April 12, 2011

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Definition of Fiduciary Proposed Rule
Room N–5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Re: Proposed Rule, Definition of the Term "Fiduciary"

Ladies and Gentlemen:

The National Association of Personal Financial Advisors ("NAPFA")[1] is pleased to present these comments in support of the Department of Labor / Employee Benefits Security Administration's (EBSA's) Proposed Rule, "Definition of the Term 'Fiduciary.'"

NAPFA supports EBSA's effort to modernize the definition of a fiduciary within the meaning of Section 3(21)(A) of the Employee Retirement Income Security Act of 1974 (ERISA). Significantly, the proposal would expand who is regarded as a "fiduciary" – moving the definition closer to the plain language of the statute, as well as updating the regulation to reflect the growth in the retirement plan markets, the proliferation of investment products available, the furnishing by practically every advisor to plan sponsors of an investment policy statement for the retirement plan, and the practical reliance of plan sponsors and plan participants upon those who provide investment advice in connection with the retirement plan.

NAPFA was founded on principles based on fiduciary concepts and the premise of putting the clients' best interest first. Given the strong support of our members for the *bona fide* fiduciary standard found in the Advisers Act, we are concerned over the well-documented efforts of some in the securities industry to diminish that standard. As to EBSA's current rule-making efforts, based upon the testimony recently received by EBSA, we are now concerned over the efforts by some organizations within the insurance and securities industries which seek to have advice provided to retirement plan sponsors and plan participants

[1] NAPFA has more than 1,400 NAPFA-Registered Financial Advisors across the United States. All NAPFA-Registered Financial Advisors must submit a comprehensive financial plan and undergo a thorough review of their qualifications prior to admission. NAPFA-Registered Financial Advisors all sign a Fiduciary Oath which states that the advisor will only work in good faith and with the best interests of the consumer at heart. NAPFA-Registered Financial Advisors are strictly Fee-Only®, which means they do not accept commissions or any additional fees from outside sources for the recommendations they make to their clients.

be governed under what is essentially an arms-length relationship and *caveat emptor* standard. We also are concerned over insurance and securities industry efforts to weaken the "sole interests" fiduciary standard of conduct applicable to ERISA accounts – the highest standard of conduct under the law, and/or to ignore ERISA's prohibited transaction rules.

The fiduciary standard results from the trust necessarily reposed in the provider of investment advice. We first explore in this comment letter the importance of this "trust" in our financial services system, which is especially important for those Americans who entrust their retirement savings to retirement plan advisors. We then set forth many of the important public policy considerations which favor the application of fiduciary status upon providers of investment advice to retirement accounts.

## THE FIDUCIARY STANDARD IS GROUNDED IN TRUST

**Trust Aids in Capital Formation and Economic Growth.** Over the past several decades academic research has revealed that robust capital markets are essential to the growth of a nation's economy. "Stock market liquidity - as measured both by the value of stock trading relative to the size of the market and by the value of trading relative to the size of the economy - is positively and significantly correlated with current and future rates of economic growth, capital accumulation, and productivity growth. Stock market liquidity is a robust predictor of real per capita GDP growth, physical capital growth, and productivity growth after controlling for initial income, initial investment in education, political stability, fiscal policy, openness to trade, macroeconomic stability, and the forward looking nature of stock prices."[2]

Yet possessing a liquid securities market is not, in itself, sufficient to promote optimum economic growth. Rather, investor trust in our capital markets system is also required.[3] "Investor trust provides the foundation on which the American securities market has been built. Without such trust, our market would be a thin shadow of its former self."[4]

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[2] Levine, Ross, and Zervos, Sara, "Stock Markets, Banks, and Economic Growth," available at http://www.worldbank.org/html/prddr/prdhome/pdffiles/wp1690.pdf.

[3] *See* Hsiu-Kwang Wu, "An Economist Looks at Section 16 of the Securities Exchange Act of 1934," 68 Colum. L. Rev. 260, 264 (1968) (noting that "[a] liquid stock market presupposes public confidence which creates willingness to purchase shares. Much of the difficulty in organizing capital markets in the less developed countries arises from public distrust and reluctance to invest funds in such markets"); *see also* Victor Brudney, "Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws," 93 Harv. L. Rev. 322, 335 (1979) (arguing that a benefit which flows from an increase in "investor faith in the market would be a reduction in the cost of capital by reason of eliminating the higher risk premiums required by investors to compensate for their fear of overreaching")/

[4] Stout, Lynn A., "The Investor Confidence Game." UCLA School of Law, Research Paper No. 02-18, at p.3. Available at http://ssrn.com/abstract=322301. Professor Stout further noted that under the rational expectations investor model, "Rational expectations investors do not invest on faith. They take nothing for granted. Rather, they must be provided with evidence that they are adequately protected before they will part with their money. Absent such evidence, they prefer to bury their savings in a coffee can in the backyard." *Id.* at p. 7. This, of course, assumes that

It is well documented that public trust in the capital markets system is positively correlated with economic growth.[5] Investors' trust arises from either government regulation ensuring advisors honor their fiduciary obligations or the existence of a fiduciary culture[6] (professionalism, if established as a norm in the society, or social capital[7]), or both.

Recent research has even revealed that differences in levels of trust by Americans in different areas of the country substantially affect the economic growth among regions.[8] Hence, particular attention should be paid by policy makers to the important role of individual investors' trust in our capital markets. One might rightfully ask, would the United States have developed a multi-trillion dollar public securities

individual investors behave rationally, possess adequate information, and are not subject to various behavioral biases which may affect their decision-making processes.

[5] *See* Putnam, R., 1993, *Making Democracy Work: Civic Traditions in Modern Italy*, Princeton University Press, Princeton, NJ; La Porta R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, 1998, "Law and Finance," *Journal of Political Economy*, 106, 1113-1155; Knack, S., and P. Keefer, 1997, "Does Social Capital Have An Economic Payoff? A Cross-Country Investigation," *Quarterly Journal of Economics*, 112, 1251-1288; and Zak, P., and S. Knack, 2001, "Trust and Growth," *The Economic Journal*, 111, 295-321.

[6] Carlin, Bruce Ian, Dorobantum, Florin, and Viswanathan, S., "Public Trust, The Law and Financial Investment" (2008), available at http://home.business.utah.edu/finmh/trust7777.pdf ("[T]he ability of clients to rely on others (develop trust) in our model is calculative and arises from two sources: the law and culture. Calculative trust … means that investors rationally compute their trust level based on their subjective beliefs about the gambles they face. In making this calculation, they take into account two primary sources of trust. Trust that arises from the law evolves because investors can rely on the government to make sure that agents honor their fiduciary duty to clients. Trust that arises from culture evolves because investors can rely on a certain amount of professionalism or the social networks that have been established in the population. That is, in the latter type of trust, agents honor the fiduciary duty due to a social norm, not a formal law. In some circumstances, these two sources of trust may be complements, but in others they may be substitutes …."). *Id.* at p.2.

[7] As societies evolve and international competitive pressures break down long-established norms, social capital may need to be replaced by the imposition of legal standards, such as the imposition of fiduciary duties. *See, e.g.*, Omori, Takashi, "Balancing Economic Growth with Well-Being: Implications of the Japanese Experience," (available at http://www.oecd.org/dataoecd/5/11/1824787.pdf), discussing the demise of a history of mutual trusting between workers and employers and other participants in business: "In Japanese and Asian development, human capital was essential, especially in accumulating technology through learning by doing. Social capital also played an important role, through mutual trust within the general public and thorough cooperative behavior among colleagues and between companies that held long-term relationships … However, just like physical capital, human and social capital may become obsolete. Some aspects of society that helped Japan to grow quickly have become obsolete and are being replaced by market mechanism and formal institutions." *Id.* at p. 1.

[8] Dincer, Oguzhan C. and Uslaner, Eric M., "Trust and Growth" (July 2007). FEEM Working Paper No. 73.2007. Available at http://ssrn.com/abstract=999922. The authors conclude: "Using data from the US states, we provide new evidence of a positive relationship between trust and economic growth and show that even in a high income country such as the US, in which property and contractual rights are protected more than the low income countries, high trust regions achieve higher economic growth."

market, in which governments and corporations can annually raise hundreds of billions of dollars in new capital, without ensuring adequate levels of trust by investors in our capital markets system?[9]

**Essential Trust Must Exist in the "System."** In whom do individual Americans place their trust? "At a minimum … American investors must believe that somehow the legal system constrains [securities professionals] sufficiently that the benefits of investing outweigh the risks. They must believe that the regulators are regulating, and the watchdogs are watching. In other words, investors may not need to trust *people* before they are willing to given up their hard-earned dollars. But they must at least trust *the system*."[10] Significant evidence reveals that individual consumers do place their trust in systems and institutions, not just in individual persons.[11]

Should individuals be permitted to only trust specific persons, and not trust other persons who undertake similar functions, confusion is likely to reign and standards of conduct will fail to protect consumers. Hence, policy makers should seek to place into effect those reforms which engender trust by individual investors in all institutions and firms which provide investment advice to individual Americans, not just in select market participants.

**Embedding Fiduciary Ties in the "System" Promotes Capital Formation.** The fiduciary relationship fosters expectations of trust and reciprocal obligation. It forms the bridge of trust[12] in our capital markets system by which individual investors form expectations that they will be dealt with properly. These expectations reduce fears of misappropriation, as the client anticipates that the investment adviser will not engage in behavior in which opportunities are usurped for the advisor's own benefit.

When, as currently exists in the United States, trust in financial institutions is low, "government involvement increases public trust and aggregate investment in the market … regulation can be responsible for catalyzing both public trust in the market and economic growth."[13] In essence, public trust in the capital markets can be increased if all individual investors access the capital markets through

[9] Stout at p. 35, observing: "[T]here is good reason to suspect that trusting investors may be the heart and soul of the modern market. Individual investors, most of whom hold rather small portfolios, own nearly 50 percent of all U.S. corporate equities. Although institutions like mutual funds, pension funds and insurance companies own most of the rest, often these institutions' investment decisions also are influenced by individuals' views of the market." *Id.* at pp.35-6.

[10] Stout at p.21.

[11] Stout at pp. 30-1.

[12] This expression is derived from Klein, D. B. (ed.), 1997, *Reputation. Studies in the Voluntary Elicitation of Good Conduct*, (Ann Arbor: The University of Michigan Press).

[13] Carlin, p. 4. ("We then analyze when it is optimal for a government to intervene in the market to protect investors. We show that when the value to social capital is relatively low and/or the growth potential in the economy is low, it is never optimal to institute a Coasian plan (absence of government regulation). We also show that *ceteris paribus* there should be more government intervention in a low-trust equilibrium than in a high-trust equilibrium." *Id.* at pp.26-7.)

fiduciary advisors who possess the "responsibility to use the [investor's] capital in the best possible way to maximize the chances that the investment is successful."[14]

The advantage consumers receive from the receipt of fiduciary advice is in overcoming consumers' own inherent limitations in achieving an understanding of the capital markets. The application of the fiduciary standard of conduct will increase the demand for financial advice,[15] and as a result in greater participation in our capital markets. This in turn will likely provide the individual investors with superior long-term rates of return for investors' portfolios well above the returns offered in bank depository accounts; in turn retirement security is better assured.

**Judicial Recognition of the Importance of the Fiduciary Standard to Investors' Faith in our Capital Markets.** Adherence to the fiduciary standard of conduct by those advisors providing personalized investment advice has been recognized by the courts as heavily influencing retail investors' faith in our capital markets:

> The conduct at issue here, breach of fiduciary duty and fraud both by omission and commission, not to mention defendant's violation of both the law and their own policies governing such accounts, is very serious indeed. Such activity shakes people's faith in the market and their ability to rely upon investment advisors, and demands heavy punishment.[16]

Indeed, the U.S. Supreme Court has also weighed in on the importance of the highest standard of conduct to be applied:

> It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry.[17]

In the first year of his administration, faced with a financial crisis of epic proportions, Franklin Delano Roosevelt told the press that his principal objective was to restore the idea that dealers in securities, both

[14] Carlin, p.6.

[15] Dr. Michael Finke in his comment letter to the SEC dated August 18, 2010, alludes to the greater potential for investors to commit capital to the markets, as well as the benefits to consumers personally should they be empowered by receipt of advice under an always-applied fiduciary standard of conduct: "It should also be noted that many do not pay for financial advice due to uneven quality and the inability to detect quality prior to purchase. Imposition of a fiduciary standard (and the use of minimum quality standards to license or certify financial advisers) could potentially broaden the market for financial advice as it has for many other professions subject to similar standards. This consumer confidence in financial advice services has never been more important in an era where individuals are increasingly responsible for their retirement and making sound choices in an increasing complex financial marketplace."

[16] *DeRance, Inc. v. PaineWebber Inc.,* 872 F.2d 1312, 1328 (C.A.7 (Wis.), 1989).

[17] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186-87 (1963), *quoting Silver v. New York Stock Exchange*, 373 U.S. 341 (1963).

new and old, are fiduciaries. Shortly thereafter, in 1934, Justice Harlan Stone explained the need for fiduciary capitalism, stating:

> I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.'

Many researchers have also taken note of the importance of strong ethical standards in preserving investor trust, in turn aiding in the formation of capital. As stated in recent dissertation:

> The failure of regulatory authorities to detect wrongdoing, enforce ethical business practices, and obtain adequate investor restitution has been of great concern to policymakers. Investor losses dent investor confidence and lower the overall willingness of the public to invest. This, in turn, hinders the formation of capital in the economy leading ultimately to lower levels of economic growth than could otherwise have been achieved.[18]

**EBSA Should Act to Restore Trust by Application of the Fiduciary Standard of Conduct.** Given the financial shocks experienced by many individual Americans recently,[19] second only to those of the Great Depression, policy makers should act to effect a restoration of trust in our securities markets, especially so as to the essential retirement savings of tens of millions of Americans. EBSA can play an important role by modernizing the definition of "fiduciary" to more closely fit the current reality, and extending ERISA's protections to a far greater number of retirement accounts.

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[18] Ramphal, Nishal Ray, The Role of Public and Private Litigation in the Enforcement of Securities Laws in the United States, p.1, available at http://www.rand.org/pubs/rgs_dissertations/2007/RAND_RGSD224.pdf.

[19] The "Great Recession" which lingers on was clearly brought about by unconstrained greed. As Professor Tamar Frankel observes, business leaders, regulators, and legislative leaders all share part of the blame:

> Too many American leaders have preached faith in the market to protect the public against dishonesty. The resistance of the leadership to the law and its constraints on the leaders' power is complemented by the elevation of self-interest and the markets. "If each person took care of himself, and if each person catered to his interests, and protected himself from others, society will be served best," they say. "Trust" has given way to "verify." At most law should help trusting persons to obtain true information. But let them make their own decisions. And if they have no expertise, they should seek the advice of private-sector experts. Yet law should be least intrusive in regulating the experts. This message empowers the powerful and releases them from the constraints of accountability to the less powerful and less expert.

Frankel, Tamar, TRUST AND HONESTY, America's Business Culture at a Crossroad (forthcoming, Oxford University Press), Introduction, p.9.

# IMPORTANT PUBLIC POLICY CONSIDERATIONS FAVOR THE IMPOSITION OF THE FIDUCIARY STANDARD OF CONDUCT

**The Capital Markets and the Consumer: Problems of Asymmetrical Information.** Many insurance and securities industry participants opposed to the impositions of fiduciary duties upon their activities may seek to opine that doing so will destroy the economy and/or renders markets inefficient. Yet, scholars observe that "[t]he reality of how markets operate contrasts sharply with textbook neoclassical theory in which anonymous buyers and sellers meet for an instant to exchange homogeneous goods at preordained equilibrium prices. The idea that prices alone allocate resources in a market economy is at best a limiting case and at worst a straw man."[20] There is diverse and extensive rationale for the imposition of fiduciary status upon providers of personalized investment and financial advice which is explored below..

**The Increased Knowledge Gap between Investment Advisers and Consumers in Today's Complex Financial World.** Without question there exists a substantial knowledge gap between fiduciary investment advisers and the vast majority of their clients in today's modern, complex financial world.

The world is far more complex for individual investors today than it was just a generation ago. Greater responsibility exists for the average American to save and invest for his or her future financial needs, such as retirement, and for the management of any accumulated retirement nest egg. In addition, there exist a broader variety of investment products, including many types of pooled investment vehicles[21] and/or hybrid products which employ a diverse range of strategies. This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those very few which best fit within the investor's retirement needs and goals. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true "total fees and costs,"[22] investment characteristics, tax consequences, and risks.

**Academic Research Reveals Insights into Investment Strategies.** Over the past several decades we have seen the evolution of Modern Portfolio Theory[23] and the Efficient Markets Hypothesis[24], and various

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[20] O'Driscoll, Gerald P., Jr. and Hoskins, Lee, "The Case for Market-Based Regulation," *Cato Journal,* Vol. 26, No. 3 (Fall 2006), pp.469-70.

[21] At the end of 2008, U.S.-registered investment companies as a whole were the largest group of investors in U.S. companies, holding 27 percent of their outstanding stock. In addition, U.S. registered investment companies held 33% of U.S. municipal debt securities and 44% of U.S. commercial paper. Investment Company Institute, 2009 Investment Company Fact Book, p.11. U.S.-registered mutual funds, closed-end funds, exchange-traded funds and unit investment trusts totaled 16,262 at end of 2008. *Id.* at p.15.

[22] Pooled investment vehicles often possess substantial "hidden" fees and costs which are not included in the fund's annual expense ratio and of which most individual investors are unaware. For a review of the literature on this issue and for a methodology for estimating these fees and costs, *see* Ron A. Rhoades, Estimating the Total Fees and Costs of Stock Mutual Funds and ETFs (April 2009), a white paper available at www.JosephCapital.com, under "Resources."

[23] In 1952, Professor Harry Markowitz, who won the Nobel Prize in Economics (1990), theorized that diversification reduces risk, and that assets should be evaluated and selected for inclusion not solely on the basis of their individual

academic studies have indicated that active managers, on average, underperform their benchmark indices.[25] Only three decades ago, a comprehensive database of securities values first became available to researchers,[26] leading to a proliferation of academic research into the efficacy of existing strategies – either over time or through back-testing of the investment methodology. Nearly two decades ago, prior academic research was synthesized into the widely utilized Fama-French three-factor asset pricing model.[27] All of these, as well as many other developments in modern finance (behavioral finance, interplay of financial capital and human capital, etc.), have led to the ability to test investment strategies for robustness and reliability. This has led to greater understanding of both the need, and the means, to conduct due diligence on both investment strategies and products. Hundreds of academic white papers now surface each year examining investment and portfolio management strategies, often revealing new insights which practitioners can seek to apply for the benefit of investment clients.

As the sophistication of our capital markets had increased, so has the knowledge gap between individual consumers (plan sponsors, plan participants) and investment advisers. Investment theory continues to evolve, with new insights gained from academic research each year. Moreover, in constructing an investment portfolio today, an investment adviser must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation (present and future) and risks to which the investor is exposed in other aspects of his or her life.

**Other Countries Recognize the Increased Difficulties Faced by Individual Investors.** In other developed countries the difficulties faced by individual investors are recognized. "With the increasing

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characteristics but rather by their effect on the investor's portfolio. It was demonstrated that an optimal portfolio could be constructed to maximize return for a given standard deviation.

[24] In 1966 Professor Eugene Fama, Sr. of the University of Chicago Graduate School of Business, utilizing extensive research on stock price patterns, developed the Efficient Markets Hypothesis (EMH), which generally asserts that prices reflect values and information accurately and quickly, and therefore it is difficult if not impossible to capture returns in excess of market returns without taking greater than market levels of risk. Various forms of the EMH exist today, and substantial confusion exists as to distinctions between collective investor rationality versus the efficacy of the EMH. Nevertheless, the EMH proponents possess substantial academic research backing either the semi-strong or weak forms of the EMH.

[25] The first studies of mutual funds (Jensen, 1965) and of institutional plans (A.G. Becker Corp., 1968) indicated active managers underperform indexes. A more recent study concludes: "For 1984-2006, when the CRSP database is relatively free of biases, mutual fund investors in aggregate get net returns that underperform CAPM, three-factor, and four-factor benchmarks by about the costs in expense ratios. Thus, if there are fund managers with enough skill to produce benchmark adjusted expected returns that cover costs, their tracks are hidden in the aggregate results by the performance of managers with insufficient skill." Fama, Eugene F. and French, Kenneth R., Luck Versus Skill in the Cross Section of Mutual Fund Returns (November 2009). Tuck School of Business Working Paper No. 2009-56 ; Chicago Booth School of Business Research Paper. Available at SSRN: http://ssrn.com/abstract=1356021.

[26] Center for Research in Securities Prices databases, maintained by the Univ. of Chicago Booth School of Business, which have over the years been expanded in terms of their number and historical coverage, and which have been subject to periodic revisions in efforts to enhance the reliability of the data and to remove survivorship bias.

[27] Fama, E.F. & K.R. French, The Cross-section of Expected Stock Returns, 47 *Journal of Finance* 427-486 (1982).

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." [28] [***Emphasis in original.***]

**The Tully Report Recognized the Knowledge Gap (But Chose to Address the Problem Incorrectly).** The broker-dealer industry previously acknowledged the wide disparity of knowledge between investment adviser and consumer in the 1995 "Tully Report"[29]:

> "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

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[28] "Submission to the Financial System Inquiry by the Financial Planning Association of Australia Limited," December 1996.

[29] In May 1994, at the request of then-SEC Chairman Levitt, and in response to concerns about actual and potential conflicts of interest in the retail brokerage industry, a "Committee on Compensation Practices" was formed, Chaired by Daniel Tully, then Chairman and CEO of Merrill Lynch & Col, Inc. This committee had three mandates: (1) to review industry compensation practices for registered representatives and their managers; (2) to identify actual and potential conflicts of interest; and (3) to identify "best practices" used in the brokerage industry to eliminate, reduce, or mitigate such practices. In 1995, the Report of the Committee on Compensation Practices, known as the "Tully Report," examined the compensation practices of broker-dealers to consider ways to minimize the conflicts between brokers and their customers. The Tully Report made several recommendations on alterations to the compensation of registered representatives and broker-dealer practices, and also concluded that fee-based programs in some cases might better align broker-dealer and client interests than traditional commission-based programs. Around the same time, broker-dealers began offering these accounts. The ability of broker-dealers to offer these accounts was given sanction by the SEC in a 2005 Final Rule, but this rule was subsequently overturned in the 2007 *Financial Planning Association vs. SEC* decision, on the grounds that fee-based brokerage accounts provided "special compensation" – which is not permitted under the broker-dealer exemption from the application of the Investment Advisers Act of 1940. Following that court decision, fee-based accounts were converted over the following year to "investment advisory accounts" or to some other form of brokerage account.

> 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."[30]

Yet the Committee which produced the Tully Report, acting under the influence of the Committee Chairman, Daniel P. Tully (at the time Chairman and Chief Executive Officer, Merrill Lynch & Co., Inc.), did not call for the imposition of fiduciary duties upon registered representatives (and did not even mention the word "fiduciary."). Instead, the Report stated that the knowledge gap "makes communication between a registered representative and an investor difficult and puts too much responsibility for decision-making on the shoulders of RRs [registered representatives] - a responsibility that belongs with the investor."[31] Yet, in reality, those individuals saving for retirement, as well as plan sponsors, cannot be expected to shoulder this heavy responsibility, and instead they need someone in whom they can place their complete trust and confidence.

**The Search for Solutions.** Given the increased complexity of our modern financial world and the resulting greater knowledge gap which exists between trained financial and investment advisers and the consumer, policy makers possess several options to counter the difficulties modern consumers of investment products and services face. These options include financial literacy education, enhanced disclosures, product simplification and/or standardization, and the imposition of fiduciary standards upon advice providers.

**Financial Literacy Efforts - While Important, They Are Largely Ineffective as to Investment Decision-Making.** Many academics, as well as consumer advocates and state securities regulators,[32] have acknowledged the substantial limitations of financial literacy efforts given the high degree of complexity of investment products and financial advice. The extremely low level of financial literacy among Americans was recently reported on by Professor Lusardi:

> Over the past thirty years, individuals have had to become increasingly responsible for their own financial security following retirement. The shift from defined benefit (DB) to defined contribution (DC) plans has meant that workers today have to decide both how much they need to save for retirement and how to allocate pension wealth. Furthermore, financial instruments have become increasingly complex and individuals are presented with new and ever-more sophisticated financial products. Access to credit is easier than ever before and opportunities to borrow are plentiful. But are individuals well equipped to make financial

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[30] "Report of the Committee on Compensation Practices" (April 10, 1995), also called the "Tully Report," at p. 15.

[31] *Id.*

[32] As stated in the consumer-oriented 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 they have neither the time nor the expertise. This is nothing to be embarrassed about. Investing can be confusing." "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.

> decisions. In other words, do they possess adequate financial literacy to do so? This paper shows that most individuals cannot perform simple economic calculations and lack knowledge of basic financial concepts, such as the working of interest compounding, the difference between nominal and real values, and the basics of risk diversification. Knowledge of more complex concepts, such as the difference between bonds and stocks, the working of mutual funds, and basic asset pricing is even scarcer. Illiteracy is widespread among the general population … Given the current low levels of financial literacy, employers and the government should devise and encourage programs that simplify financial decision-making as well as provide sources of reliable financial advice.[33]

While financial literacy programs are often touted as the "cure" for enabling consumers to make better financial decisions, a more reasoned review of the academic evidence suggests the ineffectiveness of financial literacy education. As stated by Ian Hathaway and Sameer Khatiwada, writing for the Federal Reserve Bank of Cleveland:

> Conventional wisdom tells us that a more informed consumer is a better consumer. One could reasonably argue that when dealing with complex goods and services (such as those of a financial nature), consumer knowledge is particularly important. Given the recent public policy debate about whether consumers are being taken advantage of by various financial services firms, financial education programs are likely to be one popular remedy. But, one must ask if financial literacy (i.e., a comprehension of particular financial products) allows those consumers with more of it to achieve better outcomes than those with less … Taken together, the literature does not succeed in establishing the extent of the benefit provided by financial education programs, nor does it provide conclusive support that any benefit at all exists.[34]

The huge challenges to be overcome by financial literacy efforts were also noted by Professor Lauren E. Willis:

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[33] Lusardi, Annamaria, Financial Literacy: An Essential Tool for Informed Consumer Choice? (July 2008). Paolo Baffi Centre Research Paper No. 2009-35. Available at SSRN: http://ssrn.com/abstract=1336389.

[34] Hathaway, Ian and Khatiwada, Sameer, Do Financial Education Programs Work? (April 1, 2008). FRB of Cleveland Working Paper No. 08-03. Available at SSRN: http://ssrn.com/abstract=1118485.

In another white paper critical of prior research into the effectiveness of financial literacy, Professor Willis wrote: "[Financial literacy education (FLE)] is widely believed to turn consumers into responsible and empowered market players, motivated and competent to handle their own credit, insurance, savings and investment matters by confidently navigating the marketplace. In this financially literate world, other forms of legal regulation of financial products are unnecessary and even counterproductive. This vision depends on the belief that FLE can not only improve financial behavior, but that it can do so to the degree necessary for consumers to protect and even increase their welfare in the modern financial marketplace … The demands of contemporary personal financial management are prodigious and varied … What degree of effectiveness should appropriately be claimed for the current model of financial literacy education? As yet, none …." Willis, Lauren E., Evidence and Ideology in Assessing the Effectiveness of Financial Literacy Education. U of Penn Law School, Public Law Research Paper No. 08-08; Loyola-LA Legal Studies Paper No. 2008-6; Available at SSRN: http://ssrn.com/abstract=1098270.

> The gulf between the literacy levels of most Americans and that required to assess the plethora of credit, insurance, and investment products sold today—and new products as they are invented tomorrow—cannot realistically be bridged. Educators would need to impart a sophisticated understanding of finance because rules of thumb are not useful for decisions about complex products in a volatile market. Further, high financial literacy can be necessary for good financial decisionmaking, but is not sufficient; heuristics, biases, and emotional coping mechanisms that interfere with welfare-enhancing personal finance behaviors are unlikely to be eradicated through education, particularly in a dynamic market. To the contrary, the advantage in resources with which to reach consumers that financial services firms enjoy puts firms in a better position to capitalize on decisionmaking biases than educators who seek to train consumers out of them.[35]

**Emotional Biases Limit Consumers' Ability to Close the Knowledge Gap.** Recent insights from behavioral science call into substantial doubt some cherished pro-regulatory strategies, including the view that if regulators force delivery of better disclosures and transparency to investors that such can be utilized effectively.[36] Indeed, the U.S. Securities and Exchange Commission's emphasis on disclosure, drawn from the focus of the 1933 and 1934 Securities Acts on enhanced disclosures, results from the myth that investors carefully peruse[37] the details of disclosure documents that regulation delivers. However, under

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[35] Willis, Lauren E., "Against Financial Literacy Education," Iowa Law Review, Vol. 94, 2008, at p.3; U of Penn Law School, Public Law Research Paper No. 08-10; Loyola-LA Legal Studies Paper No. 2008-13. Available at SSRN: http://ssrn.com/abstract=1105384. *See also* Lusardi, Annamaria and Mitchell, Olivia S., "Financial Literacy and Planning: Implications for Retirement Wellbeing" (2005). Michigan Retirement Research Center Research Paper No. WP 2005-108, available at SSRN: http://ssrn.com/abstract=881847 (noting that "consumers making retirement saving decisions require substantial financial literacy, in addition to the ability and tools needed to plan and carry out retirement saving plans" and confirming "survey findings about financial literacy from Bernheim (1995, 1998), Hogarth and Hilgerth (2002), and Moore (2003), who report that most respondents do not understand financial economics concepts, particularly those relating to bonds, stocks, mutual funds, and the working of compound interest; they also report that people often fail to understand loans and interest rates."

[36] Only recently have calls been heard that the SEC's emphasis on disclosure is only part of the equation for the protection for consumers. "Two things are needed for the federal securities laws, or any disclosure-based regulatory regime, to be effective. The first is straightforward: information has to be disclosed. The second is equally straightforward, but often overlooked. That is, the users of the information – for example, investors, securities analysts, brokers, and money managers – need to use the disclosed information effectively. The federal securities laws primarily focus on the former – mandating disclosure." Paredes, Troy A., "Blinded by the Light: Information Overload and its Consequences for Securities Regulation" (2003), available at SSRN: http://ssrn.com/abstract=413180 or DOI: 10.2139/ssrn.413180.

[37] For years it has been known that that investors do not read disclosure documents. *See, generally,* Homer Kripke, *The SEC and Corporate Disclosure: Regulation In Search Of A Purpose* (1979); Homer Kripke, The Myth of the Informed Layman, 28 Bus.Law. 631 (1973). See also Baruch Lev & Meiring de Villiers, Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis, 47 Stan. L. Rev. 7, 19 (1994) ("[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures …."); Kenneth B. Firtel, *Note*, "Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933, 72 S. Cal. L. Rev. 851, 870 (1999) ("[T]he average investor does not read the prospectus ….").

the scrutinizing lens of stark reality, this picture gives way to an image of a vast majority of investors who are unable, due to behavioral biases[38] and lack of knowledge of our complicated financial markets, to comprehend the disclosures provided yet alone to undertake sound investment decision-making. As stated by Professor (now SEC Commissioner) Troy A. Parades:

> The federal securities laws generally assume that investors and other capital market participants are perfectly rational, from which it follows that more disclosure is always better than less. However, investors are not perfectly rational. Herbert Simon was among the first to point out that people are boundedly rational, and numerous studies have since supported Simon's claim. Simon recognized that people have limited cognitive abilities to process information. As a result, people tend to economize on cognitive effort when making decisions by adopting heuristics that simplify complicated tasks. In Simon's terms, when faced with complicated tasks, people tend to "satisfice" rather than "optimize," and might fail to search and process certain information.[39]

As is well known, investor biases overwhelm the effectiveness of disclosures. As stated by Professor Fisch:

> 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."[40]

The inadequacy of disclosures was known even in 1930's. Even back during the consideration of the initial federal securities laws, the perception existed that disclosures would prove to be inadequate as a means of investor protection. As stated by Professor Schwartz:

> 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 anticipated that sophisticated

[38] For an overview of various individual investor bias such as bounded irrationality, rational ignorance, overoptimism, overconfidence, the false consensus effect, insensivity to the source of information, the fact that oral communications trump written communications, and other heuristics and bias, *see* Robert Prentice, "Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future," 51 Duke L. J. 1397 (2002).

[39] Parades at p.3.

[40] Jill E. Fisch, "Regulatory Responses To Investor Irrationality: The Case Of The Research Analyst," 10 Lewis & Clark L. Rev. 57, 74-83 (2006).

> market intermediaries – such as brokers, bankers, investment advisers, publishers of investment advisory literature, and even lawyers - would help filter the information down to investors.[41]

Behavioral biases also negate the abilities of "do-it-yourself" investors. As shown in DALBAR, Inc.'s 2009 "Quantitative Analysis of Investor Behavior", most individual investors underperform benchmark indices by a wide margin, far exceeding the average total fees and costs of pooled investment vehicles.[42] A growing body of academic research into the behavioral biases of investors reveals substantial obstacles individual investors must overcome in order to make informed decisions,[43] and reveal the inability of individual investors to contract for their own protections.[44] Given the foregoing, policy makers should seek to ensure that all Americans are encouraged to work with trusted fiduciary advisors, as a means of combatting such behavioral biases and ensuring greater individual financial security.

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[41] 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).

[42] *Supra* n. 17.

[43] As stated by Professor Ripken: "[E]ven if we could purge disclosure documents of legaleze and make them easier to read, we are still faced with the problem of cognitive and behavioral biases and constraints that prevent the accurate processing of information and risk. As discussed previously, information overload, excessive confidence in one's own judgment, overoptimism, and confirmation biases can undermine the effectiveness of disclosure in communicating relevant information to investors. Disclosure may not protect investors if these cognitive biases inhibit them from rationally incorporating the disclosed information into their investment decisions. No matter how much we do to make disclosure more meaningful and accessible to investors, it will still be difficult for people to overcome their bounded rationality. The disclosure of more information alone cannot cure investors of the psychological constraints that may lead them to ignore or misuse the information. If investors are overloaded, more information may simply make matters worse by causing investors to be distracted and miss the most important aspects of the disclosure … The bottom line is that there is 'doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases' … While disclosure has its place in a well-functioning securities market, the direct, substantive regulation of conduct may be a more effective method of deterring fraudulent and unethical practices." Ripken, Susanna Kim, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation. Baylor Law Review, Vol. 58, No. 1, 2006; Chapman University Law Research Paper No. 2007-08. Available at SSRN: http://ssrn.com/abstract=936528.

[44] *See* Robert Prentice, Whither Securities Regulation Some Behavioral Observations Regarding Proposals for its Future, 51 Duke Law J. 1397 (March 2002). Professor Prentices summarizes: "Respected commentators have floated several proposals for startling reforms of America's seventy-year-old securities regulation scheme. Many involve substantial deregulation with a view toward allowing issuers and investors to contract privately for desired levels of disclosure and fraud protection. The behavioral literature explored in this Article cautions that in a deregulated securities world it is exceedingly optimistic to expect issuers voluntarily to disclose optimal levels of information, securities intermediaries such as stock exchanges and stockbrokers to appropriately consider the interests of investors, or investors to be able to bargain efficiently for fraud protection."

Available at http://www.law.duke.edu/shell/cite.pl?51+Duke+L.+J.+1397.

**Investment advisers Often Use Knowledge of Client Behavior to their Advantage**. Note as well that "instead of leading investors away from their behavioral biases, financial professionals may prey upon investors' behavioral quirks … Having placed their trust in their brokers, investors may give them substantial leeway, opening the door to opportunistic behavior by brokers, who may steer investors toward poor or inappropriate investments."[45] 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."[46] Indeed, many brokers and other investment advisers have received training, time and again, stressing the need to first and foremost establish a relation of trust and confidence with the client; after trust is established, it is taught that the client usually defers to the judgment of the advisor as to recommendations made, usually without further inquiry by the client, thereby permitting the investment adviser to take advantage of the client.

Professor Langevoort undertook these further observations regarding "trust-based selling":

> [W]hen faced with complex, difficult and affect-laden choices (and hence a strong anticipation of regret should those choices be wrong), many investors seek to shift responsibility for the investments to others. This is an opportunity – the core of the full-service brokerage business – to use trust-based selling techniques, offering advice that customers sometimes too readily accept. Once trust is induced, the ability to sell vastly more complicated, multi-attribute investment products goes up. Complex products that have become widespread in the retail sector, like equity index annuities, can only be sold by intensive, time-consuming sales effort. As a result the sales fees (and embedded incentives) are very large, creating the temptation to oversell. In the mutual fund area, the broker channel – once again, driven by generous incentives - sells funds aggressively. Recent empirical research suggests that buyers purchase funds in this channel at much higher cost but performance on average is no better, and often worse, than readily available no-load funds."[47]

**The High Degree of Expertise Must Be Utilized For the Benefit of the Client, and Not to Usurp Opportunities for the Advisor.** The expert services of the fiduciary personal investment adviser are socially desirable. As in medicine or law, it can take many years to acquire the requisite degree of knowledge, skill, and experience to be a competent and effective personal investment adviser. Yet it is this very expertise that renders clients of personal investment advisers "vulnerable to abuse of trust and

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[45] Stephen J. Choi and A.C. Pritchard, "Behavioral Economics and the SEC" (2003), at p.18.

[46] 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).

[47] Donald C. Langevoort, "The SEC, Retail Investors, and the Institutionalization of the Securities Markets" (Jan. 2009), prior version available at vailable at SSRN: http://ssrn.com/abstract=1262322.

lack of care."[48] Moreover, the advisory services undertaken by investment advisers are often subject to only general prescriptions, as investment advisors must be free to react to a changing market environment.[49] If the fiduciary does not utilize his or her greater knowledge to promote the client's best interests, the fiduciary could usurp the power, authority, or trust for the fiduciary's own benefit.

**Fiduciary Status is Imposed Due to Incomplete Information: The Difficulty in Tying Performance.** The results of the services provided by a fiduciary advisor are not always related to the honesty of the fiduciary or the quality of the services. For example, an investment adviser may be both honest and diligent, but the value of the client's portfolio may fall as the result of market events. It is very rare that an investment adviser provides substantial positive returns for each period over many periods of time. (In such rare instances where such returns do occur the honesty of the investment adviser should be suspect, as was the situation with Bernard Madoff).

**Fiduciary Status is Imposed Due to the Difficulties Consumers Face in Identifying and Understanding Conflicts of Interest.** Most individual consumers of financial services in America today are unable to identify and understand the many conflicts of interest which can exist in financial services. For example, a customer of a broker-dealer firm might be aware of the existence of a commission for the sale of a mutual fund, but possess no understanding that there are many mutual funds which are available without commissions (i.e., sales loads). Moreover, Wall Street has gotten extremely good at disguising conflicts of interest arising from third-party payments, including through such mechanisms as contingent deferred sales charges, 12b-1 fees, payment for shelf space, soft dollar compensation and other substantial transaction-related costs derived from trading of securities within pooled investment vehicles. Even when compensation is fully disclosed, few individual investors realize the impact high fees and costs can possess on their long-term investment returns; often individual investors believe that a more expensive product will possess higher returns.[50]

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[48] Tamar Frankel, *Fiduciary Law* (Fathom Publishing, 2008), p. 30.

[49] *Id.* at p. 61.

[50] Professors "Madrian, Choi and Laibson recruited two groups of students in the summer of 2005 -- MBA students about to begin their first semester at Wharton, and undergraduates (freshmen through seniors) at Harvard. All participants were asked to make hypothetical investments of $10,000, choosing from among four S&P 500 index funds. They could put all their money into one fund or divide it among two or more. 'We chose the index funds because they are all tracking the same index, and there is no variation in the objective of the funds,' Madrian says … 'Participants received the prospectuses that fund companies provide real investors … the students 'overwhelmingly fail to minimize index fund fees,' the researchers write. 'When we make fund fees salient and transparent, subjects' portfolios shift towards lower-fee index funds, but over 80% still do not invest everything in the lowest-fee fund' … [Said Professor Madrian,] 'What our study suggests is that people do not know how to use information well.... My guess is it has to do with the general level of financial literacy, but also because the prospectus is so long." Knowledge@Wharton, "Today's Research Question: Why Do Investors Choose High-fee Mutual Funds Despite the Lower Returns?" *citing* Choi, James J., Laibson, David I. and Madrian, Brigitte C., "Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds" (March 6, 2008). Yale ICF Working Paper No. 08-14. Available at SSRN: http://ssrn.com/abstract=1125023.

**Fiduciary Duties Are Imposed to Reduce Transaction Costs, when Monitoring Costs are High.** In service provider relationships which rise to the level of fiduciary relations, it is highly costly for the client to monitor, verify, and ensure that the fiduciary will abide by the fiduciary's promise and deal with the entrusted power only for the benefit of the client. Indeed, if a client could easily protect himself or herself from an abuse of the fiduciary advisor's power, authority, or delegation of trust, then there would be no need for imposition of fiduciary duties. Hence, fiduciary status is imposed as a means of aiding consumers in navigating the complex financial world.[51]

**Imposition of Fiduciary Status Shifts Some Monitoring and Verification Costs to Government**. It is common that fiduciary duties, once they are imposed, result in oversight (monitoring and verification) and enforcement by agencies of government. As stated in a Government Accounting Office report:

> 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 … 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.[52]

Fiduciary relationships are relationships in which the fiduciary provides to the client a service that public policy encourages. When such services are provided, the law recognizes that the client does not possess the ability, except at great cost, to monitor the exercise of the fiduciary's powers. Usually the client cannot afford the expense of engaging separate counsel or experts to monitor the conflicts of interest the person in the superior position will possess, as such costs might outweigh the benefits the client receives

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*See also* Lee, Inmoo and Repetto, Eduardo, "Structured Products" (2010), noting that "some investors equate complex instruments with higher expected returns without realizing the fact that the products are simply repackaged versions of portfolios combining multiple securities to generate a certain type of payoff. Consequently, investors may not pay sufficient attention to the possibly high cost of these instruments."

[51] The authors of the Federal Securities Acts contemplated fiduciary advisors, given the inability of individual consumers to interpret complex financial data and concepts. 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 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." 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).

[52] 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.

from the relationship with the fiduciary. Enforcement of the protections thereby afforded to the client by the presence of fiduciary duties is shifted to the courts and/or to regulatory bodies. Accordingly, a significant portion of the cost of enforcement of fiduciary duties is shifted from individual clients to the taxpayers, although licensing and related fees, as well as fines, may shift monitoring costs back to all of the fiduciaries which are regulated.

**Specialization Leads to Greater Imposition of Fiduciary Duties: Conserving Expenditures of Time and Resources on Monitoring.** The inability of clients to protect themselves while receiving guidance from a fiduciary does not arise solely due to a significant knowledge gap or due to the inability to expend funds for monitoring of the fiduciary. Even highly knowledgeable and sophisticated clients (including many financial institutions) rely upon fiduciaries. While they may possess the financial resources to engage in stringent monitoring, and may even possess the requisite knowledge and skill to undertake monitoring themselves, the expenditure of time and money to undertake monitoring would deprive the investors of time to engage in other activities. Indeed, since sophisticated and wealthy investors have the ability to protect themselves, one might argue they might as well manage their investments themselves and save the fees. Yet, reliance upon fiduciaries is undertaken by wealthy and highly knowledgeable investors and without expenditures of time and money for monitoring of the fiduciary. In this manner, "fiduciary duties are linked to a social structure that values specialization of talents and functions."[53]

**Fiduciary Duties are Imposed Because Reliance on Market Forces for Monitoring and Enforcement is Often Ineffective.** The ability of "the market" to monitor and enforce a fiduciary's obligations, such as through the compulsion to preserve a firm's reputation, is often ineffective in fiduciary relationships. This is because revelations about abuses of trust by advisors can be well hidden (such as through mandatory arbitration clauses and secrecy agreements regarding settlements), or because marketing efforts by securities firms are so strong that they overwhelm the reported instances of breaches of fiduciary duties. It is often believed that reputation, or rather the fear of its loss, constrains opportunistic behavior. But, in today's world of financial services, in which huge marketing budgets are devoted to reputation building (or re-building), are "bad acts" by the modern large financial services firm sufficient to ensure that reputation acts as a sufficient deterrence to greed? The answer is self-evident, as large financial services firms suffered great hits to their reputation due to revelations of greed-driven and abusive practices, only to continue to prosper within a short time thereafter.

**Public Policy Encourages Specialization, Which - When Affecting Important Areas of a Consumer's Personal Life - Necessitates the Imposition of Fiduciary Duties.** As Professor Tamar Frankel, long a leading scholar in the area of fiduciary law, especially as applied to securities regulation, noted:

[53] Tamar Frankel, Ch. 12, "United States Mutual Fund Investors, Their Managers and Distributors," in *Conflicts of Interest: Corporate Governance and Financial* Markets (Kluwer Law International, The Netherlands, 2007), edited by Luc Thévenoz and Rashid Barhar.

> [A] prosperous economy develops specialization. Specialization requires inter-dependence. And interdependence cannot exist without a measure of trusting. In an entirely non-trusting relationship interaction would be too expensive and too risky to maintain. Studies have shown a correlation between the level of trusting relationships on which members of a society operate and the level of that society's trade and economic prosperity."[54]

Not all specialized services merit the application of fiduciary standards of conduct. While many persons hire others to perform services such as lawn-mowing, the acquisition of the knowledge and skills to undertake that ability one's self are readily available. Other services, such as appliance, electrical, plumbing, or auto repair, involve greater knowledge or skill, but society may perceive that these skills can still be easily acquired, at least by many in our society, or may perceive that if a person is hired to undertake repair or maintenance of equipment that the quality of work of the service provider can be more easily observed by the customer. Additionally, it may be perceived that the risk of harm to the consumer is less than that of a fiduciary service provider.

Undertaking practice as a fiduciary requires a substantial investment in education – often over many years and at the exclusion of other pursuits in life. Fiduciary duties are therefore imposed by law when public policy encourages specialization in particular services, such as investment management or law, in recognition of the need for specialization and the value such services provide to our society.

**Public Policy Encourages Participation in our Capital Markets: Individual Investor Trust in Investment advisers Through the Imposition of Fiduciary Duties is Essential.** Financial planning services encourage participation by investors in our capital markets system, which in turn promotes economic growth. It has been stated that the first and overriding responsibility any financial professional has is to all of the participants of the market. This primary obligation is required in order to maintain the perception[55] 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 market 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 U.S. and world-wide economy. Indeed, academic research has revealed that individual

[54] Tamar Frankel, "Trusting And Non-Trusting: Comparing Benefits, Cost And Risk," Working Paper 99-12, Boston University School of Law.

[55] "Applying the Advisers Act and its fiduciary protections is essential to preserve the participation of individual investors in our capital markets. NAPFA members have personally observed individual investors who have withdrawn from investing in stocks and mutual funds due to bad experiences with registered representatives and insurance agents in which the customer inadvertently placed his or her trust into the arms-length relationship." Letter of National Association of Personal Financial Advisors (NAPFA) dated March 12, 2008 to David Blass, Assistant Director, Division of Investment Management, SEC regarding the Rand Study.

investors who are unable to trust their investment advisers are less likely to participate in the capital markets.[56]

> Hence, in order to promote public policy goals, the law requires the imposition of fiduciary status upon the party in the dominant position. Through the imposition of such fiduciary status, the client is thereby afforded various protections. These protections serve to reduce the risks to the client which relate to the service, and encourage the client to utilize the service. Using the services of financial planners thereby encourages more prudent saving and investing, including enhanced participation in the capital markets. Fiduciary status thereby furthers the public interest and promotes economic growth.

**Public Policy Encourages Saving and Proper Investing for Future Financial Needs: Trusted Guidance Is Required.** As stated by Professor Macy: "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."[57]

[56] "We find that trusting individuals are significantly more likely to buy stocks and risky assets and, conditional on investing in stock, they invest a larger share of their wealth in it. This effect is economically very important: trusting others increases the probability of buying stock by 50% of the average sample probability and raises the share invested in stock by 3.4 percentage points … lack of trust can explain why individuals do not participate in the stock market even in the absence of any other friction … [W]e also show that, in practice, differences in trust across individuals and countries help explain why some invest in stocks, while others do not. Our simulations also suggest that this problem can be sufficiently severe to explain the percentage of wealthy people who do not invest in the stock market in the United States and the wide variation in this percentage across countries." Guiso, Luigi, Sapienza, Paola and Zingales, Luigi. "Trusting the Stock Market" (May 2007); ECGI - Finance Working Paper No. 170/2007; CFS Working Paper No. 2005/27; CRSP Working Paper No. 602. Available at SSRN: http://ssrn.com/abstract=811545.

[57] Macy, Jonathan R., "Regulation of Financial Planners" (April 2002), a White Paper prepared for the Financial Planning Association; http://fpanet.org/docs/assets/ExecutiveSummaryregulationoffps.pdf provides an Executive Summary of the paper.

## IN CONCLUSION

With Americans living longer and, in many instances, with fewer precious retirement funds available for retirement, it is absolutely essential that Americans have fundamental legal protections for the assets they do have in the form of fiduciary laws – such as ERISA. EBSA should apply fiduciary status more broadly in accordance with the plain meaning of the statute. The expanded definition of fiduciary is also reflective of the important role of trust in our economy, as well as the important public policy reasons supportive of the application of the fiduciary standard in today's modern, complex financial world.

The U.S. Department of Labor / EBSA is depended upon by the average American to protect their hard earned retirement dollars. With the shift away from defined benefit plans and toward individually managed defined contribution accounts, Americans have over the past several decades changed the manner in which they provide for retirement. EBSA's rule proposals to modernize ERISA standards reflect the real face of American retirement in today's more complicated financial world.

NAPFA applauds these timely updates to better address the reality of the complex financial world facing individual Americans today. We urge EBSA to proceed to adopt the Proposed Rules, without delay.

Respectfully submitted,

| Susan MacMichael John, CFP® | Ellen Turf | Ron A. Rhoades, JD, CFP® |
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