Fiduciary Papers #18:
No Person Can Serve Two Masters:
A True Fiduciary Avoids Conflicts of Interest
and Does Not Seek Additional Profit

The "No Conflict" and "No Profit" Rules, Generally

The rules applicable to fiduciaries under state common law, from which ERISA and the Investment Advisers Act of 1940 are derived, include the "**no conflict rule**," which prevents a fiduciary placing himself or herself in a position where his or her own interests conflict or may conflict with those of the client.

The common law rules applicable to fiduciaries also include the "**no profit rule,"** which requires a fiduciary not to profit from his position at the expense of his or her client. At times the no profit rule has been strictly enforced, even to the point of overturning transactions between fiduciaries and their clients where no extra profit was derived by the fiduciary above that which other market participants would have derived.

The history of the Investment Advisers Act of 1940 indicates the desire of the crafters of the Advisers Act that the "no conflict rule" should be embraced:

> "[T]he Committee Reports indicate a desire to ... eliminate conflicts of interest between the investment adviser and the clients as safeguards both to 'unsophisticated investors' and to 'bona fide investment counsel.' The [IAA] thus reflects a ... congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested." *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 191-2 (1963).
>
> "The IAA arose from a consensus between industry and the SEC that 'investment advisers could not 'completely perform their basic function — furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments — unless all conflicts of interest between the investment counsel and the client were removed.'" *Financial Planning Association v. Securities and Exchange Commission*, No. 04-1242 (D.C. Cir. 3/30/2007) (D.C. Cir., 2007), *citing SEC vs. Capital Gains* at 187.

The "sole interests" standard generally requires avoidance of conflicts of interest, while the "best interests" standard (found in the Advisers Act) permits some conflicts of interest provided they are properly managed. But, in the field of financial services, conflicts of interest are extremely difficult to "properly manage." The reason is clear – when the investment adviser receives additional compensation, such differential compensation typically flows from recommending a higher-cost or higher-fee investment product. And the academic research is clear on this point – the higher the fees and costs of investment products, all other things being equal, the lower the returns to investors, on average.

What is “Informed Consent”?

Due to the difficulties investment advisers possess in complying with the fiduciary duty of loyalty, and in particular the “no conflict” and “no profit” rules, **informed consent** is often not possible. Disclosure, in and of itself, does not negate a fiduciary’s duties to his or her client.

As stated in an SEC No-Action Letter: “We do not agree that an investment adviser may have interests in a transaction and that his fiduciary obligation toward his client is discharged so long as the adviser makes complete disclosure of the nature and extent of his interest. While section 206(3) of the [Advisers Act] requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, <u>the adviser's fiduciary duties are not discharged merely by such disclosure and consent</u>.” *Rocky Mountain Financial Planning, Inc*. (pub. avail. March 28,1983). [<u>Emphasis added.</u>]

The ineffectiveness of disclosure as a means of providing consumer protection has long been known, and it has been confirmed by academic research. “Disclosure forms the central focus of most of the federal securities laws ... From a behavioral perspective, however, disclosure risks confusing investors already suffering from bounded rationality, availability and hindsight.” Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC (2003), at pp.69-70. *See also* Daylian M. Cain, George Loewenstein, and Dona A. Moore, The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest (1993) (“Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors’ conflicts of interest are honestly disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse.”) As Professor Cain stated in a public appearance, “It does not appear that sunlight is the best disinfectant, after all.” (Fiduciary Forum, Washington, D.C., Sept. 2010).

Even with informed consent, the proposed transaction must be fair and reasonable to the client. “One of the most stringent precepts in the law is that a fiduciary shall not engage in self-dealing and when he is so charged, his actions will be scrutinized most carefully. When a fiduciary engages in self-dealing, there is inevitably a conflict of interest: as fiduciary he is bound to secure the greatest advantage for the beneficiaries; yet to do so might work to his personal disadvantage. Because of the conflict inherent in such transaction, it is voidable by the beneficiaries unless they have consented. Even then, it is voidable if the fiduciary fails to disclose material facts which he knew or should have known, if he <u>used the influence of his position to induce</u> the consent <u>or if the transaction was not in all respects fair and reasonable</u>.” [<u>Emphasis added.</u>] *Birnbaum v. Birnbaum*, 117 A.D.2d 409, 503 N.Y.S.2d 451 (N.Y.A.D. 4 Dept., 1986).

The fiduciary duty to avoid conflicts of interest, and the necessity to obtain the informed consent of the client as to conflicts of interest not avoided, were well known in the early history of the Advisers Act. In an address entitled “The SEC and the Broker-Dealer” by Louis Loss, Chief

Counsel, Trading and Exchange Division, U.S. Securities and Exchange Commission on March 16, 1948, before the Stock Brokers' Associates of Chicago, the fiduciary duties arising under the Advisers Act, as applied in the *Arleen Hughes* release, were elaborated upon:

> [W]hen one is engaged as agent to act on behalf of another, the law requires him to do just that. *He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses*. This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law 'acts not on the possibility, that, in some cases the sense of duty may prevail over the motive of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty.' Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine 'has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.''
>
> *This time-honored dogma applies equally to any person who is in a fiduciary relation toward another*, whether he be a trustee, an executor or administrator of an estate, a lawyer acting on behalf of a client, an employee acting on behalf of an employer, an officer or director acting on behalf of a corporation, *an investment adviser* or any sort of business adviser for that matter, or a broker. The law has always looked with such suspicion upon a fiduciary's dealing for his own account with his client or beneficiary that it permits the client or beneficiary at any time to set aside the transaction without proving any actual abuse or damage. What the recent Hughes case does is to say that such conduct, in addition 'to laying the basis for a private lawsuit, amounts to a violation of the fraud provisions under the securities laws: This proposition, as a matter of fact, is found in a number of earlier Commission opinions. *The significance of the recent Hughes opinion in this respect is that it elaborates the doctrine and spells, out in detail exactly what disclosure is required when a dealer who has put himself in a fiduciary position chooses to sell his own securities to a client or buys the client's securities in his own name ...*
>
> *The nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases use of the term 'principal' itself may suffice. In others, a more detailed explanation will be required. In all cases, however, the burden is on the firm which acts as fiduciary to make certain that the client understands ....* [*Emphasis added*.]

Who Do You Represent?

Do you represent the investment or insurance product manufacturer, as a distributor?

Or do you represent the client, as a trusted advisor and, in essence, a “purchaser’s representative” and agent?

You can’t do both – and be a bona fide fiduciary.

In essence, there is a fundamental conclusion that we must all acknowledge – no client of a fiduciary investment adviser would ever consent to be harmed. Nor are clients gratuitous toward their adviser, willing to accept lower returns so that their “trusted advisor” can receive greater compensation.

The Mind-Numbing “Harmonization” of Broker-Dealer and Investment Adviser Regulation

The desire to raise the standards of broker-dealers, by disallowing some of the types of conflicts of interest they possess (such as “prizes” from sales contests for particular products), and by imposing a duty of care (which “suitability” did not impose), is a positive development.

But it should not come at the expense of lowering the fiduciary standard – in particular the fiduciary duty of loyalty.

There will come a time when the world will look back upon the efforts by the SEC to accommodate conflicts of interest for dual registrants as a sad episode in the history of securities regulation.

There will come a time when the world will look at “Regulation Best Interest” – and the various “best interests” regulations adopted by state insurance commissioners – as sad attempts to obfuscate and to confuse consumers, and – at a minimum – a misrepresentation of the actual duties possessed by brokers (who under the ’34 Act do not possess a fiduciary duty of loyalty):

> “The relationship between a customer and the financial practitioner should govern the nature of their mutual ethical obligations. Where the fundamental nature of the relationship is one in which customer depends on the practitioner to craft solutions for the customer’s financial problems, the ethical standard should be a fiduciary one that the advice is in the best interest of the customer. To do otherwise – to give biased advice with the aura of advice in the customer’s best interest – is fraud. This standard should apply regardless of whether the advice givers call themselves advisors, advisers, brokers, consultants, managers or planners.” James J. Angel, Ph.D., CFA and Douglas McCabe Ph.D., Ethical Standards for Stockbrokers: Fiduciary or Suitability? (Sept. 30, 2010).

There will come a time when “harmonization” – a frequent buzzword advocated by the broker-dealer and asset management industries – will be viewed as what it truly is, an effort to afford those who presumably act in the “best interest” of their customers with the opportunity to secure additional profits at their customers’ expense.

Let true fiduciaries adhere to the stricter standard found in a bona fide fiduciary duty of loyalty, and avoid wherever possible conflicts of interest, to never seek additional profit, and to adhere to the requirement of receipt of only reasonable compensation for the professional services such trusted advisers provide.