the applicable rules will be followed. If, then, an association’s code is not actually enforced, and perhaps is just aspirational in nature, the primary rationale for using the code as evidence of a standard of care does not exist.

- No Independent Cause of Action

The violation of a code of ethics or conduct promulgated by a private professional organization has never been held to give rise to an independent cause of action for negligence or malpractice. For example, in *Taylor, Thon, Thompson & Peterson v. Cannaday*, the court rejected the argument that any deviation by an architect from standards set forth in the Architects’ Handbook of Professional Practice, published by the American Institute of Architects, constituted negligence *per se*. Instead, the *Cannaday* appellate court agreed with the trial court, which admitted the Architects’ Handbook of Professional Practice merely as evidence of the architect’s duty and not as controlling authority. The court explained: “... [A]bsent

⁷ 913 F.2d 802 (10th Cir. 1990).

⁸ 890 SW.2d 425 (Tenn. 1994).

⁹ *Evans v. Rite Aid Corp.*, 478 S.E.2d 846, 848 (S.C. 1996).

¹⁰ *Flatt v. Superior Court*, 885 P.2d 950 (Cal. 1994).

specific statutory incorporation, the provisions of a national code are only evidence of negligence, not conclusive proof thereof.”¹¹ Courts have held similarly in malpractice claims against professionals as diverse as accountants¹², real estate agents¹³, and alcohol and drug abuse counselors.¹⁴

- Disclaimers

Some courts have cited disclaimer language as a reason not to recognize a cause of action based on violation of an ethical rule,¹⁵ and therefore the Task Force could consider including language to the effect that the code is not intended to be used in legal proceedings against members by establishing a standard of care or creating a cause of action. The Code of Conduct adopted by the College of Trial Counsel, for example, includes this statement:

This Code of Trial Conduct is intended to provide guidance for a lawyer’s professional conduct except insofar as the applicable law, code or rules of professional conduct in a particular jurisdiction require or permit otherwise. It is a guide for trial lawyers and should not give rise to a cause of action, create a presumption that legal duty has been breached, or form the basis for disciplinary proceedings not called for under the applicable disciplinary rules.

¹¹ Taylor, Thon, Thompson & Peterson.

¹² Thayer v. Hicks, 793 P.2d 784 (Mont. 1990)(holding that accountants’ failure to comply with Generally Accepted Auditing Standards and Generally Accepted Accounting Principles was not negligence per se, rather it was merely evidence of negligence).

¹³ Menzel v. Morse, 362 N.W.2d 465 (Iowa 1985).

¹⁴ Morgan v. Psychiatric Institute of Washington, 692 A.2d 417 (D.C. 1997).

¹⁵ See, Hizey v. Carpenter, 830 P.2d 646, 651 (Wash. 1992)(relying on disclaimer language in Code of Professional Responsibility and Rules of Professional Conduct to hold that their violation neither creates a separate cause of action nor constitutes evidence of malpractice by attorney); Terry Cove North, Inc. v. Marr & Frielander, P.C., 521 So. 2d 22 (Ala. 1988); Mozzochi v. Beck, 529 A.2d 171, 176 n.8 (Conn. 1987); Carlson v. Morton, 745 P.2d 1133 (Mont. 1987).

Reporter's Comment: This legal memorandum, while believed to be authoritative as to the current general state of the law as of the date of its publication, is intended for the use and benefit of the Financial Planning Association only. Accordingly, this legal memorandum is not intended to be, and shall not be, relied upon by any member of the Financial Planning Association nor any other person or entity in connection with his or her activities as a financial planner, registered representative, registered investment adviser representative, insurance agent, or otherwise.

APPENDIX E

MEMORANDUM

TO: Fiduciary Task Force Working Group I
FROM: Robert H. Neill, Esq.
Date: January 12, 2007
RE: Duties of a Fiduciary under ERISA

Introduction¹

This memorandum provides a general overview of the Employee Retirement Income Security Act of 1974 (ERISA). A more detailed analysis has been provided by Don Trone in a Fiduciary 360 publication containing a comprehensive set of legal memorandums on specific ERISA requirements and prohibitions that is being mailed to each member of Working Group I. A memorandum from this publication covering "The roles and responsibilities of all involved parties (fiduciary and non-fiduciary) are defined, documented and acknowledged,"² directly relates to our discussions, and is separately provided to Working Group I.

ERISA Overview

ERISA is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans.

ERISA requires plans to provide participants with plan information including important information about plan features and funding; sets minimum standards for participation, vesting, benefit accrual and funding; provides fiduciary responsibilities for those who manage and control plan assets; requires plans to establish a grievance and appeals process for participants to get benefits from their plans; gives participants the right to sue for benefits and breaches of fiduciary duty; and, if a defined benefit plan is terminated, guarantees payment of certain benefits through a federally chartered corporation, known as the Pension Benefit Guaranty Corporation (PBGC).

In general, ERISA does not cover retirement plans established or maintained by governmental entities, churches for their employees, or plans which are maintained solely to comply with applicable workers compensation, unemployment or disability laws. ERISA also does not cover plans maintained outside the United States primarily for the benefit of nonresident aliens or unfunded excess benefit plans.

¹ This memorandum is based primarily on research from the Department of Labor Web site relating to ERISA.

² See page 10 of *Fiduciary 360 Legal Memorandums to Accompany U.S. Editions of the Prudent Practices Fiduciary Handbook Series*.

Fiduciary Protections Contained in ERISA

ERISA protects a plan's assets by requiring that those persons or entities who exercise discretionary control or authority over plan management or plan assets, anyone with discretionary authority or responsibility for the administration of a plan, or anyone who provides investment advice to a plan for compensation or has any authority or responsibility to do so are subject to fiduciary responsibilities. Plan fiduciaries include, for example, plan trustees, plan administrators, and members of a plan's investment committee.

The primary responsibility of fiduciaries is to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries must act prudently and must diversify the plan's investments in order to minimize the risk of large losses. In addition, they must follow the terms of plan documents to the extent that the plan terms are consistent with ERISA. They also must avoid conflicts of interest. In other words, they may not engage in transactions on behalf of the plan that benefit parties related to the plan, such as other fiduciaries, services providers or the plan sponsor.

Fiduciaries who do not follow these principles of conduct may be personally liable to restore any losses to the plan, or to restore any profits made through improper use of plan assets. Courts may take whatever action is appropriate against fiduciaries who breach their duties under ERISA including their removal.

Although many of the provisions of ERISA relate to the duty, of a fiduciary the primary provision prescribing the duties of a fiduciary are found in ERISA Section 406. Below are the pertinent provisions of ERISA Section 406(a):

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and –

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

Reporter's Comment: This legal memorandum, while believed to be authoritative as to the current general state of the law as of the date of its publication, is intended for the use and benefit of the Financial Planning Association only. Accordingly, this legal memorandum is not intended to be, and shall not be, relied upon by any member of the Financial Planning Association nor any other person or entity in connection with his or her activities as a financial planner, registered representative, registered investment adviser representative, insurance agent, or otherwise.

APPENDIX F

MEMORANDUM

TO: Fiduciary Task Force

FROM: Ron A. Rhoades, Esq.

Date: January 29, 2007

RE: Lessons From Behavioral Science: The Effectiveness of Disclosures Provided to Clients of Financial Intermediaries

A. Introduction. One of the key issues confronting the Fiduciary Task Force is whether consumers of financial planning advice achieve a sufficient understanding of the distinctions between the varied duties of fiduciaries and non-fiduciaries. Specifically, is a consumer of financial planning services likely to be able to provide “informed consent” when a financial planner who “holds out” as a trusted advisor (fiduciary) or who actually provides financial planning services, then seeks to “change hats” and assume non-fiduciary status, with consequential lesser protections afforded to the consumer. Stated differently, should the “fiduciary status” of a financial services intermediary be capable of “waiver” by the client through disclosure and informed consent?

In the setting of a financial services relationship between the financial planner and his or her client, two questions must be asked:

First, whether there exists adequate disclosure of the change of relationship from a fiduciary financial planning role to a non-fiduciary implementation role and the resulting change in legal standards applicable to the financial planner.

Second, whether there would likely exist an adequate understanding of that disclosure by the consumer of financial services and hence, whether informed consent would exist.

This memorandum seeks to provide policymakers with additional information discerned from recent research into behavioral science as applied to financial intermediaries and their important¹ relationships with their customers or clients, particularly as to the efficacy of disclosures and informed consent.

¹ “The rise of the financial intermediary was characterized by Professor Clark as representing an advanced stage of capitalism in the development of modern capitalistic civilization. In this stage, capital suppliers concentrate on whether they should relinquish their funds to a particular intermediary, and the intermediary to a greater or lesser

B. U.S. Securities Laws Are Generally Based Upon A Disclosure Regime. While securities laws often appear to impose limitations on actions by financial services intermediaries, such as “do not commit fraud,” in many instances the absence of fraud is found where there exists disclosure of material facts (including disclosures of conflicts of interests). Federal securities laws and regulations protect investors largely through requiring the disclosure of information – whether it be of material facts regarding an issuer of a security, or of compensation paid to a financial services intermediaries, or of conflicts of interest which exist as to financial services intermediaries. Indeed, it has been stated that in the United States, “federal securities law’s exclusive focus is on full disclosure.”²

C. General Inadequacies of Disclosures. Despite the reliance of securities regulators upon disclosures, many investors do not enjoy the intended protections of securities laws because the disclosures are: (1) inadequate (as to the quality or quantity of information provided); (2) incomprehensible to the individual consumer in terms of the language or terminology utilized; or (3) deficient in timing (*i.e.*, coming only after the consumer makes a decision). While efforts are made to undertake disclosures in “plain English,” this may have exacerbated a related problem – one in which individual investors receive a large volume of disclosure documents to the point of being overwhelmed. This is especially so when individuals invest in a mutual fund or variable annuity. As a result, disclosure is often ineffective or opaque, and this leads to abusive sales practices and investor harm.

D. “Access to Information” = “Disclosure”? Some disclosures are not necessarily proactively undertaken to consumers prior to investment decisions being made. Instead, “access” to the disclosure is provided. The view that access to disclosure is equivalent to disclosure under the securities laws has been strongly advanced recently. For example, the NASD in its 2005 “Report of the Mutual Fund Task Force: Mutual Fund Distribution,” the NASD undertook this proposal regarding mutual fund point-of-sale disclosure documents and, as well, prospectus delivery:

By giving investors a short disclosure document with access to further information through hyperlinks, the Profile Plus would allow investors to review as much or as little detail about a fund as desired and to easily compare all funds offered by a particular broker-dealer. To the extent that the Commission is concerned that investors will not actually go to the Profile Plus on the broker-dealer’s website, that is a matter of investor choice, exactly the same as choosing not to read hard copy disclosure or not to listen to oral disclosure. The web site mode of delivery is, in the Task Force’s view, critical to effective and timely disclosure of this information for the benefit of investors ...

extent would be competent to advice on investment choice. The intermediary’s brokerage services is essential to match suppliers and issuers of capital in the modern economy and securities intermediaries are in a position of relative trust and confidence *vis a vis* their capital supplying clients. The rise in financial intermediation has been empirically studied to bear a direct correlation with economic development, as financial intermediation is closely related to the growth of capital markets.” Iris Chiu, “Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from the EU’s Markets in the Financial Instruments Directive.” 2 *Journal of International Commercial Law and Technology* 38 (2007).

² 1 Thomas Lee Hazen, *The Law Of Securities Regulation*, § 8.1[1][B], at 740 (4th ed. 2002). As this memorandum demonstrates, “[d]isclosure is the primary tool of the present U.S. securities regulatory regime. Yet disclosure is unlikely to help investors suffering from overconfidence, loss aversion, and cognitive dissonance.” Stephen J. Choi & A.C. Pritchard, “Behavioral Economics and the SEC” (2003).

The Task Force urges the Commission to apply an “access equals delivery” approach for the mutual fund prospectus. The Commission should take the position that an investor’s access to the fund prospectus through the Internet would constitute delivery for purposes of the federal securities laws.³

[Emphasis added.] An example of an actual adoption of an “access equals delivery” of disclosure can be found in the controversial Merrill Lynch Rule, as it was finally adopted by the U.S. Securities and Exchange Commission in June 105, which in pertinent part states:

(ii) Advertisements for, and contracts, agreements, applications and other forms governing, accounts for which the broker or dealer receives special compensation include a prominent statement that: “Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons’ compensation, may vary by product and over time.” The prominent statement also must identify an appropriate person at the firm with whom the customer can discuss the differences.⁴

[Emphasis added.] The move from actual disclosure of conflicts of interests, to embracing a more limited disclosure regime which requires the investment consumer to proactively seek out information (whether it be via the internet or by asking questions of an “appropriate person” at the brokerage firm), creates additional hurdles to the adequacy of disclosure and informed consent, as will be demonstrated later in this memorandum.

E. Consumer’s Responsibility? Under one view within the securities industry, consumers bear the burden of reading and understanding disclosure documents, and consumers should ask questions when they need more information. An example of this view is illustrated by the 1995 Tully Report.⁵ For example, the Report states:

As a general rule, RRs [i.e., registered representatives] and their clients are separated by a wide gap of knowledge – knowledge of the technical and financial management aspects of investing. The pace of product innovation in the securities industry has only widened this gap. It is a rare client who truly understands the risks and market behaviors of his or her investments, and the language of prospectuses intended to communicate those understandings is impenetrable to many.

³ NASD, “Report of the Mutual Fund Task Force: Mutual Fund Distribution” (2005).

⁴ 17 CFR §275.202(a)(11)-1(a)(1)(ii),

⁵ “Report Of The Committee On Compensation Practices,” April 10, 1995, from a Committee formed at the request of SEC Chairman Arthur Levitt, and chaired by Daniel P. Tully, Chairman and Chief Executive Officer, Merrill Lynch & Co., Inc. This Report is hereafter referred to as the “Tully Report.”

This knowledge gap represents a potential source of client abuse, since uninformed investors have no basis for evaluating the merits of the advice they are given. It also makes communication between a registered representative and an investor difficult and puts too much responsibility for decision-making on the shoulders of RRs – a responsibility that belongs with the investor.

Brokerage firms are not – and cannot be – teaching institutions for investors, but practices that narrow the knowledge gap between investors and RRs can only be viewed positively. Only one "best practice" was found in this area:

MAKE SPECIAL EFFORTS TO INFORM INVESTORS OF THEIR RIGHTS AND RESPONSIBILITIES. All brokerage firms distribute such materials to their clients, as required by law. Typically, however, these are done in print so small that only the most diligent would wade through them. One firm interviewed provides each new account holder with a clear and thorough document explaining risk, return, and the role of the registered representative. The document provides a summary of services provided by the firm, trade and settlement arrangements, and procedures for resolving complaints. Further, the document spells out the client's responsibilities with respect to communicating objectives, and so forth. Other firms spell out alternative compensation arrangements which are fee-based rather than transaction-driven

Investors have an important role to play in the alignment of interests described above. Intense competition has created a buyers' market for brokerage services, giving investors of the 1990s the power to demand AND RECEIVE high levels of professionalism and quality service.

Using their ability to direct business to organizations that serve them well, and to withhold it from those who serve them poorly, today's investors have more potential power over the behavior of brokers than any regulator or consumer watchdog. Investors' insistence on professionalism and quality service is the ultimate safeguard of their own best interests and, indirectly, the ultimate enforcer of high standards within the brokerage industry ...

[Clients must assume decision-making responsibility for their accounts. It is their responsibility to evaluate the advice of their brokers and to determine which actions will be taken. In many cases this means that clients must educate themselves in the basics of financial markets, the nature of risk, and other aspects of investing. Good decisions cannot be made in ignorance....⁶

[Emphasis added.] Interestingly, while the Tully Report expressly acknowledged the "knowledge gap" between registered representatives (RRs) and their customers, noted that certain disclosures are "impenetrable" to many individual investors, and set forth a long list of contents of a broker-dealer's disclosure form an investor must "wade through" (the length of which disclosure form has only increased in recent years), the Tully Report still took the view that registered representatives should not shoulder the burden of investment responsibility, but rather that the individual consumer should bear this burden. The Tully Report asserts that individual investor consumers have the power to influence the behavior of

⁶ Tully Report, pages 15-18.

registered representatives. Implicit in this statement is that individual consumers possess the ability to obtain knowledge (ostensibly through adequate disclosures under the securities laws), coupled with the ability to understand and apply that knowledge to the decisions presented to the investor. The Tully Report places the burden on individual investors to become educated about the “basics” of the financial markets, the “nature of risk,” and “other aspects of investing,” but the Tully Report does not specify how this should occur or how long such an educational process would be expected to take.

The Tully Report is by no means alone in this view of individual investors possessing responsibility for their own investment decisions. Many other commentators or regulators promote the concept that individual investors possess responsibility to protect their own interests:

- “[I]t is for investors themselves to take advantage of higher standards of disclosure”⁷
- “The client [of a CFP certificant] is responsible for accepting or rejecting recommendations and for retaining and/or delegating implementation responsibilities.”⁸
- “By far the best way for investors to protect the money they put into the securities markets is to do research and ask questions.”⁹

F. Consumer “Understanding” of Disclosures, Generally. To accept the premise that investors are responsible for their own actions, it is necessary to conclude that investors are not only armed with adequate disclosure, but also that they possess an ability to understand the disclosures which have been provided to them. Assuming, for the moment, that the disclosure is adequate (in writing, in “plain English” to the extent possible, specific as to the material facts to be disclosed, and communicated to the investor in advance of any decision by the investor), the sole question then becomes the adequacy of understanding of the disclosures which have been made.

In the context of financial planning decision-making and investment decisions, it cannot be denied that the financial world of individual consumers of financial services has become increasingly more complex in recent years. As stated in the well-written consumer brochure, “Cutting Through the Confusion”:

While some people are comfortable handling their own investments, many are not. They find the idea of creating a plan for allocating their assets bewildering, choosing a mutual fund intimidating, and designing an investment portfolio to be one more thing for which

⁷ Tharman Shanmugaratnam: “Regulating the capital markets: making market discipline work,” derived from speech by Tharman Shanmugaratnam, Deputy Managing Director of the Monetary Authority of Singapore at the StanChart-Reuters-Business Times Investment Awards ceremony, Singapore, 16 Feb 2001.

⁸ CFP Board of Standards, Inc., “Financial Planning Practice Standards” (Rev. 07/03), in the explanation of Standard 500-1, which explanation further notes: “If there are conflicts of interest, sources of compensation or material relationships with other professionals or advisers that have not been previously disclosed, such conflicts, sources or relationships shall be disclosed at this time.”

⁹ U.S. Securities and Exchange Commission, “The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation” (online brochure, 1/2007).

they have neither the time nor the expertise. This is nothing to be embarrassed about. Investing can be confusing.¹⁰

Evidence of lack of consumer understanding of even basic investment concepts abounds. For example, a 2002 Forbes Magazine survey finding that eighty-four percent of the surveyed investors believe that higher fund expenses result in higher performance by the fund.¹¹ As stated in the main body of this Final Report of the FPA[®] Fiduciary Task Force, even a vast majority of college students chose a higher-expense S&P 500 index fund over a lower-expense S&P 500 index fund, even when presented with detailed information.

The United States is not alone in the complexity of its financial markets. As stated over ten years ago in a report issued by the Financial Planning Association of Australia Limited:

With the increasing complexity of the financial system, the wide range of choices available and the role of compulsory savings, advice is playing an ever important role for consumers ... Deregulation has created a large number of investment alternatives and means of accessing them ... that the first priority for most people is to seek advice on the financial strategy that best suits their circumstances. The selection of investment products is secondary, yet still this requires access not only to information on the numerous investments available in the market but also analysis and application of that information to individual circumstances ... Strategy plays a key role in effective financial decision making and most consumers will not be in a position to develop their own strategy ... **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.** Despite extensive information being available on drugs (via the internet and by other means) people still seek the advice of a doctor to determine an appropriate response to a medical problem and, where necessary, to prescribe the most suitable drug.¹²

[Emphasis in original.]

While the modern financial world has grown increasingly more complex over the last several decades, only recently has substantial thought been given to the ability of individual investors to achieve adequate understanding in order to make informed decisions. As stated by Professor Steven L. 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

¹⁰ “Cutting Through The Confusion,” a brochure published by the “Coalition on Investor Education,” which consists of the Consumer Federation of America, the North American Securities Administrators Association, the Investment Adviser Association, the Financial Planning Association, and the CFA Institute.

¹¹ Neil Weinberg, “Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs,” Forbes Magazine, Oct. 14, 2002, at 220.

¹² “Submission to the Financial System Inquiry” by the Financial Planning Association of Australia Limited, December 1996.

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.¹³

While the U.S. Securities and Exchange Commission has put greater emphasis on “plain English” writing, and this is a welcome development, plain English writing primarily addresses the problem of overly legalistic writing. Plain English writing does not provide a solution to achieving consumer understanding in an inherently more complex financial world. The investment, tax and financial worlds have become increasingly complex. The 20th Century saw an explosion of specialization, in response to an ever-more complex world. Specialists exist as a means to guide consumers through a complicated undertaking, such as the development of a financial plan. Specialists exist in recognition that the vast majority of consumers will possess neither the time nor the knowledge and experience to tackle a complex field and make good choices. Accordingly, the SEC’s emphasis on disclosure and its advice to individual investors to “do research and ask questions” may be misplaced.

G. The Robert Prentice Article: Behavioral Biases Which Inhibit Informed Consent By Individual Investors. In the last few decades scholars of behavioral economics have endeavored to show that actual human behavior is characterized by “bounds” that limit the extent to which people actually and effectively pursue utility maximization. In a law journal article entitled “Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future,”¹⁴ Professor Robert Prentice provides key insights into behavioral bias which illuminate the inadequacy of informed consent in the context of securities regulation. Various excerpts from this seminal article follow:

- “[C]ompanies, if left unregulated, will not disclose the socially optimal amount of financial information ... they will disclose suboptimally because disclosure implicates two types of costs. First are operational costs (out-of-pocket expenses, diversion of staff time, etc.). Second, and more critical, are inter-firm costs that can put a disclosing firm at a disadvantage relative to its competitors [f]ull voluntary disclosure ... rarely seems to occur in reality, and firms typically do not disclose more than regulation requires.”
- “[T]here are limits to reputation. Even economists concede that providers of both goods and services with high-quality reputations are constantly tempted to provide a low-quality service at a high-quality price and thus earn a large return ... Firms often can keep their defalcations and other errors quiet, especially because most disputes are handled through low-profile arbitration rather than more newsworthy litigation.”
- “Today investors have tons of information ... Thanks to SEC disclosure requirements, EDGAR, and the Internet, even the most unsophisticated and dunderheaded investors have access to much the same information available to the most sophisticated of professional and institutional investors¹⁵ ... what

¹³ 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).

¹⁴ 51 Duke L. J. 1397 (2002).

¹⁵ The teachings of behavioral finance arguably counsel against too much disclosure, at least when it is not fairly organized and carefully presented. To this end, a Securities Industry Association document prepared after the

makes investors vulnerable often is not their lack of information, but a wide variety of limitations on human reasoning exposed by a substantial body of behavioral literature that ... indicates that many if not most investors, even with more information, will be unable to adequately protect themselves under his system. Psychological factors often prevent investors from adopting sufficiently wary attitudes. Importantly, even sophisticated (issuer-level) investors tend to be subject to these limitations.”

- Behavioral concepts affecting the ability of individuals to provide informed consent include:
 - *The Concept of Bounded Rationality.* “[H]uman rationality is bounded. It is now widely recognized ... that because they seldom have complete and perfectly accurate information and never have perfect capacity to process that information, people are intendedly rational, but only limitedly so. Because of bounded rationality, it is erroneous to assume that the parties usually will negotiate the most efficient possible contract.”¹⁶
 - *The Concept of Rational Ignorance.* “It is reasonable for decisionmakers ... who do not have unlimited time and unlimited resources, to choose not to gather all the relevant information for their decisionmaking. Decision-makers must choose among numerous demands on their time and attention and will often sensibly choose to ‘satisfice’ rather than to optimize their decisionmaking.”¹⁷
 - “Because an intermediary likely will present [the investor] with a relatively detailed form contract (investor regulation invalidates the SEC’s ‘plain English’ requirements, so the intermediary is free to inundate [the investor] with massive legal boilerplate), her ability to understand its obscure terms is bounded.”
 - “An investment of the time and mental energy needed to master the details of the contract may not be cost-justified, especially because the agent with whom [the investor] is dealing probably has no authority to alter the contract anyway. Therefore, rather than bargain extensively over the terms of the contract and how much she will pay for protection from fraud or unsuitable recommendations, [the investor] likely

adoption of Reg FD (for “Fair Disclosure,” which regulation makes it illegal for senior executives of publicly traded issuers to privately disclose material nonpublic information to any of a carefully defined class of persons, most notably investment analysts), claimed that “[t]he barrage of unorganized data is simply too much for investors, most of whom have neither the time nor the inclination to sort through the data and perform quality analysis of their own. Investor behavior was beginning to indicate information overload even prior to Reg. FD, as evidenced by behavioral finance studies that illustrate an inability to process ever growing informational inputs.” Securities Industry Association [now called the Securities Industry and Financial Markets Association, or SIFMA], “Costs And Benefits Of Regulation Fair Disclosure 17” (May 2001).

¹⁶ “The concept of bounded rationality reflects the recognition that people have limited cognitive capacities. As a result, people cannot attend to all available information or evaluate their choices fully, particularly with respect to complex decisions. Instead, they engage in satisficing—investing a level of effort that will produce a satisfactory, if not optimal, outcome. Bounded rationality is not, strictly speaking, a bias; it is a rational explanation for investor use of heuristics and other short cuts rather than more complete information.” Jill E. Fisch, “Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst,” 10 *Lewis & Clark L. Rev.* 57, 69-70 (2006).

¹⁷ The author of this memorandum notes that, while he is an attorney and is well-versed in the terminology utilized in many forms of commercial contracts as well as securities brokerage firm relationships and mutual fund disclosures, he does not read most of the consumer contracts which he signs, nor does he know anyone who does.

will sign the contract without meaningful negotiation and usually without reading more than a few parts of it. It is well known that investors typically do not read disclosure documents when investing in securities, and Professor Melvin Aron Eisenberg notes in the context of insurance contracts and other similar types of contracts that this is a sensible (if not optimally rational) strategy, concluding that ‘most form takers will find it irrational to engage in search and deliberation on any given form.’”

- *Overoptimism*. “Even if [the investor] reads the contract with the issuer and clearly sees and understands its limitation of liability provisions, [the investor] still may not bargain to change them. Humans are inherently overoptimistic in most settings; they think that good things are going to happen to them and that the bad things that happen to others will not happen to them ... Studies indicate that the overoptimism bias affects humans in the sphere of investments as well.”
- *Overconfidence*. “[The investor’s] optimism will be fueled by a Wall Street marketing juggernaut whose dominant message is simple: Wall Street can make you rich – and fast ... optimism will tend to lead her to believe that she will succeed where others will fail, that she will know the right path where others will be misled, that she will be impervious to fraud where others are victimized. [The investor’s] vulnerability to overoptimism will be reinforced by her overconfidence.”¹⁸
 - “Educated people and professionals are generally just as subject to phenomena such as overoptimism and overconfidence as are unsophisticated investors.”
- *Insensitivity to the Source of Information*. “Another reason [the investor’s] tendency will be to fail to realize that she is being defrauded and to fail to contract to protect herself from that fraud is the general human insensitivity to the source of information ... studies show that people have difficulty disregarding information, even when they learn that it is from an unreliable source.”
 - “[P]eople generally believe that they are good at detecting when they are being lied to, when the behavioral research shows that they are not.”
 - “[O]nce a broker successfully cultivates trust, willing reliance by the sophisticated investor -- imprudent though it may seem in hindsight -- is quite likely and, for that reason alone, worthy of some protection.”
- *Oral Communications Trump Written Communications*. “[The individual investor] will enter into a contract with a securities professional after a period of negotiation. These negotiations likely will be oral, either in person or via telephone, and eventually [the investor] will find a professional whom she trusts ... Studies show that people whose success depends on the efforts of others tend naturally to form positive impressions of those on whom they depend. Once they decide to trust, they ‘overdraw’ on the information available; this simplifies life and allows customers to act as though they possessed real knowledge about a broker’s future

¹⁸ In an oft-repeated quotation in the finance literature, DeBondt and Thaler state that “perhaps the most robust finding in the psychology of judgment is that people are overconfident.” Warner Debondt & Richard Thaler, *Financial Decisionmaking in Markets and Firms: A Behavioral Perspective*, in *Finance*, vol. 9 of *HANDBOOK OF OPERATIONS RESEARCH AND MANGEMENT SCIENCE*, chap. 13, at 385-86 (1995).

conduct. Only after that trust and positive impression are established will the securities professional provide the written adhesion contract for [the investor] to sign ... Although [the investor] would be wise to read the contract in its extensive detail and to bargain for fraud protection, she probably will not do so. One simple reason is that in daily commercial intercourse, oral communications trump written communications.”¹⁹

- *Hesitation to Confront.* “Other reasons that [the investor] will hesitate to confront the intermediary over its form contract (and likely elicit the ‘What, you don’t trust us?’ response in an attempt to shame her into signing the contract immediately) include the availability bias ... and her realization that failure to show trust poisons relationships.”
- *Recency, Concreteness.* “[Investors] would tend to give undue weight to their good relationship with the manager at the time of contract formation, because that relationship is vivid, concrete, and instantiated, as compared with the possibility that the manager would exploit the bargain at some point in the future, which is abstract, general, and pallid.”
- *Representativeness Heuristic.* “[P]eople ... tend to judge probabilities by flouting numerous rules of statistics and to focus instead upon the degree of similarity that an item seems to bear to a category or parent population. Because of this influence, [the individual investor] would tend to overestimate the extent to which the present relationship with the [broker] is a reliable index of the future relationship.”

In summary, individual consumers possess substantial barriers, resulting from behavioral biases, to the provision of informed consent, even after full disclosure. Moreover, “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.”²⁰

H. What Are the Possible Responses to Inadequacy of Informed Consent? Given the behavioral biases and the huge knowledge gap, both of which pose substantial barriers to the ability of investment

¹⁹ When the sellers of investment products present consumers with lengthy written contracts to sign, the individual investor, just like consumers of consumer products, tend to sign without reading them in any detail, especially after they have decided to trust the seller. Donald C. Langevoort, “Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers,” 84 Cal. L. Rev. 627, 682 (1996). “Most sales pitches in the securities field are made orally, yet most adhesion contracts disclaim oral representations in legal boilerplate. Why? For competitive reasons, sellers have an incentive to make oral representations to buyers of securities and then to present the buyers with written contracts that disclaim those same representations.” Robert Prentice, “Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis,” 2003 U.Ill.L.Rev. 337, 419 (2003).

²⁰ Robert Prentice, “Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis,” 2003 U.Ill.L.Rev. 337, 343-4 (2003), *citing* Jon D. Hanson & Douglas A. Kysar, “Taking Behavioralism Seriously: The Problem of Market Manipulation, 74 N.Y.U. L. REV. 630 (1999) *and citing* Jon D. Hanson & Douglas A. Kysar, “Taking Behavioralism Seriously: Some Evidence of Market Manipulation,” 112 Harv. L. Rev. 1420 (1999). Given potential use of behavioral biases by financial intermediaries, should there be attempts to educate individual consumers on how to counter these biases? “The ... direction – inviting a role that securities regulation has never taken that seriously – is to become an aggressive therapist, seeking to de-bias investors from all their dangerous propensities ... I doubt that the government could do this well, or that the intended audience would have the inclination to learn.” Donald Langevoort, “Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation,” Paper 64, Berkeley Program in Law & Economics, Working Paper Series (2002).

consumers to provide informed consent in matters relating to their investments and financial affairs, what is the correct response of policymakers? There are at least four possibilities²¹, only two of which appear mutually exclusive.

(1) Enhance The Disclosures. Disclosure regimens are historically strengthened following a financial crisis. For example, the adoption of the Sarbanes-Oxley Act greatly strengthened corporate disclosures following several high-profile failures of large public companies. While it is hopeful that a financial crisis not be necessary for disclosures to be enhanced, it is possible to enhance disclosures significantly. For example, rather than the somewhat vague disclosures provided as exhibits to the CFP Board's Code of Ethics, a much stronger form of disclosure could be advanced whenever a fiduciary advisor seeks to switch to non-fiduciary status:

Our (Fiduciary) Financial Planning Services. My firm, Smith & Jones, is a personal financial planning firm. In undertaking financial planning for our clients (and in providing investment advisory services) we are fiduciaries to our clients. As a fiduciary personal financial planner we possess the duties to act in your best interests, with due care, and in good faith. As a fiduciary I am required to reasonably avoid conflicts of interest, and even where they are not avoided I must properly manage the conflict of interest in order to keep your best interests paramount at all times. As a fiduciary and professional financial planner I am also required to ensure that the total fees and costs you bear in connection with the investments I recommend to you and your receipt of financial planning and investment advice are reasonable in light of all the circumstances. As a fiduciary I am also required to consider, in the formulation and implementation of your financial plan, your probable need to minimize income taxes over the long term.

Our (Non-Fiduciary) Brokerage and Insurance Services. My firm also functions, for some of its customers, as a broker-dealer firm and as an agent for insurance companies. As a broker-dealer firm or insurance agent, my firm is not a fiduciary to our clients. If you deal with me and my firm in this capacity, and not as the client of a financial planner, you will not possess the protections afforded in a fiduciary-client relationship. For example, neither my firm nor I are required to avoid conflicts of interest. Also, neither I nor my firm is required to act in your best interests. Instead, our duties are much more limited, such as the duty to ensure that the products or investments we sell to you are suitable to you only from the perspective of whether they fit your overall risk profile. Additionally, as a registered representative of a broker-dealer firm (or as agent of an insurance company), neither me nor my firm are required to ensure that the products or investments sold to you are suitable as to their overall fees and costs nor as to their tax attributes. In my capacity as a registered representative of a broker-dealer firm and/or as agent of an insurance company I will not be acting as your financial planner, nor am I required to adhere to the Code of Ethics and Rules of Conduct of either the Certified Financial Planner Board of Standards, Inc. (whose license I possess to use the CFP® mark only in connection with my activities as a financial planning). Nor will I be required to adhere to the Code of Ethics and Rules of Conduct of the Financial Planning Association (of which I am a member). In summary, should you choose to implement the financial plan I may develop for you in my non-fiduciary capacity as a registered representative of a broker-dealer firm and/or insurance agent for an insurance company, you will have waived important protections.

You Possess A Choice. You possess the choice as to whether to implement any financial planning recommendations either with:

- (1) a fiduciary financial planner / investment adviser who acts in your best interests;

²¹ Professor Schwartz notes: "There are three possible ways to respond to this insufficiency [of the effectiveness of disclosures]. The first is to tolerate insufficient disclosure and its resulting information asymmetry. The second is to proscribe transactions for which the asymmetry exceeds certain bounds. The third is to require supplemental protections to minimize the asymmetry or mitigate its consequences." Steven L. Schwarcz, "Rethinking The Disclosure Paradigm In A World Of Complexity," Univ.Ill.L.R. Vol. 2004, p.1, 17 (2004). For purposes of this analysis the author separates out "supplemental protections" into two distinct potential responses.

(2) a non-fiduciary broker or insurance agent who is not required to act in your best interests.

You are under no obligation to utilize my firm to implement any financial planning recommendations I make to you.

Discussion Encouraged. I urge you to discuss any aspect of this Disclosure and of these rules with me or with a fiduciary financial planner of your choosing (and not associated with my firm) or your legal counsel prior to signing.

Acknowledgement That You Have Read This Disclosure. By signing below, you agree that you have read and understand this Disclosure and that it was provided to you prior to your decision to use the broker-dealer and/or insurance agency services provided by my firm and by me.

Acceptance. I have read and received a copy of this Disclosure and understand that by using you and your firm as a broker-dealer and/or an insurance agent I will not have the protections of a fiduciary relationship with you or your firm. I understand that you are not required to act in my best interests, that you will not be acting as my trusted advisor, and that you will possess various conflicts of interest which will not be fully disclosed to me. I will be responsible for protection of my own interests. I have been provided with a copy of this Disclosure, and I have been advised to review this Disclosure from time to time.

_____ Date: _____
Customer

Even armed with such a disclosure, it is suggested that other conditions should exist in order for the disclosure to be effective:

- The compensation model adopted by the broker-dealer firm or insurance agent must not appear to the customer to be one in which continual advice is to be provided. Only transactions should be permitted in which discrete compensation is paid. Hence, the receipt of ongoing 12b-1 fees, broker-dealer fee-based account fees, and other continual forms of compensation are inconsistent with the non-fiduciary model.
- The disclosure must be clear and unequivocal, and undertaken in a separate document, preferably with 12-point type, with various sections highlighted in **bold** and in red ink.
- Financial plan analysis and plan presentation must be kept separate and apart from implementation.
- The course of conduct of the broker-dealer firm and its employee must be consistent with its non-financial planner role. Even with clear disclosures and a course of dealing consistent with a firm acting as a “financial planner” during the financial planning analysis and preparation phase but a “broker” during implementation, the relationship between the customer and the broker-dealer could easily be misunderstood. If the conduct of a registered representative or other broker-dealer employee suggests, perhaps inadvertently, the continuation of the financial planner relationship while brokerage services are being provided, then the broker-dealer and its registered representative could still be found to be a financial planner and fiduciary under the law.

Of course, the likelihood of such a severe disclosure regime ever being adopted by regulators is remote. Even if adopted, it is still likely – due to the behavioral biases noted previously – that many individual consumers will not read or seek to adequately understand the disclosure which they are signing. The complexity of today’s financial world – with many different types of risks to which individual investors may be exposed, a bewildering array of product offerings, recent and ongoing developments in investment theory and portfolio management, and tax laws providing both opportunities and traps for the

unwary – make the possibility of informed consent even more remote, even when consumers are provided with substantially better disclosures.

(2) Adopt Additional Protective Measures (Certifications). Another solution would be to provide the individual consumer of financial planning services with some measure of additional protection, other than disclosure. One supplemental protection that minimizes information asymmetry is the furnishing of some form of guarantee²² of the quality of the financial services intermediary. For example, membership in the FPA and/or certification as a “Certified Financial Planner™” are examples of a form of “guaranty” – a private-sector certification of the quality of the financial services provider. However, the ability of consumers to rely upon this “guarantee” is not substantial. The CFP® and related “certification marks are financial planning credentials awarded by Certified Financial Planner Board of Standards Inc. (CFP Board) to individuals who meet education, examination, experience and ethics requirements.”²³ Moreover, the CFP Board is very careful in its online search service for consumers to locate CFP® certificants to avoid any monetary or other guaranty of the quality of the certificant, noting that the search service is not a referral service. The Financial Planning Association’s search service makes this appropriate disclaimer: “This service provides access to PlannerSearch for search purposes only and participants should be aware that no representations about the suitability of this information and these services are made or endorsed.”²⁴ It should also be noted that neither the CFP Board of Standards, Inc. nor the Financial Planning Association engages in any form of peer review.

A different form of certification could emerge from the ISO 22222 International Standard. This International Standard has been drawn up with the objective of achieving and promoting a globally accepted benchmark for individuals who provide the professional service of personal financial planning. Certification of compliance with the standards is possible from an accredited organization (“an independent third-party certification body able to demonstrate its compliance with ISO/IEC 17024 and which has certification to this International Standard within its scope”), or through certification by other parties (such as by another organization, or through peer review), or through self-assessment.²⁵

Another means to secure enhanced protection would be through governmental regulation of financial planners, imposing standards for acceptance into a “profession” of financial planning, requirements for maintaining licensure (including continuing education and peer review), and a disciplinary process for suspension or revocation of licensure. The nature of such government regulation (federal or state, governmental agency and/or self-regulatory organization and/or professional regulatory organization) is beyond the scope of this memorandum, but may be explored further in future FPA® Fiduciary Task Force deliberations.

²² Regulation of financial intermediaries can contribute to quality information and advice, but regulation is unlikely to remove variability of the quality of services provided by the financial intermediary nor should be perceived as an implicit contract or guarantee that consumers will be protected from loss. The need will remain for consumers to make their own inquiries and assessments as to the suitability of the advice for that particular consumer.

²³ Definition provided at www.cfp.net.

²⁴ From www.fpanet.org web site.

²⁵ International Organization for Standardization, ISO 22222:2005(E), Section 8.3.

(3) Accept Inadequacy of Informed Consent. This paradigm reflects the current state of affairs in the United States for many individual investors. Disclosures, coupled by scattered attempts at consumer education by a variety of organizations, remain the primary means of addressing the “knowledge gap” between most financial intermediaries and individual consumers. While attempts to increase the efficacy of disclosure might be helpful to some investors, under this alternative regulators would tolerate the substantial information asymmetry which exists today between financial intermediaries and the vast majority of individual investors.

Under this laissez-faire view, the question might be posed as to why is it necessary to protect investors? Proponents of this approach may assert that investment entails risk and the investor should realize this and not expect any special protection over and above the general law of theft and fraud.²⁶ Hence, under this point of view policymakers would tolerate the unfortunate consequences resulting upon the set of individual investors who are unable to overcome the “knowledge gap” and who might be preyed upon by financial intermediaries who might fail to act in the individual consumer’s best interests. Policymakers may determine that reputational concerns alone would deter financial intermediaries from inappropriate conduct.²⁷ Policymakers may also be concerned with the cost of increased regulation in relation to its benefits.²⁸

²⁶ The vast majority of economists have rejected this view for many years. As stated by Grower, “[T]his robust affirmation of laissez-faire principles has long since been rejected and it has been recognised that it is the investors’ own fault only if they were in a position to judge the extent of the risk. A variety of methods have been tried in an attempt to ensure that. The oldest is to provide for disclosure of information, with liability to criminal penalties and, perhaps, damages at the suit of the investor if the information was not truthfully disclosed. The weaknesses of that are that only sophisticated investors will be able to make an informed judgment on the information disclosed (others need professional advice) ... Hence disclosure has had to be supplemented by regulation” L. C. B. Gower, “Review of Investor Protection – A Discussion Document (London: Her Majesty’s Stationery Office, 1982).

²⁷ “It may be argued that intermediaries could be relied on to self-regulate as they would protect their own reputations. [Citing Stephen Choi, “Promoting Issuer Choice In Securities Regulation” (2001) 41 Virginia Journal of International Law 815.] Reputational capital is important to intermediaries and it may be argued that the intermediaries’ own drive towards reputational protection acts as a form of control on abusive behaviour against clients. However, research reveals that reputational pressures alone do not prevent wrong-doing.” Iris Chiu, “Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from the EU’s Markets in the Financial Instruments Directive.” 2 Journal of International Commercial Law and Technology 38, 39 (2007).

²⁸ If additional regulation of financial planners is merited, in the form of adoption of a non-waivable fiduciary duty to act in the client’s best interests in all phases of the financial planning relationship, there must be shown a causal relation between the adoption of a fiduciary standard and substantial benefits to the clients. “If retail investors are relying inappropriately in making investment decisions due to overconfidence, anchoring, bounded rationality, or other biases, should regulators respond, and, if so, how? A central objective of the federal securities laws was protection of the retail investor, and the SEC continues to view investor protection as its primary goal ... The primary difficulty with disclosure as a regulatory response is that there is limited evidence that disclosure is effective in overcoming investor biases. ... It is unclear ... that intermediaries offer meaningful investor protection. Rather, there is continued evidence that broker-dealers, mutual fund operators, and the like are ineffective gatekeepers. Understanding the agency costs and other issues associated with investing through an intermediary may be more complex than investing directly in equities ... once regulators move beyond disclosure into substantive efforts to constrain irrational behavior, regulation imposes substantial costs on the securities markets.” Jill E. Fisch, “Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst,” 10 Lewis & Clark L. Rev. 57, 74-83 (2006).

(4) Ban Attempts to Secure Informed Consent. Under this paradigm a legislature (or regulatory organization), recognizing the inadequacy of informed consent, undertakes a judgment that the lack of informed consent is so harmful, either to individual investors (as to inability of individuals to secure the returns of the capital markets within a reasonable spectrum of risks due to poor or conflicted advice, or unwillingness to seek advice given concerns regarding ability to obtain trusted advice, or to the national interests - *i.e.*, placing additional burdens upon government due to inadequate retirement savings and/or improper investments of retirement “nest eggs”) as to merit further regulatory restrictions upon financial planners. Under this scenario the regulatory body prohibits the fiduciary advisor from seeking informed consent to the casting off of fiduciary status.

Why insist upon fiduciary status (or its continuation throughout the financial planning process)? Simply put, in the context of securities regulation, fiduciary status has long been seen as a means to encourage consumers to place their trust in financial services intermediaries. As stated by John H. Walsh, in discussing the evolution of federal securities legislation in the 1930’s:

Despite current opinion, the important role moral purpose played in creating modern regulatory institutions should not be forgotten. To understand the regulatory regimes our predecessors created and bequeathed to the modern age, one must understand the fundamental impulses that inspired them. Now ignored, or even disavowed, moral purpose once served as such an impulse. This is an area where history has something to offer the law. The greater the modern age’s subjective distance from the regulatory vision of an earlier era, the more law needs history to explain what our predecessors thought they were doing. Moral purpose played a fundamental role in creating the federal regulatory regime for the securities industry. Indeed, in many respects, even though federal regulation was a product of the 1930s, it reflected an orthodox Progressive sensibility. This was no accident ... In August 1932, [Franklin Delano Roosevelt] turned to a moral policy vision. His purpose, he decided, was to ensure the character of the people who composed the securities industry ... FDR’s moral purpose was a deliberately chosen policy and, once chosen, that it played an important role in the creation of the federal regulatory regime ... FDR’s proposals for implementing his vision—fiduciary duties and a simple code of ethics—also speak to modern times. Commentators have recognized that fiduciary duties provide a legal basis for a justifiable expectation of trustworthiness. FDR’s code should be seen in the same light. As an effort to restore public trust in financial intermediaries—why else make it simple enough for the public to understand?—it represents a practical solution to a vexing problem. How does public policy produce trust? More specifically, how does public policy produce trust on a sufficient scale to influence an entire economy? The idea of a simple code, containing basic ethical principles, propagated across an entire industry, is a serious approach to the problem.²⁹

²⁹ John H. Walsh, J.D., Chief Counsel in the Office of Compliance Inspections and Examinations of the United States Securities and Exchange Commission, “A Simple Code of Ethics: a History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry,” 29 Hofstra Law Review 1015 (2001).

Under many of our federal securities laws, financial services intermediaries have been unable to seek informed consent to an act which would otherwise violate of a duty possessed by the intermediary to the customer or client. In other words, the federal securities laws often prohibit waiver by customers or clients of many of the duties imposed upon financial securities intermediaries.³⁰ These prohibitions against waiving rights under securities laws are consistent with a long line of cases which hold that one may not contract against his fraud.³¹

Similarly, one paradigm for the regulation of financial planners, whether it be limited (such as granting of the right to utilize certain marks associated with financial planning, or restricting membership in an organization composed of financial planners) or more comprehensive (federal or state legislation requiring registration and requiring adherence to certain professional rules of conduct), is adoption of the stance that financial planners, once they hold out as financial planners (or use similar titles) or engage in a financial planning relationship, cannot alter their duty to continue to act in the best interests of their client. Given the intertwining of the processes of financial planning, during which the development of the plan (or its modification), implementation and monitoring may all occur at once (or during the same conversation between the financial planner and the client), this approach would avoid the necessity of constant disclosures of the status of the financial planner. In other words, the confusion which results from “switching hats” over and over would be avoided.

I. Conclusion: A Cost-Benefit Analysis Is Required. The choice of one or more remedies to the persistent problem of the ineffectiveness of disclosures is a policy choice, and one which should be undertaken following an examination of the various costs and benefits which result for consumers of financial planning services, individual financial planners, and the profession of financial planning.

³⁰ Securities Exchange Act of 1934, Section 29(a), and Investment Advisers Act of 1940, Section 215.

³¹ Robert Prentice, “Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis,” 2003 U.Ill.L.Rev. 337, 353 (2003). “By prohibiting fraud and mandating disclosure, the securities laws protect investors and promote honesty, trust, and ethical behavior in commercial transactions. The securities laws set standards that serve to socialize, to educate, and to direct individuals toward more morally appropriate forms of behavior. The antiwaiver provisions and the mandatory nature of the securities laws send a strong signal that certain behavior will not be tolerated in any transaction involving a security.” Elaine Welle, “Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement,” 56 Wash. & Lee L. Rev. 519, 541 (1999).

“Alternative Viewpoint”
Relative to Certain Elements of the
FPA[®] Fiduciary Task Force’s
Final Report on Financial Planner
Standards of Conduct

drafted by certain members of the

FPA[®] FIDUCIARY TASK FORCE

for review by the

FINANCIAL PLANNING ASSOCIATION
BOARD OF DIRECTORS

June 1, 2007

[Alternative Viewpoint]

(The following is an excerpt from the FPA® Fiduciary Task Force’s Final Report. Text in bold in sections “E.” and “F” serves to highlight the sections to be discussed in this Alternative View.)

The FPA® Fiduciary Task Force undertakes the following *recommendations* to FPA’s Board of Directors as to positions which should be undertaken in future policy initiatives:

- A. *The six-part financial planning process as it currently exists is adequately set forth in the July 2003 CFP Board’s Financial Planning Practice Standards.*
- B. *The definition of “personal financial planning subject areas” contained in the terminology section of the July 2003 CFP Board’s Financial Planning Practice Standards is reaffirmed.*
- C. *“Financial planning” shall include activities which relate to “retirement planning,” “estate planning,” “risk management planning,” and other portions of a comprehensive financial planning process, and the “best interests of the client” standard shall apply in each of those instances.*
- D. *The “best interests of the client” standard **shall apply when a financial planner implements** any portion or element of a financial plan presented by that financial planner to the client.*
- E. *The “best interests of the client” standard **shall apply to persons holding out as financial planners or who otherwise create a reasonable expectation regarding an advisory relationship.***
- F. *When the circumstances set forth in Recommendations C (financial planning in any of the financial planning practice areas), **D (implementation of a financial plan)** or **E (holding out as a financial planner)** exist, professional standards of conduct shall apply to a financial planner in her or his services to a client. In such instances the financial planner shall possess the following five major responsibilities to the client:*
 - 1. *A financial planner shall put the clients’ best interests first;*
 - 2. *A financial planner shall act with due care and in utmost good faith;*
 - 3. *A financial planner shall not mislead clients;*
 - 4. *A financial planner shall provide full and fair disclosure of all material facts; and*
 - 5. *A financial planner shall disclose and fairly manage all conflicts of interest.*

(Bold added.)

An Alternative Viewpoint – Yet Agreement With The Vast Majority of the FPA® Fiduciary Task Force’s Report.

While the vast majority of the FPA® Fiduciary Task Force’s Final Report (“Report”) possesses broad consensus, there are particular recommendations or points of emphasis in which there is not unanimous agreement. Accordingly, several members of the FPA® Fiduciary Task Force (hereinafter referenced to as “we”, or “our”) have expressed specific significant concerns should this work product develop into a standard to which Financial Planning Association (hereafter “FPA”) members may be legally held. It should be duly noted that generally speaking the majority of the Task Force members expressing this “Alternative Viewpoint” are individuals who practice as dual registrants, have significant experience in compliance, or represent a financial services industry group, however this viewpoint has been fully endorsed by at least one Task Force member who could be described as a fee-only planner and author. Despite the fact that these individuals make up a minority of the Task Force, it could be argued that they represent the viewpoint of the majority of FPA’s membership. Time did not permit the opportunity to have this section of the report be reviewed by the entire Task Force, and therefore we do not at this time know if additional members of the Task Force will agree or disagree with its theories. As stated in the “Memo of Intent” that led to the formation of the FPA: “Any individual or entity that supports financial planning will be valued equally as a member of FPA.” We believe FPA should continue to unify the voice, focus and resources of the financial planning community, and not adopt positions which would deter from this mission.

As there are many areas of consensus and agreement with the Report, this discussion is intended to highlight the distinctions in opinions and to draw attention to the concerns expressed. While the FPA® Fiduciary Task Force fully anticipates that further work addressing these areas where consensus has not been found will be performed during the upcoming “Working Group 3” sessions, it is felt that FPA’s Board of Directors needs to be apprised of the barriers to consensus that have been encountered to this point.

We understand that this document will be submitted to supplement the primary report. Our purpose is to collect and summarize several of the concerns that have been highlighted and discussed by those holding alternative views and concerns. We do not represent these views to be fully comprehensive, or even that we have reached consensus amongst ourselves. Rather, it may be more fair to say that at this point in the process we have each found that we can not claim full agreement with the Task Force Final Report, although each of us has differing specific areas of concern. A universal concern would be that FPA may unilaterally install a fiduciary standard based upon the findings of the Report. Below we will summarize the nature of various concerns that have been discussed, and will conclude with some suggestions for future consideration.

While there is agreement with the majority of the Final Report, including the firm desire to see financial planners always act in the best interests of their clients, we believe that FPA should adopt aspirational standards of professional conduct which invoke fiduciary status, but fall short of creating a “technical” fiduciary status under law. More specifically, we feel that FPA should not adopt mandatory fiduciary duties for financial planners who at times may not be

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functioning as “financial planners”. It must be recognized that at times it may be legitimate for an FPA member to function solely in his or her role as a registered representative or insurance agent (as examples). However, it should never be acceptable for an FPA member, or any individual, to represent to a customer that he/she is acting as a Financial Planner when that is not the case. Rather it must be a duty of the FPA member to fully identify and disclose the nature of the relationship to the client. Specifically the Task Force members who hold this view are uncomfortable with the wording of Recommendations “E” and “F” above where they state “*The “best interests of the client” standard shall apply to persons holding out as financial planners*”. As discussed in detail below these Task Force Members believe that something more is required in order to create a legally binding fiduciary relationship.

The Task Force does reach consensus as to the “spirit” of the findings. This has been summed up by one Task Force member as:

“We believe in reliability, accountability, promise keeping, and confidence earning trustworthiness. However, we do not believe in putting people in positions of exposing themselves to unintended, unanticipatable consequences when they have done a good job under circumstances known and relevant at the time actions were taken.

This does not mean best possibilities out of all the possibilities in the universe. It means taking into account business realities including relationships and the possible implications of those relationships that have been disclosed as part of the engagement (i.e. broker dealer relationships) and anticipates that the client is not a fool (i.e., she knows the planner is in business for profit).”

Another Task Force member representing an industry group shared an entirely different appraisal (paraphrased):

“The Industry would have concerns about the application of the fiduciary standard to the implementation of a financial plan. The suitability rules are written carefully so as not to subject a planner to liability for not recommending the best available product. I fear that a fiduciary standard may subject a Planner/Representative to liability should they not recommend, for example, XYZ mutual fund (in retrospect determined to be the best fund option for the client) because their broker-dealer does not have a selling agreement with the fund company (or some other restriction prohibits it sale). I think there are an infinite number of variations on this theme that could be later be determined to be a violation of the fiduciary standard in implementing the plan.”

The Diversity of Membership of the FPA vs the Diversity of this Task Force. We anticipate that the Financial Planning Association will be considerate of the impact of its pronouncements upon members of the organization, as well as upon consumers of financial planning services. FPA's members practice within several regulatory frameworks, including that of registered representatives of broker-dealers, registered investment advisers (or their representatives), and insurance agents. In fact, 70% or more of the FPA's individual members either hold a registered representative registration (Series 6 or 7) and/or an insurance license. By contrast, the FPA[®] Fiduciary Task Force only possessed a minority of its members from the broker-dealer and/or insurance agency communities, or practicing dual-registrants, while the majority of the Task Force members were either registered investment advisers (fee-only), consumer advocates, or regulators.

“Bait and Switch” Should Never Be Permitted When A Contract Of Trust Exists. All members of the Task Force appeared to agree that what we find so troubling and offensive, and what we MUST inhibit is the practice of "bait and switch". Our profession simply cannot allow folks to pretend to be worthy of trust and confidence, only to intentionally, systematically, institutionally, or otherwise act in a manner unworthy of that trust once granted by a client.

There are two elements to this "contract of trust" - an offer to be trusted AND an agreement to trust (acceptance). This may also occur in the reverse, with a client offering to trust – and a professional accepting that trust. When both elements are present a contract of trust exists, and the highest standard **must** apply. However, we must envision that there may be legitimate circumstances wherein the client does not place his trust and confidence in the planner (as an advisor), or where the planner has not asked for or accepted the client's trust and confidence.

Holding Out As A “CERTIFIED FINANCIAL PLANNER™” or Simply As A “Financial Planner” The presumption that simply handing out a business card with the designation "CFP[®]" and/or CERTIFIED FINANCIAL PLANNER™" (Financial Planner) to a client automatically creates a fiduciary relationship in full fruition fails logic. Some individuals who meet the criteria to utilize the CFP[®] mark may not always work as Planners in each and every engagement. We do not believe it should be the function of this Task Force, or of FPA, to require all members to engage in a fiduciary relationship in every client engagement. Rather, it is critically important that the Planner not misrepresent the nature of the engagement – whatever that engagement may be. What is important for our purposes is that Planners keep their bargains. What we should expect of all Planners (and FPA members) is that they will accurately and clearly tell the client what the arrangement and engagement is - and what it is not, and then honor those terms. FPA would be fully within its rights to expect nothing less of its members.

[Alternative Viewpoint]

When it comes to the nature of the relationship, placing, as a determining factor, the responsibility solely on the "perception" of the client likewise fails to stand as an adequate determining factor. While what the client "perceives the deal to be" sounds good, and may reasonably during the "finding of facts phase" of a hearing be a factor for consideration, it simply can not be the only prong to the test. It is only one prong, but there must be more. This concern stems from the fact that we can not always assure or assume the integrity and honesty of the client. Some clients may forget genuine, clear and appropriate disclosures that were in fact delivered by the planner in good faith and candor. Further, in pursuit of a recovery of money, many claimants may simply assert that they "perceived" the planner in whatever way their lawyer counseled them would lead to the greatest award. While in an aspirational sense we fully support this idea – we believe the words, "perception of the client" on a stand alone basis, make for bad law, and create potential additional confusion.

One Task force member reports (paraphrased):

“...there will be problems in the real world – even with our best efforts to act in the client’s best interests. The business reality is that the documents we must use (if with a BD or insurance company) will probably state very different language than any IA/fiduciary documents so we’ll be in a contradiction right off the bat. I would also like to see the final FPA stance allow for individuals that believe in financial planning but may go thru career and philosophical changes (i.e., start off transaction oriented; get their CFP® designation; and move to fee-only financial planning – as an example) not be excluded from FPA’s membership because their employer won’t allow the extra burdens that may come along with fiduciary standards.”

In another message this same Task Force member shared:

“Interestingly enough, my broker dealer seems to understand the holding out issue and is very strict on how we define for the client what is and is not financial planning..... For example, with regards to holding out, our business cards and letterhead may have CFP behind our names, but not the words Certified Financial Planner. The BD appears to have come to the conclusion that telling the public we have earned the credential by putting the letters after our names is acceptable, but spelling out the words under our names like a job title or job description is not acceptable since we are also registered reps and not exclusively financial planners. So we can hold out up to a point and satisfy their compliance concerns. More to the point, they don't consider putting CFP after a name as holding out. But if you spell it out, that's holding out.”

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Another Task Force member who represents an industry group shared:

“I simply can't understand why a yellow pages advertisement that contains a bullet point list of services offered including "financial planning" along with "securities," "insurance," and "tax preparation" should subject that financial advisor to a fiduciary duty when he recommends a \$2,000 IRA mutual fund purchase, an auto insurance policy, or prepares the person's tax documents. In my mind, applying the fiduciary standard to a planner simply because he indicates he can offer financial planning services, whether or not he is offering the service to the specific client, makes little sense.”

This same individual Task Force member (the representative of the industry group) believes that many of “the issues... could be effectively addressed via FPA advertising guidelines and/or disclosure documents rather than the wholesale application of the fiduciary standard to the various services included in the financial advisor's practice.”

We fully recognize the difficulty in resolving this dilemma on behalf of our profession, but note that we are not the first to encounter this roadblock. SEC Staff struggled (we might say unsuccessfully) with this same issue in the interpretation letter released relative to the BD Exemption (commonly known as the Merrill Lynch rule) (see *The SEC No-Action Dec. 16, 2005 No-Action Letter.*) The CFP Board of Standards, Inc. (hereafter “CFP Board”) has struggled with the same issue as evidenced by the comments following recent proposals to amend that organization’s standard. This summarizes the concern expressed by the Alternative Viewpoint sub-set of the Task Force relative to Recommendations “E” and “F”. Below we will continue to discuss additional concerns.

Concerns Regarding Legal Liability. Despite the Simon memo (Assessment of the impact of Association Codes, found elsewhere in the Report), some of us are convinced that we DO need to treat FPA’s words as if they will be law, and assure their fairness to both clients and planning professionals. Even if not "enforced" by FPA, our work may be entered into evidence in hearings - and may be interpreted by those who are not fully familiar with our profession. Our words must be clear. On the things that we wish to stand to the word - there must be no ambiguity. On topics where objective human interpretation is required, we must allow room for such judgment, perhaps by supplying examples and by explaining the various prongs of the tests of logic. An alternative “Professional Case Law” based review process will be discussed and suggested below.

It must further be noted that the consequences to an FPA member charged with a breach of technical fiduciary status, even if ultimately found to have acted properly, may still be dire. *In the Matter of IFG Network Securities, Inc.*, (Page 39 of the full report) SEC brought charges against four Planners claiming among other things fiduciary violations. One member of the Task Force has had the opportunity to interview one of these defendants. The defendant learned quickly that his E&O coverage did not cover administrative actions brought by a regulatory

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body. Although finally found not guilty, the trial lasted several years, moved between several states, and consumed nearly \$1,500,000 of the Planner's personal resources. He was forced into bankruptcy, and on return to practice with his reputation damaged, he still owes nearly \$700,000 to his attorneys. This brings up a question – *although the SEC clearly sought to prove breach of fiduciary duty, might the outcome have been different had there been in place at that time an FPA "technical fiduciary" standard, defining the obligations of these Planners as Planners?* There is no realistic recourse available to this planner to seek a recovery should the government be found to have brought the case improperly. See *InvestmentNews* "High Price for Justice," at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20060828/SUB/608280734/-1/INIssueAlert04&ht=>

Many client initiated claims are brought in closed door confidential arbitration forums, and there is no appeal option available. The arbitrators may be trained in NASD rules, but they are primarily unfamiliar with the nuances of financial planning. The misinterpretation or misapplication of a "standard" promulgated by FPA if entered into evidence against a Planner may have devastating consequences. Again, we believe that any standard proposed by FPA must be unambiguous where no flexibility is needed, and flexible where appropriate.

A challenge envisioned in the permanent legal attachment of "technical fiduciary" status to all activities of Financial Planners, is that it may invoke conflicts with current regulations, real world business practices and may attach unintended liabilities. This risks rejection by a significant segment of FPA's membership, and extensive confusion regarding FPA's mission "to be the home to all who champion the financial planning process and to the financial planning community". Another potential issue is that poor drafting risks entangling planners who have committed no wrong, with claims that they may have violated the "word" of the code (even if not its spirit).

Finally, FPA does not possess the power or authority to mandate that financial planners who work as registered representatives or insurance agents always be subject to fiduciary duties and their attendant potential liabilities. Broker-dealer firms and insurance companies (and their compliance officers) will simply not permit this to occur.

On the Role of Professional Leadership and Example. As leaders within the community of financial planning professionals, FPA has a unique ability to lead and call members and others to the higher purpose. It has been FPA's history that we have promoted the CFP® program because of its known transformative influence. Many of those who today are leaders within our community entered the profession through or from other avenues. The CFP® educational program opened their eyes, altered their thinking in a positive manner, created a more holistic and comprehensive manner of viewing clients and the potential professional relationship that the Certified Financial Planner™ candidate may have with them. By encouraging people in related fields to pursue the CFP® designation we were and have been bringing these folks along the path of a life altering educational experience, offering an on ramp to a community whose culture calls

them to seek to find their best, and requires them to learn and adhere to a code of professional ethics. This process has moved many more Planners in the right direction than might have been the case had a high barrier with barbed wires been erected. We propose that maintaining such a pathway to professionalism must be preserved. When we place barriers to entry we must be considerate of several needs: to protect the public; to advance the profession; and to continue to bring those in financial services into the “professional” fold. We must be careful not to close too quickly the doors that allow folks to evolve into mature financial planning professionals. Eventually, given enough time it may become possible to require prerequisite degrees and “bar” exams prior to entry into the financial planning professional realm. We are simply not there today. While we may take great pride in the fact that now, as never before, undergraduate and graduate level degrees in financial planning exist – the number of those graduates is not yet sufficient to populate the full ranks of Planners. That will take at least a generation. We must maintain the process of conversion into professional financial planners from neighboring and related financial services fields.

The Efforts of Those Who Have Obtained Greater Knowledge of Financial Planning Should Not Be Cast Aside. Many individuals have devoted significant effort to attaining the CFP® designation while working under a current framework that permitted them to determine the nature of their client engagement (transaction-based or financial planning/fiduciary). Their efforts to enhance their education and the ability to serve their clients effectively should not be cast aside. FPA should continue to foster financial planning as a means of serving clients better, regardless of the regulatory framework which may apply during implementation of a financial plan, nor should those who have obtained the CFP® designation be prevented from operating other businesses.

On “Aspirational” Codes. Other organizations, when faced with challenges similar to those of FPA, have elected to craft and install “aspirational” standards and codes of ethics. This was the path selected by the Investment Adviser Association (whose members are technical fiduciaries under law) and recently by The Securities Industry and Financial Markets Association (SIFMA) – (formerly the Securities Industry Association,) SIFMA states that although its standards are “aspirational in nature”, its members have an obligation to “abide by the highest professional standards” because “anything less would be inconsistent with the trust our clients have placed in us.”

Freedom of Contract Should Be Respected; Investor Rights To Contract To A Different Standard Should Be Protected. We are a capitalist society, and as such both providers of financial planning services and investment products and consumers should be free to contract for whatever level of protection the consumer desires. Investment entails risk and costs, and investors should realize this. It should be noted that fiduciary standards of conduct often lead to greatly enhanced compliance regimens, such as the gathering and documentation of additional information to meet the “prudent process” which a fiduciary should follow. Such additional work

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bears costs. Forcing all financial planners to practice under a fiduciary liability (as opposed to a “suitability” which is already heavily regulated and supervised) may be tantamount to raising fees and costs, especially for smaller investors. We do not believe FPA should turn its back on smaller investors who may not be able to afford to engage a planner under a fiduciary standard of conduct. Nor should FPA turn its back upon larger investors who desire to execute transactions or purchase products, and who knowingly engage an FPA member to serve as their insurance agent, registered representative or broker with full understanding of the nature of the relationship.

All FPA Members Should Aspire To Put Clients’ Interests Foremost At All Times. We should seek to have FPA members aspire to higher standards. While recognizing that different legal standards apply to the varied activities of financial planners, FPA should provide additional guidance to a pathway on how to proceed in a manner that will keep clients’ interests paramount at all times.

We have observed significant push back on numerous occasions when one group or another proposed a calibration out of touch with mainstream practice (*example: CFP® Lite*). In a sense mainstream practice is the accepted standard of conduct for financial planners. FPA should not adopt a standard of conduct which is out of the mainstream of current practices, especially when the adoption of a standard of conduct bearing great potential financial liability to institutions who employ financial planners may result in causing such employers to prevent membership in FPA or place the employee in direct contradiction with the obligations incumbent upon membership in FPA.

It should also be noted that the broker-dealer community has established with FPA’s assistance its own organization, The Financial Services Institute (“FSI”). FSI has begun soliciting registered representatives associated with its member broker dealer firms to join FSI and to pay dues that may be utilized by FSI to promote its own regulatory objectives. Depending upon the issue FSI’s mission and FPA’s may be aligned or opposing. Some may view FSI as an organization competing with FPA for membership.

SUGGESTIONS AS TO POSSIBLE SOLUTIONS.

Discussion of the Two Types of “Fiduciary” – The “Technical” vs. the “Case Law.” In the view of some of us “there are two types of fiduciaries--a "technical" fiduciary defined by statute and a “common law fiduciary” defined by the relationship.

The notion of “technical fiduciary” is a statutory approach to official functions that are heavily regulated by government. Mainly this involves those with *legal* ownership of other people’s money where *beneficial* ownership goes to another. These include ERISA officers, bankers, insurance companies, estate administrators, treasurers, trustees and physical custodians, among others. Such individuals are properly required to be forthright in their dealings with clients. They are also heavily regulated in their duties with onerous proscriptions against theft and self-dealing. In these instances, the question of whether a “fiduciary” relationship exists depends upon the functions served; the intent of the applied language is to proscribe theft and self-dealing. Unfortunately, they can carry onerous penalties for actions that can sometimes occur in the ordinary course of business without intent to steal. By implication, it carries a form of “*per se*” liability that is rightfully resisted by individuals loathe to serve as unwitting guarantors of third party success. This might be appropriate for these particular *technical* fiduciary duties but it is inappropriate for financial planners in the uncertain world of advisory relationships.

The other (“common law fiduciary”) is entirely appropriate for financial planning relationships. This engages the “case law” approach where the term “fiduciary” describes relationships wherein a party seeking assistance and advice seeks the services of a party with superior knowledge and skill. When the party of superior knowledge and skill freely accepts the *trust, confidence* and *reliance* of the seeker and knows that the seeker is reliant upon his or her fidelity to the seeker’s interests, that relationship constitutes a common law “fiduciary” relationship. In these instances, the question of whether a “fiduciary” relationship exists depends upon the relationship between the truster and the trusted. When freely acquiescing in the dependent relationship, the individual advisor’s duty is to serve the client and put the client’s interests ahead of those of the individual advisors. However, his or her duty is not to serve as a guarantor of investment success or product integrity. That is the job of others.

The BD’s resist becoming technical fiduciaries. But they cannot resist becoming common law fiduciaries if, in fact, they ask for trust, reliance and confidence and receive it. That is the essence of the common law fiduciary relationship. To the best of our knowledge, no third party including broker-dealers and CFP Board have the power to keep that fiduciary relationship from flowering. Again, this is why we keep pounding on the relationship. If we look to the relationship, we do not run into the hair splitting.

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We thus argue *against* a technical fiduciary standard and for the common law *relationship* based standard based on trust, confidence and reliance. We do not believe that FPA should use the word "fiduciary" (in any standard that may be promulgated) for the fact that it would likely be confused by the bureaucrats (and in legal proceedings). Likewise, terms like "best interests" carry an implication of unspecified liability. They should be avoided. Similarly, caution should be used with such phrases as "conflict of interest" or the assumption that an advisor's compensation violates his or her duties of loyalty. Financial planners must be paid. We ought not favor one compensation scheme over another if an advisor has justly earned and maintained the client's trust, confidence and reliance.

No third party can make you a common law fiduciary. Only you and the client and the nature of your relationship can do that. When you said "trust me" there you are. Moreover, the individual should have no choice or discretion accepting the implications of being a fiduciary. When the individual says, "Trust me. Have confidence in me. Rely upon me," the individual is proclaiming that he or she is willing to serve as a common law fiduciary and is responsible for all the implications that flow therefrom. This is not the same as a statutory or "technical" fiduciary. Frankly, we feel it is a more profound approach solidly based on the promises and commitments of a skilled and dedicated professional. However, it does not contain the hidden "gotchas" that tend to scare people.

Accordingly, we suggest a relationship based standard heavily employing the words "Trust," "Confidence" and "Reliance" anticipating that the guidance of real life cases will flesh out their meaning. If we overlay case law on top of the common law version, we believe we stand up as legitimate professional advisors embracing our responsibilities. (Please see the further discussion of "Case Law" below).

Case Law Development Approach Recommended. (At least two Task Force members propose the following):

When it comes to enforcement, and it is our opinion that there needs to be strong enforcement at the professional level, we believe that the mechanism that has the best opportunity to both serve and instruct may be the development of a distinct body of professional "Case Law". At the moment the closest thing that we have lies with CFP Board. In our American system of jurisprudence, judges consider real world facts and circumstances and then apply law to those circumstances. This system begins with the gathering and analysis of information. From this analysis a judge issues a "finding of fact". In some hearings a jury determines the "facts" of a case. Once the facts are determined, human judgment is applied, interpreting the law to reach a conclusion as to the appropriate determination and outcome under law. The parties to such a contest have a right to public written decisions explaining the rationale used in making a determination. Additionally, there is an appeals process that similarly results in a written explanation of how the facts and circumstances of the case at issue fit within the interpretations

of the laws or rules to be applied. This process of American jurisprudence allows us all the opportunity to observe the ever-changing and evolving body of legal thought. We may all learn from decisions rendered on cases heard. The lines of thought and logic that have led to a specific decision may be referenced in future cases.

The CFP® Board, Not The FPA, Appears to be the Best Place to Develop this “Case Law”.

Although the CFP Board of Standards, Inc. has an extensive professional review process, we, the professional community of Certified Financial Planners™, are unable to benefit from the guidance that may be derived from an examination of the thoughts of those who have applied the CFP Board Code of Ethics to the real world circumstances that led to a CFP Board hearing. Synthesizing this into a body of legitimate professional “CFP® Case Law”, modeled on the American system, may offer many benefits.

Were CFP Board to develop an ever-evolving body of professional “CFP® Case Law” we believe that this body of understanding could both complement a Code of Ethics and enhance it by demonstrating the best of current thought on professional behavior in light of given facts and circumstances. Such “CFP® Case Law” would not be binding in court or arbitration. Rather, it would provide guidance both in future CFP disciplinary cases, and to CFP® professionals in the field who struggle every day seeking to find the right path forward. Ultimately the “CFP® Case Law” itself becomes a body of rules, complementing, interpreting, and supplementing the Code of Ethics itself. Eventually some of these rulings and findings may find their way into the courts and may help establish common law precedents. In this manner we may be able to level the playing field, causing the force of law to apply to all financial planners within the jurisdiction of the ruling court, not just CFP’s and not just FPA members.

Disclosure Is The Foundation of Our Securities Laws. All of the task force members agree that “bait and switch” tactics must not be utilized by any FPA member. To this end, adequate disclosure of the nature of the relationship should be given. As stated in Appendix F to the Final Report, “[f]ederal securities laws and regulations protect investors largely through requiring the disclosure of information ...” We should not abandon the view noted in the memorandum set forth as Appendix F that “consumers bear the burden of reading and understanding disclosure documents, and consumers should ask questions when they need more information.

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The FPA May Help to Enhance Disclosures. We support the principle that a financial planner shall not misrepresent to the client the nature of his/her relationship and the type of engagement. Furthermore, we fully support the mandate that a financial planner shall clearly and fully identify the nature of the relationship between the financial planner and the client. To enhance consumer understanding, FPA could do a great service by suggesting adequate disclosures of the nature of the relationship, especially when implementation of the financial plan is to be undertaken following its presentation. FPA could also develop sample engagement letters or contracts for its members. The language of such disclosures or engagement letters should be neutral in tenor and not be viewed as condemning any one manner of practice. Clear disclosure of relevant information that a reasonable and informed consumer would want to know should be expected and required. If current disclosures are inadequate, as the Final Report suggests, FPA should seek to enhance the current disclosures and have them applied.

The FPA Should Continue To Promote A Better World. We fully support FPA in any efforts to promote how the world should be. That is the nature of an aspirational statement. It is a goal, a calling, and a mission.

Moreover, it is recognized that the current securities regulatory environment has created certain chaos. Hence, FPA should continue to advocate solutions, **including the possibility that wholesale regulatory changes are needed**, for the benefit of both financial planners and consumers of financial planning services. **Should the FPA Board of Directors choose, FPA could advocate for the adoption of fiduciary status for all financial advice-givers, through changes to federal and/or state law. We would be in favor of such regulatory developments.** This would preserve a “level playing field”. But FPA should not attempt to force upon its members a standard of conduct which is not mandated by current regulation and which cannot, in the real world, be adhered to by many of FPA members who practice under the eyes of watchful institutions and various regulatory frameworks.

Thank you for taking the additional time to consider these alternative views and concerns.

Sincerely,

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