

# Who Is a Fiduciary and What Does a Fiduciary Investment Advisor Do?

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**W**e cannot do everything ourselves. Different people are more capable in certain endeavors than others. When we don't have the time, inclination, or ability to master the knowledge and skills necessary to act capably on our own behalf, we must rely on others.

In matters of the utmost importance, we seek the help of professionals. The disparity between the skills and abilities of everyday people versus those of professionals is insurmountably wide. When we seek professional advice, we effectively cede—we entrust—control over aspects of our bodies, rights, and wealth to doctors, lawyers, and financial advisors. Out of necessity, we place our trust in their competence, integrity, and diligence and we become vulnerable to their mistakes or misdeeds.

If the professionals we must rely upon are not accountable to high standards of conduct, there is little or no basis for trust. Just as individual instances of misconduct or incompetence can have devastating consequences for the recipients of bad advice, systemic deficiencies in standards of professional conduct cut deeply into the fabric of society. When people lose confidence in a profession, they avoid it and try to do things for themselves, even if they can't do those things well. Without true accountability, the bonds of trust are weak and society suffers from lack of collaboration and productivity.

Society has long recognized the need for professional standards of conduct that

require practitioners to serve their clients' best interests—a fiduciary standard of conduct. The opening three paragraphs of this article paraphrase words Cicero spoke more than 2,000 years ago when, as a young attorney, he spoke about the consequences of violations of codes of conduct required of trustees.<sup>1</sup> Those expressions of societal expectations regarding required conduct for people in positions of trust during Roman times were not new even then. The origins of fiduciary obligations can be traced back further by more than 1,700 years to the earliest history of recorded law.<sup>2</sup>

## WHO IS A FIDUCIARY?

A fiduciary is a person to whom property or power has been entrusted and who is obligated to provide services to ethically and competently care for that property or exercise that power on behalf of the entrustor. This definition of a fiduciary is based upon four features that fiduciary scholar Tamar Frankel proposes as the defining attributes that all fiduciaries share:

*First, fiduciaries offer mainly services (in contrast to products). The services that fiduciaries offer are usually socially desirable, and often require expertise, such as healing, legal services, teaching, asset management, corporate management, and religious services.*

*Second, in order to perform these services effectively, fiduciaries must be entrusted with property or power.*

*Third, entrustment poses to entrustors the risks that the fiduciaries will not be trustworthy. They may misappropriate the entrusted property or misuse the entrusted power or they will not perform the promised services adequately.*

*Fourth, there is a likelihood that (1) the entrustor will fail to protect itself from the risks involved in fiduciary relationships; (2) the markets may fail to protect entrustors from these risks, and that (3) the costs for the fiduciaries of establishing their trustworthiness may be higher than their benefits from the relationships.<sup>3</sup>*

In elaborating upon these four features, Frankel speaks to the importance of fiduciary relationships in the same ways expressed by Cicero. The first highlights the fact that reliable professional relationships benefit society by allowing specialization and marketplace efficiency.

The second connects the needs of the client or entrustor to the obligations of the fiduciary by focusing upon the property or power placed in the care and control of the fiduciary. Considered the most important of the four attributes, entrustment “greatly affects the existence, nature, and rules of fiduciary relationships,” Frankel states. Without entrustment, there is no basis for the fiduciary relationship.

The third addresses the vulnerability of the entrustor to the fiduciary as a result of the control or influence the

fiduciary is able to exercise over the entrustor's property and affairs. Fiduciary laws and regulations establish requirements and limitations—fiduciary duties—to protect the entrustor from the potential risk of abuse of power by the fiduciary.

The fourth attribute is important yet more subtle than the others. Unlike other marketplace interactions, entrustors have limited ability to directly protect themselves. Delegating authority, and even aspects of property ownership rights, to fiduciaries is risky. Normal marketplace checks and balances, such as greater transparency and accessibility of information and equivalence of knowledge among participants that help protect customers in counterparty transactions, are missing from fiduciary relationships. Finally, if there are no legally recognized and enforceable standards of conduct for professionals, practitioners must individually prove to prospective clients that they will be trustworthy and competent. The cost of doing so is high and may limit the willingness of professionals to provide services due to economic considerations. Such conditions demand third-party intervention—typically by governmental, professional society, or other independent, third-party oversight.

With respect to the fourth attribute, consider this famous quote of Supreme Court Justice Benjamin Cardozo:

*Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.<sup>4</sup>*

“Morals of the market place” can be read to mean the fair dealing (suitability) standard dealing with counterparty transactions such as traditional

Table 1

**SUMMARY OF STARK DIFFERENCES IN ATTRIBUTES OF COUNTERPARTY VERSUS ADVISORY RELATIONSHIPS**

Attributes	Counterparty Transactions	Professional Advice
Relationship Involved	Arms-length; parties are unrelated with no special obligation to one another	Property or power is entrusted to the care of the professional; trustee-trustor relationship
Handling of Conflicts	Conflicts are acknowledged; each party serves its own self-interest	Conflicts must be avoided or managed and mitigated in the interest of the client
Knowledge Gap Involved	Narrow knowledge gap; material information is readily accessible	A wide gap in knowledge and skill between the client and professional and is not easily bridged
Required Standard of Care	Fair dealing; do not deceive	Fiduciary; serve clients' best interests
Regulatory Regime	Rules-based; delineates the “you may and may not” boundaries (rules) of fair dealing	Principles-based; captures the duties associated with professional conduct

brokerage relationships. The assumptions underlying a transactional relationship are vastly different from those of a fiduciary relationship, as captured in table 1.

As illustrated by table 1, the characteristics of an arms-length counterparty transaction are entirely different from those of an advisory relationship. Most significantly, the level of reliance upon the professional advisor and the vulnerability of the client are much higher when professional advice is involved. That is why a high fiduciary standard is required for advisory relationships versus the much lower set of rules for fair dealing that may suffice for transactional relationships.

Clients are placed at extreme risk when they believe they have engaged a professional advisor who is obligated to serve their best interests but actually are working with a practitioner who is not accountable as a fiduciary and does not adhere to fiduciary obligations. Systemic misalignment of standards of care through deficiencies in regulatory regimes require reform to protect client interests, as we have seen in recent efforts in the United States to extend the fiduciary standard to all investment advisory relationships.<sup>5</sup>

To summarize, the informational imbalance (frequently referred to as

“asymmetry of knowledge”) and the entrustment of property or power to the professional creates a special relationship of trust and confidence between the fiduciary and client. The unique attributes of fiduciary relationships make clients especially vulnerable to abuse with limited ability to protect themselves from such abuse. The protections of law and third-party oversight are, therefore, necessary. Society has long recognized these facts and codified fiduciary principles and duties as such.

**WHAT DOES A FIDUCIARY INVESTMENT ADVISOR DO?**

The principles of fiduciary duty are generally consistent across professions. However, they differ in interpretation and application. For fiduciary investment advisors, the foundation of fiduciary duty begins with loyalty and care. From these, other fiduciary responsibilities flow.

The duty of loyalty focuses upon the obligation to always serve clients' best interests. A second and closely associated obligation of loyalty relates to conflicts of interest. Conflicts must be avoided or managed and mitigated to serve clients' best interests.<sup>6</sup>

Arthur Laby, Rutgers University law professor, describes the duty of loyalty as a “negative duty” in that it typically requires the fiduciary to refrain from

behavior that could be injurious to the client, e.g., do not engage in self-dealing or place your interests ahead of the client's, do not mislead, do not commingle client funds, do not reveal private client information, and so forth.<sup>7</sup>

In contrast, Laby notes the following:

*The duty of care is a positive duty. It arises from control or discretion that the fiduciary exercises over the principal's affairs. Control gives the fiduciary the means to take steps to act for the principal's benefit and is necessary to engage in the very conduct that the parties agreed the fiduciary will perform. In fact, one may think of the duty of care in the first instance as a duty to maintain control.*<sup>8</sup>

The duty of care requires fiduciary advisors to faithfully and competently perform their services. "In contrast to the duty of loyalty, which is linked to misappropriation of entrustment, a violation of the duty of care is linked to lack of expertise, inattention, and negligence."<sup>9</sup>

Fiduciary scholar Ron Rhoades expands the duty of care by drawing in elements of professional aspirations to serve clients and society at large by meeting high standards:

*The quest for excellence is the essence of due care. Due care requires a member to discharge professional responsibilities with competence and diligence. It imposes the obligation to perform professional services to the best of an investment adviser's ability with concern for the best interest of those for whom the services are performed and consistent with the profession's responsibility to the public.*<sup>10</sup>

The obligation for the fiduciary to act prudently is central to the duty of care, so much so that the concept has been firmly established in law and regulation under various forms of what has come to

be known as the "prudent person rule." As articulated under the Employee Retirement Income Security Act of 1974 (ERISA), the prudent person rule requires fiduciaries to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] 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."<sup>11</sup>

The prudent person rule is flexible to the situation in that it speaks to the need for a fiduciary to act in accordance with the norms that are expected to be applied under the prevailing circumstances by someone acting in a comparable role. Thus, for a professional advisor, the required standard of conduct rises to that of an expert and, under such circumstances, the prudent person rule is often relabeled as a prudent expert rule under which the fiduciary will be expected to competently apply generally accepted investment principles and practices.

Fulfillment of the duty of loyalty and adherence to the prudent person (or expert) rule are matters of process rather than outcome. As Laby has noted:

*[O]ne must evaluate the duty of care ... by the process the fiduciary undertakes in performing his functions, not the outcome achieved. The very word "care" connotes process ... How else may one determine whether a financial advisor who regularly achieves below average returns, or an attorney who loses most cases, has performed his duty of care? It is only through evaluating the steps the fiduciary took while doing his job, and not whether they resulted in success, that one may judge whether he has breached his duty.*<sup>12</sup>

Many subsidiary duties and responsibilities emanate from the duties of loyalty and care and there is no apparent consensus among legal scholars as to what constitutes the full range of fiduciary

duties. Moreover, some duties overlap under the headings of both loyalty and care. Figure 1 presents a summary of generally recognized responsibilities of fiduciary investment advisors and the alignment of those responsibilities to the primary duties of loyalty and care.

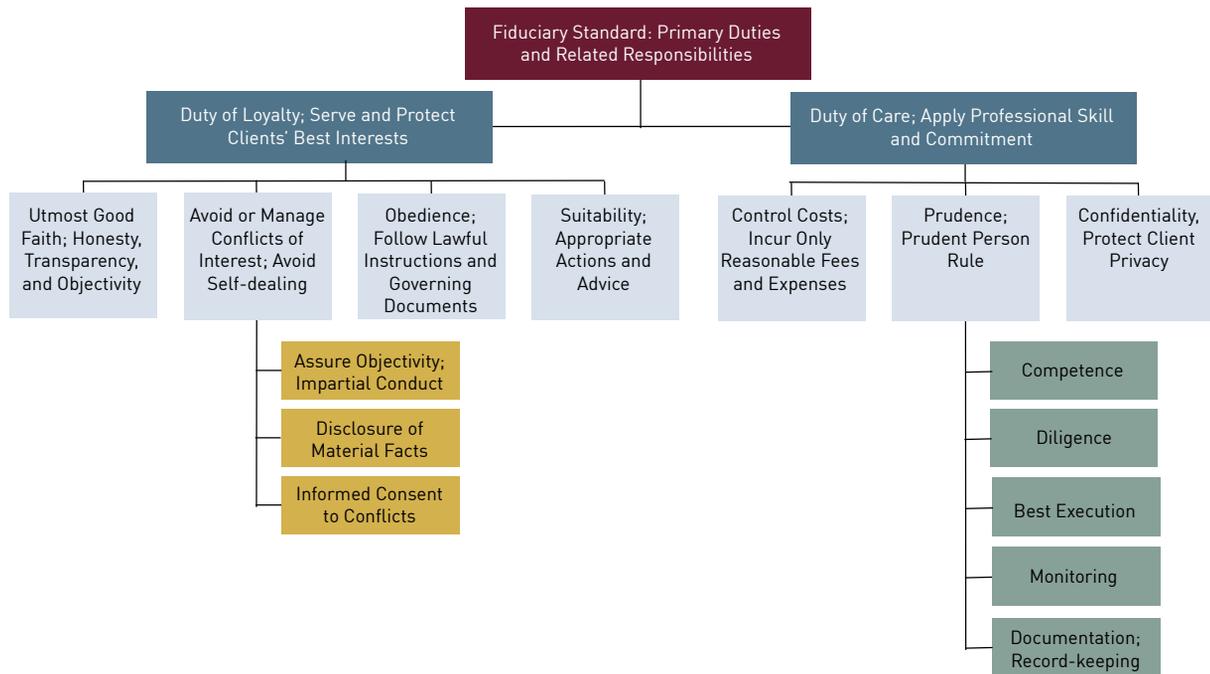
The fiduciary standard is principles-based, as is evident from the duties and responsibilities that frame the standard. As such, the standard is sufficiently malleable to apply to a wide range of facts and circumstances. Trying to construct a job description for a fiduciary investment advisor from a task analysis for every situation the professional must address would be an exercise in futility and failure. However, laws, regulations, and professional best practices that reinforce and elaborate upon core fiduciary duties point to a set of precepts to guide the conduct of fiduciary investment advisors.

The major laws governing investment fiduciaries who are entrusted authority over funds held by trusts (Uniform Prudent Investor Act released in 1940, UPIA); foundations, endowments, and government sponsored charitable organizations (Uniform Prudent Management of Institutional Funds Act released in 2006, UPMIFA); state, county, and municipal retirement plans (Uniform Management of Public Employee Retirement Systems Act released in 2006); qualified retirement plans (ERISA); and individuals (Investment Advisers Act of 1940) share at least seven common obligations.

- Understand and comply with the standards, laws, and governing documents that apply to the entrusted property or powers under the fiduciary's care.
- Manage risk in accordance with the risk/return profile of the client/investors; diversify to manage the risk of large losses unless it is clearly imprudent to diversify (due to a short investment time horizon, for example).

Figure 1

DUTIES AND RESPONSIBILITIES OF FIDUCIARY INVESTMENT ADVISORS



- Comply with the terms of an established investment policy suited to the needs of the client/investors.
- Prudently select service providers (such as investment managers) and document due diligence.
- Control and account for material information; provide transparent accounting of entrusted property, costs, and conflicts.
- Monitor the activities of service providers.
- Avoid conflicts of interest or manage conflicts in the clients' interests.

Precepts can be developed more fully in the form of specific practices. For example, Fi360, Inc.<sup>13</sup> has published a series of three “Prudent Practices” handbooks to “provide investment fiduciaries with an organized process for making informed and consistent decisions.” The three handbooks are substantiated in law, regulation, and fiduciary best practices. They are designed for investment advisors, investment managers, and investment stewards.<sup>14</sup> (Note: Fi360 defines “stewards” as fiduciaries who are not generally financial services

professionals but are responsible for entrusted assets of trusts, retirement plans, charitable organizations, and other institutions in their roles as employees or directors.)

Various other professional organizations have set and enforce standards geared for specific professions within the field of financial advice. The standards serve to differentiate the professions and elevate them beyond mere compliance with the law.

Figure 2 illustrates a hierarchy of standards for financial advisors. The relationship between the levels in this hierarchy is discussed below.

The foundation for oversight and standard setting is established by laws and the regulations of federal and state government entities, as well as self-regulatory organizations that have rule-making and enforcement powers that carry the force of law. This level of oversight is the focus of attention for most practitioners because it sets baseline obligations with robust enforcement ramifications for offenders.

Employers of financial advisors, and firms that have contractual oversight responsibilities for financial advisors, establish and enforce standards of conduct (typically compliance policies and procedures) that must be aligned with, and no less stringent than, the obligations imposed by law and regulation.

Professional organizations that award credentials generally promulgate codes of ethics and standards of conduct that designees are required to follow or face sanctions, including possible revocation of the organization’s credentials. The standards established by these organizations can be no less stringent than those founded in law and regulations and they are typically higher than the requirements set by employers. Investments & Wealth Institute,<sup>15</sup> CFP Board,<sup>16</sup> and CFA Institute<sup>17</sup> are examples of highly respected professional organizations with high standards of conduct for practitioners in different (yet overlapping) segments in the field of financial advice.

Finally, individual advisors may operate according to their own set of professional

Figure  
2

## HIERARCHY OF STANDARDS FOR FINANCIAL ADVISORS



principles. Their unique standards can be no lower than those established at the lower levels of the hierarchy, at least not without running the risk of sanctions.

The most important takeaway from the hierarchy of standards for advisors is that fiduciary accountability exists at all levels. The highest standards required are those imposed by practitioners and colleagues striving for professional excellence.

### SUMMARY AND CONCLUSION

Society has long recognized the need for professionals to be accountable as fiduciaries. The duties of fiduciaries align to what society expects and prospective clients value most highly: trustworthy and competent advice (the duties of loyalty and care). Laws and regulations set the baseline standard for fiduciary obligations, but leaders in the field look beyond compliance to achieve excellence. Acting in concert with colleagues to set high standards of conduct for practitioners is the surest path to having the field of financial advice recognized and valued as a true profession. ●

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### ENDNOTES

1. This quote of Cicero is from a transcript of "For Sextus Roscius of America," by Marcus Tullius Cicero delivered at trial in 80 BC, translated by C. D. Yonge (1903), [https://en.wikisource.org/wiki/For\\_Sextus\\_Roscius\\_of\\_Ameria](https://en.wikisource.org/wiki/For_Sextus_Roscius_of_Ameria). "In private affairs if any one had managed a business entrusted to him, I will not say maliciously for the sake of his own gain and advantage, but even carelessly, our ancestors thought that he had incurred the greatest disgrace. Therefore, legal proceedings for betrayal of a commission are established, involving penalties no less disgraceful than those for theft. I suppose because, in cases where we ourselves cannot be present, the vicarious faith of friends is substituted; and he who impairs that confidence, attacks the common bulwark of all men, and as far as depends on him, disturbs the bonds of society. For we cannot do everything ourselves; different people are more capable in different matters. On that account friendships are formed, that the common advantage of all may be secured by mutual good offices. Why do you undertake a commission, if you are either going to neglect it or to turn it to your own advantage? ... You undertake the burden of a duty which you think you are able to support; a duty which does not appear very heavy to those who are not very worthless themselves."
2. Blaine F. Aikin and Kristina A. Fausti, *Fiduciary: A Historically Significant Standard*, *Review of Banking and Financial Law*, Boston University School of Law 30 (2010–2011): 155.
3. Tamar Frankel, *Fiduciary Law* (Oxford University Press, 2011): 6.
4. *Meinhard v. Salmon*, 249 N.Y.458, 464 (1928) (Cardozo).
5. The Department of Labor issued a final rule, the "Conflict of Interest Rule," on April 8, 2016, to extend fiduciary accountability to all who provide advice pertaining to assets held in ERISA retirement plans and individual retirement accounts. As of this writing, that rule has been partially implemented and is scheduled for full implementation on January 1, 2018. The rule is available at <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806>. Section 913 of the Dodd-Frank Act of 2010 authorizes, but does not require, the Securities and Exchange Commission (SEC) to extend fiduciary accountability to those who provide advice to retail investors. At the time of this writing the SEC has not acted upon that authority. The Dodd-Frank Act is available here: <https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>. Section 913 begins on page 449 and the authority to extend fiduciary accountability to providers of advice to retail investors is found on page 453.
6. Frankel, *Fiduciary Law*, p. 108, Frankel describes the two core obligations of the duty of loyalty thusly: "The duty of loyalty takes two aspects. One aspect is a requirement that fiduciaries act for the sole benefit of the entrustors. After all, if the entrusted property or power does not belong to the fiduciaries it follows that the fiduciaries may not benefit from it, except upon the consent of the true owner or the source of this authority or the law. The other aspect of the duty of loyalty is a prohibition on fiduciaries from acting in conflict of interest with the interests of the entrustors (always in relationship to the entrustor property or power)." Note that this "sole benefit" obligation derived from trust law and at work under ERISA is more stringent than a "best interest" obligation in that the former generally requires conflicts to be avoided whereas the latter allows conflicts to exist so long as they are managed in the client's interest.
7. Arthur R. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, *American University Law Review* 54, no. 1 (2004): 75–149.
8. Laby, *Resolving Conflicts*, p. 110.
9. Frankel, *Fiduciary Law*, p. 169.
10. See [http://www.fi360.com/main/pdf/2011\\_rhoades1\\_supplemental.pdf](http://www.fi360.com/main/pdf/2011_rhoades1_supplemental.pdf), p. 85.
11. The text of ERISA Section 404(a)(1)(B) is available, courtesy of Cornell Law School's Legal Information Institute, at <https://www.law.cornell.edu/uscode/text/29/1104>.
12. Laby, *Resolving Conflicts*, p. 117.
13. Fi360, Inc. (established in 1999) provides financial professionals with the education, designations, training, and tools necessary to act in a fiduciary capacity in their work with investors. The author of this article, Blaine Aikin, is executive chairman of Fi360.
14. Fi360's *Prudent Practices for Investment Advisors handbook* is available here: [http://www.fi360.com/uploads/media/handbook\\_advisors.pdf](http://www.fi360.com/uploads/media/handbook_advisors.pdf).
15. The Investments & Wealth Institute *Code of Professional Responsibility* is available here: <http://www.investmentsandwealth.org/pages/Code-Professional-Responsibility>, and on page 62 of this issue.
16. CFP Board's *Standards of Professional Conduct* are available here: <https://www.cfp.net/docs/ethics-enforcement/standards-of-professional-conduct-final.pdf?sfvrsn=2>.
17. CFA Institute's *Code of Ethics and Standards of Professional Conduct* are available here: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n6.1>.

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