The Committee for the Fiduciary Standard: Five Fundamental Fiduciary Principles

- The Committee for the Fiduciary Standard (the Committee) advocates enactment of federal law to extend <u>the</u> fiduciary standard to all investment professionals who provide investment advice or who hold themselves out as investment advisors.
- "<u>The</u> fiduciary standard" is intended by the Committee to mean the fiduciary duties and practices that are well defined in existing laws (especially ERISA, UPIA, UPMIFA, and MPERS) and regulations. Emphasis on the established fiduciary standard is important because the Committee is concerned that others who call for the "harmonization" of regulatory structures governing registered investment advisers and broker-dealers under "<u>a</u> fiduciary standard" may seek to dilute the established fiduciary standard and weaken investor protections for clients of advisers.
- The Committee highlights five fundamental fiduciary principles associated with the fiduciary standard because they (1) are likely to be recognized by both financial professionals and the public as inherently important in advisory relationships which are based upon trust and (2) are either not required or are treated differently under the suitability standard. The five principles are:

    1. **<u>Put the client's best interest first</u>**. A fiduciary owes a singular duty of loyalty to the investor(s) he or she serves. This stands in stark contrast to the divided loyalties of a non-fiduciary, such as a broker. Arguably, the principle could stand alone as the "golden rule" of fiduciary duty. An assessment of whether a trusted advisor has violated the fiduciary duty of loyalty may well boil down to whether the best interests of a client have been compromised by an advisor's incompetence, negligence, deceit, self-dealing, or failure to recognize and resolve a conflict in the client's favor.
    2. **<u>Act with prudence; that is, with the skill, care, diligence and good judgment of a professional</u>**. The fiduciary is held to a prudent expert standard. It goes well beyond the suitability requirement to have sufficient knowledge about an investor's circumstances and the characteristics of various investment choices to make a suitable recommendation. A fiduciary is expected to appropriately apply generally accepted investment theories. The fiduciary standard recognizes that when an investor seeks advice, the advisor is in a superior position of knowledge and/or authority over the client's assets; as such, the fiduciary must be both loyal and competent. Under the suitability standard, rules of fair trade apply because a transaction involves a presumption that, equipped with material facts about the object of the trade, the investor is capable of deciding an appropriate course of action. It is worth noting that the Committee does not oppose retention of the suitability standard for purely transactional business; rather, the Committee is adamant that those who provide advice are effectively functioning as fiduciaries and should be clearly recognized and held accountable as fiduciaries under the law.
    3. **<u>Do not mislead clients; provide conspicuous, full and fair disclosure of all important facts</u>**. While important in both advisory and transactional relationships, disclosures required for investment advisors are more extensive and are oriented toward factors that may influence a client's decision to establish a long-term relationship of trust, such as business practices and conflicts of interest. On the other hand, brokerage disclosures are generally intended to provide a client adequate information to evaluate the merits of a particular transaction. Currently, clients are generally confused, and often misled, about

the duties owed to them by the financial services representative with whom they are working. By extending the fiduciary standard to all advice providers, much of this confusion can be eliminated.

4. **<u>Avoid conflicts of interest</u>**. A conflict of interest is a circumstance that makes fulfillment of a fiduciary's duty of loyalty less reliable. Hence, conflicts by fiduciaries are to be avoided whenever possible.
5. **<u>Fully disclose and fairly manage, in the client's favor, unavoidable conflicts</u>**. Certain conflicts cannot be avoided, such as when an advisor's employer provides investment products that may fulfill important unmet investment needs in client accounts. In this example, the fiduciary's singular duty of loyalty to the client is in conflict with the advisor's probable desire to help his employer's business results. In such circumstances, the fiduciary should resolve the unavoidable conflict in the client's interest by removing any impediments to the advisor's objectivity. Again, in the example given, for the advisor to justify making an investment in a proprietary portfolio, the advisor should assure that the investment has come out on top through a thorough and objective due diligence selection process and the advisor must not receive compensation that is higher than what would be earned by using a comparable non-proprietary alternative. The handling of prohibited transactions under ERISA, which includes a limited number of exemptions when "safe harbor" procedures are followed, provides a suitable model for effective management of unavoidable conflicts. Informed consent is an important requirement that should be included in the regulation of unavoidable conflicts. This would help assure such conflicts are both unavoidable and managed because no rational person would consent to a conflict that they know to be detrimental to their interests.

- The five fundamental fiduciary principles are not intended to capture all that is required of a fiduciary. Nevertheless, these five simple principles can serve as a powerful guide to appropriate conduct for professionals who are depended upon to provide trustworthy advice. Indeed, the fact that five principles can be used so effectively in governing behavior speaks volumes as to the difference between a professional, principles-based approach for advisory relationships versus a rules based approach typical of most commercial relationships.
- Finally, the five fundamental fiduciary principles can serve as a checklist to help assure that investors' best interests are not compromised in the process of crafting regulatory reforms. Compromising the best interests of investors is, by definition, an irreconcilable departure from the meaning of a true fiduciary standard. Each proposed departure from the established fiduciary standard should be measured against the five principles to make sure they meet these fundamental prerequisites for trustworthy advice.

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