That Fiduciary Question

By Marianne M. Jennings

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

—Matthew 6:24

Quoting the New Testament in financial research seems odd, but this Biblical admonition was the central theme of a recent work on who owes a fiduciary duty to whom (Walsh and Johns 2013). Client relationships with broker–dealers and investment advisors have swirling conflicts of interest. Brokers earn varying high commissions on certain products and those differentials can influence recommendations that they make to their clients. Even non-commission advisors face pressure from their employers to sell certain investment vehicles, but those investments may not be in the best interests of the clients (Schwarcz 2005).

This cloud of conflicts is exacerbated by a statutory distinction between broker–dealers and investment advisors that puzzles their clients. Investment advisors are classified as fiduciaries who must act in the best interest of their clients, but brokers are not considered fiduciaries. To clients, the two roles look identical. And the industry has blurred the roles of the two together.

A Dodd-Frank-mandated Securities and Exchange Commission (SEC) study (SEC 2011) recommended one fiduciary standard for broker–dealers and investment advisors.1 Mary Jo White, head of the SEC, has publicly revealed her position—everyone should operate under a fiduciary standard. With rulemaking reforms about to be proposed, and facing reversal of a 75-year-old standard, the financial industry stands at the crossroads—a time for reflection, introspection, and, perhaps, self-reform.

The History and Basics of Fiduciary Regulation

When financial markets created mutual funds, closed-end funds, and investment trusts, they had investment vehicles that flew under the regulatory radar. The initial securities laws of 1933 and 1934 did not apply. Congress, concerned about reining in bad behaviors, passed the Investment Company Act of 19402 to afford investors in these new vehicles the transparency and disclosure the earlier laws afforded those purchasing stocks and bonds (Slaughter 2014). The requirements of audits and distribution of financial reports under the Act provided investors with disclosure and transparency. The accompanying Investment Advisers Act of 1940 established a fiduciary standard for investment advisors.3

Broker–dealers were specifically exempted from those fiduciary standards if certain conditions were satisfied, including self-regulation and adoption of ethics codes. The National Association of Securities Dealers (NASD) was the industry-created self-regulatory organization (SRO). The NASD evolved into the Financial Industry Regulatory Authority (FINRA). Broker–dealers who do business with the public are required to be registered with FINRA. Investment advisors are regulated by the SEC.

That Investment Advisor/Broker–Dealer Exemption

Under the initial statute, broker–dealers were under a suitability standard, one described as fair dealing. There is no ongoing duty to monitor a client’s funds and investments. Broker–dealers may make a recommendation on a particular security, but once the transaction is complete, the broker–dealer’s obligation and compensation end.

Market structure has changed the roles of broker–dealers. They now offer fee-based accounts to their customers. In fee-based brokerage accounts, broker–dealers offer advice and custodial and record-keeping services in exchange for a fee based on the client’s assets.4 The SEC allowed the new fee structure and the broker-dealer fiduciary exemption as long as the broker–dealers stuck to advice that was only “incidental” to their brokerage services. Because of court challenges to the authority of the SEC to expand the exemption, the SEC took a different approach in regulation of this hybrid professional.5 The SEC issued a rule that allowed it to determine advisory status on a case-by-case basis focused on the structure of commission charges and the extent of advice offered (limited one-time or ongoing advice).6

However, the courts’ position on the broker–dealer exemption is as long as there is a commission payment arrangement, the exemption applies, regardless of the type of advice or the conflicts that might exist in broker–dealers pushing certain stocks.7 One wrinkle in precedent came through the decision in Thomas v. Metropolitan Life Insurance Company, in which a broker–dealer sold a client an investment vehicle that entitled him...
to a higher commission than similar investments offered by other firms. Although the court found that the broker had no fiduciary duty to the client, the dictum in the case revealed discomfort with this type of conflict.

The changing structure of investment firms has added to the confusion about fiduciary duties and exemptions. Today, an investment advisor may or may not be affiliated with a broker. Data from SEC (2011) indicate that 88 percent of investment advisors are also registered as broker–dealers. The SEC also found that 34 percent of retail-level investors view the primary function of broker–dealers as “giving advice” (SEC 2011, p. 100).

The Scope of the Investment Advisor’s Fiduciary Duty

An investment advisor’s fiduciary role has two components (Wrona 2012). Under the duty of care, the investment advisor is required to provide only “suitable” investment advice—taking into account the client’s individual situation and objectives. The duty of loyalty requires an investment advisor to serve the best interest of the client, which means that an investment advisor must not profit on his or her (or the firm’s) investments at the expense of the client. Advisors also must disclose conflicting positions of their firms. The U.S. Supreme Court has established the breadth of this duty in a decision that concluded that the “fundamental purpose” of the Investment Advisers Act was “to achieve a high standard of business ethics in the securities industry.”

SRO Self-Regulation

Beyond the statutory responsibilities and regulations, broker–dealers are subject to FINRA rules (some of which were originally NASD rules) on care and duties owed to clients. FINRA imposes the suitability standard, but other duties include timely confirmation, fair and balanced communications, and disclosure of conflicts. FINRA has continued to expand the disclosure requirements of broker–dealers.

The Demand For Change: 2008’s Collapse and Dodd-Frank

One of the central questions that emerged during the congressional hearings on Dodd-Frank, following the 2008 financial market collapse, was whether an investment firm—namely, Goldman Sachs—owed a fiduciary duty to clients who were purchasing mortgage-backed securities through Goldman when Goldman held short positions in those same instruments. Goldman held short positions because it knew about low-quality mortgages in the pool. Goldman did not choose the mortgages in the pool but was involved in the choice of a consultant for the pool selection. The consultant was not aware of Goldman’s plan to position itself short to profit from a deal it was structuring and, indeed, was confused by the selection of lower-quality mortgages for the pool (Morgenson and Story 2009).

During the hearings, Goldman took the position that it was simply selling securities and taking orders for the purchase of those securities. Under the definitive distinction between broker–dealers and investment advisors, Goldman did not owe a fiduciary duty to purchases and, as such, did not need to disclose this backdrop of involvement.

The technical distinction in duties was the focus of Senator Carl Levin’s (D-MI) questions of Lloyd Blankfein, Goldman's chief executive officer and chairman, as described in Hansard (2010):

Senator Levin: In a deal where you are selling securities and you are intending to keep the short side of that deal, do you think you have an obligation to tell the person that you're selling that security to in that deal that you are keeping the short position in that deal?

Mr. Blankfein: I don’t think we would disclose that. … If a client came to us and asked us to buy something from him and we intended to hold the long position, I don’t think we have an obligation of telling him that our intention is to hold it. … We are buying from sellers and selling to buyers. … That is not a conflict. … They wouldn’t care what our views are.

According to Adams (2010), another Goldman executive, Daniel Sparks, was asked, “Do you have a duty to act in the best interests of your clients?” Mr. Sparks replied, “I believe we have a duty to serve our clients well.”

Following the hearing, several senators proposed bills that ranged from proposed criminalization of certain broker-dealer conduct to leaving the decision to the SEC, which was the final language in Dodd-Frank. The SEC study concluded that investors are confused about the roles and duties of advisors and broker–dealers and that parsing legal language was adding to their confusion. The study recommendation was the adoption of one standard.

What Lies Ahead and What Could Be Done

One SEC commissioner has described the existing regulations for investment advisors and broker–dealers “as a ‘badly worn patchwork quilt’ in desperate need of reform” (Varnavides 2011, p. 204). The same commissioner also has noted that investment advisors and broker–dealers “often provide practically indistinguishable services to retail investors and direct them to the same [financial] products” (Walter 2009).

The SEC findings regarding investor confusion, at this point, are an incontrovertible given. However, the financial industry will be able to participate in the rulemaking process in order to understand the consequences of a uniform fiduciary standard. For example, a single fiduciary standard results in higher costs for retail investors. Disclosure requirements also would reduce the speed in broker-dealer transactions because disclosures, forms, and compliance will slow down trades (Lin 2014). Walsh and Johns (2013) conclude that a commission-based compensation system cannot support fiduciary standards, and that broker–dealers will move to minimum-asset-percentage based models. As a result, smaller portfolio investors will not qualify for advice.

Another interesting line of research provides insight into a risk one-standard advocates often fail to acknowledge. When investors have full liability protection, they delegate...
evaluation and lose the healthy skepticism needed for investment decisions (Ben-Shahar and Schneider 2011). The imposition of fiduciary standards on broker–dealers may lessen the instinctive self-protection efforts of investors (Prentice 2011).

Easterbrook and Fischel (1993) argue that one impact of the imposition of fiduciary duty would be the loss of contractual autonomy, i.e., the ability of investors to negotiate rights and obligations according to their needs.

The imposition of one standard also will trigger industry responses (Romano 1993). This new firm structure could carry a banner of: “No advice here. Only orders.” The unintended consequence of more regulation is often evasion of regulation.

**Introspection: Can the Course Be Changed?**

The inexorable march to one-standard duties is the result of inaction and abuses within the financial industry that culminated with the industry testimony during the Dodd-Frank hearings. When ethical issues arise in an unregulated area, businesses and industries enjoy wide latitude. Some members of the profession or industry will seize the unregulated moment a bit too aggressively. Goldman’s testimony about its view of fiduciary duty is an example of using an unregulated area to one’s advantage. The sole ethical standard is, “This is what the law allows.”

Every business statute or regulation that presently exists began as an ethical dilemma. The political science model developed by James Frierson posits a sequence of stages. The 2008 market collapse moved the issue very quickly from the latency stage through the public awareness stage to activism, leaving it (for several years now) in the regulatory phase. Rather suddenly, the issue of fiduciary duty, one that had occupied the halls of academia since the 1940s, was being covered in USA Today (see Lynch 2010). The public suddenly had an interest in the nuances of defining investment advisors versus broker–dealers.

The x-axis of figure 1 represents time and the y-axis represents options for self-regulation. The longer companies and industries wait to take self-corrective action, the less likely self-correction will be allowed and the more likely regulation results—often with unintended consequences, including additional costs. The public loses faith in a company’s or industry’s willingness to change and takes the issue to the activism stage, a stage that demands change. If voluntary reform is still not forthcoming, the issue moves into the litigation, legislative, or regulatory (administrative agency) stage. Inaction leaves the industry or company with a lesser voice in this stage of the cycle (Jennings 2006, 2014).

The hard truth is that valid industry arguments about the risks of a uniform fiduciary standard are falling on deaf ears (Coffee 2004).

However, some strategies can be used in the final phase of the regulatory cycle that would give the industry a chance to influence what form the new regulation will take. The key is for the industry to acknowledge the issues that require behavior modification and then offer solutions to address those issues, thus limiting overly broad regulatory strokes. Acknowledging that bad behaviors have occurred in the industry is a means of establishing credibility and earning a seat at the rule-making table. The Department of Labor (DOL) has published a 300-page proposal that is now in the comment stages. The proposed fiduciary standard is expanded but exemptions are also included. For example, the proposed rule includes a “best interest contract exemption” for broker-dealer reps and insurance agents who provide advice to individual retirement account owners as small business retirement plans. The proposal has other...
carve-outs as well, which indicates that DOL considered industry-raised issues. The 2015 proposed rule has been changed substantially from the 2010 proposal, evidence of the cycle’s interactive nature and the ability of those affected to offer feedback even in the final stage of the cycle.

Focus on the Type of Investor to Be Protected
Bai (2014) suggests that subjecting broker–dealers to a fiduciary standard will have only a limited effect on institutional investors. Lydenberg (2014) suggests that the rule-making could be refocused with these questions: Which investors are we trying to protect? Where does that protection need to be provided? How can we best narrow the scope to afford that protection without increasing costs or eliminating services for those investors? There is precedent for limitations on protections because the SEC has permitted investment advisors to modify an advisor’s liabilities through a hedge clause. The modifications in the 2015 proposal indicate a willingness of regulators to adopt a more refined approach as opposed to a blanket application of the fiduciary standard to all who interact with clients. The research cited here on potential cost to clients has proven to be important as the rule progresses through the comment periods. Focus on Defining the Duties of Broker–Dealers
Another strategy at this stage of the cycle would be to concentrate on the conduct that fueled the revolt. In broker-dealer cases discussed in this review, as well as in the Dodd-Frank hearings, the conduct of the broker–dealers was ethically shocking (Angel and McCabe 2013). Regulating to curb the shocking conduct pulls the cycle back to a more reflective mode and reduces its speed by focusing on specific conduct; for example, the requirement to disclose that you can make a higher commission by selling your own company’s products to investors is a basic ethical tenet that should be followed regardless of statutory requirements. Likewise, letting your client know that the investment vehicle you are recommending is one in which you carry a short position is not an ethical gray area.

Admission of fault and concession produce regulations that address issues but do not result in the ill-effects discussed earlier.

Offering a basic set of rules that apply across the investment markets, regardless of the role played by a given individual or institution in those markets, is another possibility. Applying the principles of agency law is one suggestion (Sikoff 2013). The duties under agency law, sometimes referred to as a “universal standard of care,” are more specific than just duties of loyalty and care, e.g., Varnavides (2011) suggests the following five core principles from the Committee for the Fiduciary Standard:

1. Put the client’s best interest first.
2. Act with prudence—the skill, care, diligence, and good judgment of a professional.
3. Do not mislead clients; provide full and fair disclosure of all important facts.
4. Avoid conflicts of interest.
5. Fully disclose and fairly manage, in the client’s favor, unavoidable conflicts.

Another suggestion that has been advanced is the adoption of the sole interest (or sole benefit or exclusive benefit) standard, which is a principle of trust law that requires a trustee to carry out trust duties solely in the interest of the beneficiary. Under this standard, conflicts are not permitted. A slight modification of this standard specifies the best interest of the client, which uses a cost–benefit analysis for impact on the client (Di Lorenzo 2012).

Strengthen SROs and Enhance Enforcement.
Self-regulation is a tool that can be used at any stage of the regulatory cycle. The focus in developing regulation should be accompanied by rigorous enforcement. The financial industry suffers from an enforcement hesitancy that affects other professions. Demonstrating an ability to censure or banish for egregious conduct buys credibility in the cycle.

Conclusion
Regulation is inevitable when professions do not undertake the introspection and self-reforms necessary to rein in those who follow just the law, ignoring the ethical issues in their standards. A singular ethical standard of, “What can I get away with under the law?” is the beginning of a cycle.

Often business and professional behaviors that meet legal requirements become so engrained and accepted that those in a profession or industry fail to see the resulting harms or understand public perception. An industry defines itself by its standards but also by its willingness to change standards when necessary and discipline the outliers who are moving the regulatory cycle to change ethically questionable into illegal behavior.

The recommended SEC action on one standard for broker–dealers is now in the final stage: rulemaking. Resistance is now futile. The “I followed the law” defense does not work when public outcry is so strong. Acknowledging the ethical issues is a prerequisite for credibility at the table as the reforms are structured. The financial industry must be certain that the simple ethical standards of honesty in dealing with clients are followed and, in the case of conflicts, that disclosure is the industry’s expectation.

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Endnotes
1. Another complication is that the Department of Labor (DOL) is considering the imposition of new fiduciary standards in its area of jurisdiction— that of employer-sponsored retirement fund managers and advisors. The DOL also appears to be leaning toward adoption of the uniform fiduciary standard.
6. Since the time of the 1940 legislation, specific federal laws have applied to investment professionals in certain roles. For example, the Employee Retirement Income Security Act (ERISA) specifies rules and duties for certain fund managers, and is administered by the DOL, and thus differs from the SEC-administered securities and investment company statutes. Under ERISA, investment managers who serve as pension plan fiduciaries for employer-sponsored retirement plans have four duties including the duty of loyalty. These expanded duties under the DOL’s current one-standard proposals.

7. Thomas v. Metropolitan Life Insurance Company, 631 F.3d 1153, 1164 (10th Cir. 2011). The SEC supported the judgmental position as a GFI § 275; however, that support was issued before the release of the Dodd-Frank study.


10. NASD Rule 2120(d); NASD Rule 2340; NASD Rule 2720; and NASD Rule 3040, respectively.

11. For example, following the 2008 market collapse, in 2009, FINRA began requiring that broker-dealers who sell real estate investment trusts (REITs) disclose the market value of those REITs on client statements. The post-2008 market values have been significantly lower than the original investment values because of the real estate market collapse.

12. Despite this public position, Goldman Sachs admitted in a January 2010 open letter to its clients, “We may trade, and have existing positions, based on trading ideas that we have discussed those ideas with you” (Sorkin 2010). The same disclosure had appeared in the fine print in the firm’s marketing materials, but the memo was the first affirmative disclosure to clients.

13. The new proposed rule withdraws the original 2010 proposal.

14. A summary of the proposed rule can be found on the Department of Labor website. http://www.dol.gov/ERISA/dol/lawsuit.pdf. By way of full disclosure, it should be noted that the Committee for the Fiduciary Standard (a lobbying group) opposes any effort to create a new set of standards to replace the existing, well-litigated, and relatively well-defined statutory, SRO, and regulatory fiduciary standard (see www.thefiduciarystandard.org; retrieved May 23, 2014). The Committee for the Fiduciary Standard emphasizes the results of a study by Finke and Langdon (2012) that concluded that the imposition of the fiduciary standard on broker-dealers would have no impact on the ability of investors to obtain services. The Committee for the Fiduciary Standard partially funded Finke and Langdon’s study.

References


