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Submitted via E-mail to: jmatthews@naic.org

January 21, 2018

NAIC ANNUITY SUITABILITY (A) WORKING GROUP
c/o Jolie Matthews
National Association of Insurance Commissioners
444 North Capitol Street NW
Suite 700
Washington, DC 20001

Re: 11/24/17 NAIC proposed revisions to the *Suitability in Annuity Transactions Model Regulation* (#275), in which the regulation would be renamed: *Suitability and Best Interest Standard of Conduct in Annuity Transactions Model Regulation.*

Dear Working Group Members:

I write on my own behalf, and not as a representative of any institution nor organization.[1] I appreciate the effort of the Working Group to advance the standards of conduct for firms and individuals engaged in "annuity transactions" and to enhance the disclosures provided to customers in annuity transactions. However, I write to urge caution regarding the use of the terms "best interests" and "advisor" in reference to this standard of conduct. I then suggest alternatives.

This comment letter is divided into the following main sections:

1. The phrase "best interests" (as utilized, in its context, "best interests of the consumer") is a phrase that has been reserved under the law for a fiduciary-client relationship, not a salesperson-customer relationship. The proposed modifications incorporating such a "best interests" standard without the imposition of bona fide fiduciary obligations is wholly inappropriate.
2. The use of the term "best interests" in the regulation could lead to a finding of fiduciary status for insurance producers (brokers/agents) under general principles of state common law, exposing them to a higher duty of due care, loyalty and utmost good faith and liability resulting therefrom.
3. NAIC should take care to not mix two relationships under the law that so many jurists and commentators have opined simply cannot be reconciled: the fiduciary-entrustor relationship and the salesperson-customer relationship.

[1] These comments represents the views of Ron A. Rhoades only, and is not necessarily representative of any firm, institution nor organization with whom he may be associated. Ron A. Rhoades is an Asst. Professor of Finance at Western Kentucky University, Bowling Green, KY, where he serves as Program Director for its Personal Financial Planning program. He has taught courses in Retirement Planning, Insurance and Risk Management, Advanced Investments, Applied Investments, Estate Planning, the PFP Capstone course, and several more. He is also an estate planning and tax attorney (Member, The Florida Bar), registered investment adviser, and Certified Financial Planner™. Dr. Rhoades has served on many industry committees, and he is a frequent speaker at national and regional conferences on issues relating to the application of fiduciary duties to the delivery of investment and financial advice.

4. NAIC's use of the term "best interests" could potentially amount to the NAIC's endorsement of fraud.
5. The use of the term "advisor" in the regulation implies a relationship of trust and confidence between an insurance producer and customer, when in fact none exists the vast majority of the time.
6. The disclosure of the specific amount of cash compensation should be broadened to all annuity sales, not be limited to those instances wherein insurance producers receive above three (3) percent of the amount invested, and should be stated in dollar terms and in writing to the customer.
7. In no event should the regulation restrain the use of "best interests" by limiting the obligation through specific rules stated that producers need not recommend the least expensive annuity or the annuity with a higher payout rate. The regulation should not seek to confine the fiduciary obligation to the effect that there is no obligation to recommend the "best" annuity available in the marketplace. These restraints are not reflective of the overwhelming academic research in this area concluding that fees and costs matter a great deal to investment returns. Moreover, the regulation's language is an ill-advised attempt to provide a rules-based regulatory restriction upon the broad principles-based fiduciary duty of due care.
8. Given the U.S. Congress' move to classify equity indexed annuities (also known as "fixed indexed annuities) (hereafter "EIAs") as insurance products, and given the existence of fixed-interest-rate deferred or immediate annuities ("fixed annuities"), and the ongoing utilization of these products as investments, particularly for retirees, the NAIC should consider regulation of how the products are recommended or sold. Such regulation might involve:
    a. A segregation of the roles of "insurance advisor" (fiduciary) versus "insurance salesperson," with appropriate regulation for each; and
    b. For insurance salespeople, the adoption of additional disclosure obligations, such as those contained in the proposed revisions to Model #275.
    c. For insurance producers who either actually undertake the delivery of investment advice, or who hold themselves out as advisors (or similar terms), the regulation can be modified to state such producers become fiduciaries, under general principles of state common law, when they enter into a relationship of trust and confidence with a client.
    d. The formulation of regulations (or proposed legislation) permitting insurance agents to waive commissions from the sales of annuity products (thereby reducing the costs to investors, and providing a means for all annuities to be evaluated on their merits by disinterested, fiduciary financial advisors who truly act in their client's best interests). Additionally, the formation of regulations (or proposed legislation) permitting the ability of insurance agents to specify (within the maximum range permitted by the annuity product provider) the amount of any commission to be paid, thereby permitting insurance agents to negotiate in advance with the client as to the amount of reasonable compensation to be paid, and then shop for annuities as a fiduciary as a representative of the client under a "levelized commission/compensation" mechanism; this also permits insurance agents to ensure that the amount of compensation received is "reasonable" for the services provided as required by a bona fide fiduciary standard of conduct.

My comments, in which I explain the legal and academic rationale for the foregoing statements and positions, now follow. Given the lack of adequate understanding of the fiduciary standard of conduct displayed by some commentators, and of understanding the distinctions between fiduciary and non-fiduciary (arms-length) relationships, I provide great detail, for the Working Group's benefit.

1. **The phrase "best interests" (as utilized, in its context, "best interests of the consumer") is a phrase that has been reserved under the law for a fiduciary-client relationship, not a salesperson-customer relationship. The proposed modifications incorporating such a "best interests" standard without the imposition of bona fide fiduciary obligations is wholly inappropriate.**

1.1. "Acting in One's Best Interests" is the Phrase Utilized to Describe Fiduciary Obligations to Lay Persons in Language They Better Understand.

1.1.1. The phrase "act in the best interests of the client" is used to explain, in language a non-lawyer would understand, the core aspect of the fiduciary duty of loyalty as well as elements of the fiduciary obligation of due care and utmost good faith.

1.1.1.1. Lay persons would be misled into relying upon an insurance producer who is selling particular products, even though the lay person (consumer) is not afforded the protections of a bona fide fiduciary standard. Lay persons understand the term "best interests" to apply to advisers whom they can trust.[2]

1.1.1.2. The regulatory permission effectively granted to insurance salespersons under the Working Group's proposal - to utilize a phrase such as "I am bound by regulation to act in your 'best interest's" – when there is no actual requirement to adhere to a fiduciary obligation and the relationship remains one in which the customer does not receive the protections of fiduciary law - would cause tremendous harm to consumers.

1.1.1.3. In essence, consumers would believe that they could rely upon an insurance salesperson's advice, given the regulatory approval of the use of the term "best interests" by salespersons, and such reliance by consumers would certainly be justified in such a circumstance. In essence, consumers would be lulled into thinking that they could rely upon the recommendations provided, when in fact such is not the case. As a result, such consumers would seldom undertake the efforts they should to protect their own interests, such as seeking out additional knowledge about the annuities recommended or seeking second opinions or alternative proposals from other insurance producers.

1.1.1.4. Consumers should not be forced to investigate, in order to discern whether those who hold themselves out as acting in their best interests, as fiduciaries, actually do so.[3]

1.1.1.5. Simply put, because under the proposed model regulation an insurance producer could state that she or he acts in the "best interests" of the customer, when in fact no duty of loyalty nor substantially enhanced duty of due care (to the level of a true fiduciary) exists, consumers will

[2] It has long been a concern that lay consumers often place trust in non-fiduciary actors in financial services, even when such trust is not merited, due in major part to how broker-dealer firms and their registered representatives now hold themselves out and promote themselves, and the increased scope of the advice which they provided. *See Recommendation of the Investor as Purchaser Subcommittee: Broker-Dealer Fiduciary Duty (U.S. Securities and Exchange Commission, 2012): "*Because federal regulations have not kept pace with changes in business practice, broker-dealers and investment advisers are subject to different legal standards when they offer advisory services. Those legal standards – a suitability standard for broker-dealers and a fiduciary duty for investment advisers – afford different levels of protection to the investors who rely on those services. Key differences include the requirements that investment advisers, as fiduciaries, act in the best interests of their clients and appropriately manage and fully disclose conflicts of interest that could bias their recommendations. Investors typically make no distinction between broker-dealers and investment advisers, and most are unaware of the different legal standards that apply to their advice and recommendations. Although many investors don't understand the meaning of "fiduciary duty," or know whether it or suitability represents the higher standard, *investors generally treat their relationships with both broker-dealers and investment advisers as relationships of trust and expect that the recommendations they receive will be in their best interests" [Emphasis added.]*

[3] As the SEC staff stated in its 2011 Study, "Retail investors are relying on their financial professional to assist them with some of the most important decisions of their lives. Investors have a reasonable expectation that the advice that they are receiving is in their best interest. They should not have to parse through legal distinctions to determine whether the advice they receive was provided in accordance with their expectations." SEC Staff, Study on Investment Advisers and Broker-Dealers, As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, January 2011 (available here: http://www.sec.gov/news/studies/2011/913studyfinal.pdf).

have reasonably placed their trust and confidence in the insurance producer even though, in effect, an arms-length relationship still exists.

1.1.2. The term "best interests" has an established legal meaning, which NAIC should not seek to alter.

1.1.2.1. *Black's Law Dictionary* (10th ed. 2014) defines a fiduciary duty as "a duty to act with the highest degree of honesty and loyalty toward another person and in the *best interest* of the other person") (*emphasis added*).

1.1.2.2. The meaning of "best interests" as indicative of the fiduciary relationship is universal in other common law countries. As the joint judgment of McHugh, Gummow, Hayne and Callinan JJ explained in *Pilmer v Duke Group*, a decision from Australia, it is the "pledge" (undertaking) by one party to act in the best interests of the other which makes fiduciary relationships distinct from other relationships.[4]

1.1.2.3. The Working Group's proposal to utilize the term "best interests," short of imposing a bona fide fiduciary obligation, would undermine centuries of legal precedent.

1.1.2.4. The Working Group's proposal would therefore fail to heed the warnings of the late Justice Benjamin Cardoza, who so famously wrote: "Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions [citation omitted]. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[5]

1.1.2.5. The Working Group's proposal, if adopted, would change the definition of "best interests" – representing a significant erosion of an established definition that is currently understood by jurists, financial advisors, and consumers to refer to the key legal obligations of a fiduciary.

1.1.2.5.1. Such a change in the definition of "best interests" could result in an erosion of the duties owed to those who are fiduciaries in other contexts – such as those who undertake to care for incompetent or dependent people (such as children or infants), attorneys who represent the important legal interests of their clients in a variety of contexts, and the duties of trustees toward their beneficiaries.

1.1.2.5.2. The Working Group should not seek to degrade the long-established obligations of bona fide fiduciaries by ignoring centuries of legal understanding, and lay understanding, of the term "best interests."

1.2. <u>Understanding the Two Different Forms of Commercial Relationships Under the Law: "Who's On Top"?</u> There exist two fundamentally different forms of commercial relationship in the law: the salesperson-customer relationship, and the fiduciary-entrustor (or fiduciary-client) relationship. These relationships are completely different under the law, and stark distinctions exist between the legal duties of the various parties in these relationships. Understanding fiduciary duties begins with an understanding of the two general types of relationships between product and service providers and their customers or clients under the law – "arms-length relationships" and "fiduciary relationships."[6]

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[4] *Pilmer v The Duke Group (in Liq)* (2001) 207 CLR 165, [70]-[71]. *See also Norberg v Wynrib*, [1992] 2 S.C.R. 226 at 230 [Canada], per McLachlin J: "The essence of a fiduciary relationship… is that one party exercises power on behalf of another and pledges himself or herself to act in the best interests of the other."

[5] *Meinhard vs. Salmon*, 164 N.E. 545 (N.Y. 1928).

[6] "The legal system provides for only two levels of trust and their differentiation is necessary for them to be useful tools for parties setting up relationships ... In essence, legal systems provide only two levels of loyalty between contracting parties, arm's-length and fiduciary relationships. The difference in the degree of trust that the two levels of loyalty entitle the parties is dramatic. Fiduciary relations impose a pure duty of loyalty, according to which the fiduciary must place the interests of his employer before his own. Arm's-length relations, by contrast, allow exploitation within the parameters of good faith." Georgakopoulos, Nicholas L., "Meinhard v. Salmon and the Economics of Honor" (April 1998, revised Feb. 8, 1999). Available at SSRN: http://ssrn.com/abstract=81788 or DOI: 10.2139/ssrn.81788.

1.2.1. Even with enhanced safeguards afforded to consumers such as enhanced disclosure obligations, the arms-length relationship of the parties involved in the sale of an investment or insurance product can still be described as:

PRODUCT MANUFACTURER(S)

⇩

MANUFACTURERS' (SALES) REPRESENTATIVES

⇩

CUSTOMER

1.2.2. The fiduciary relationship is altogether different. The fiduciary acts as a "purchaser's representative" – *i.e.*, on behalf of the client. The fiduciary "steps into the shoes of the client" and acts as if the client would act for himself/herself – but armed with the knowledge, skill, experience and hence expertise that the fiduciary possesses and is required to apply prior to making any recommendations to the client. The fiduciary relationship can be modeled as follows:

CLIENT

⇩

FIDUCIARY (PURCHASER'S OR CLIENT'S REPRESENTATIVE)

⇩

PRODUCT MANUFACTURERS

1.2.3. Enhancements to required disclosures do not turn those in arms-length relationships into fiduciary actors. While disclosures can be an important consumer protection, much academic research has revealed the limits to their effectiveness. Because disclosures are so often ineffective as a means of protecting consumers, the law applies the protections of the fiduciary relationship in situations where public policy so dictates.

1.3. Arms-Length Relationships: Actual Fraud is Prohibited; Additional Obligations May Be Imposed by Law Short of Fiduciary Obligations. "Arms-length" relationships apply to the vast majority of service provider–customer engagements.[7] In other words, non-fiduciaries who contract with each other can engage in "conduct permissible in a workaday world for those acting at arm's length."[8]

1.3.1. In arms-length relationships, the doctrine of *caveat emptor*[9] generally applies,[10] although there are many exceptions made to this doctrine in which enhanced disclosure obligations arise, mandated

[7] *See, for example, Hartman v. McInnis, No. 2006-CA-00641-SCT (Miss. 11/29/2007)* ([O]rdinarily a bank does not owe a fiduciary duty to its debtors and obligors under the UCC … the power to foreclose on a security interest does not, without more, create a fiduciary relationship … a mortgagee-mortgagor relationship is not a fiduciary one as a matter of law."). "[T]he significant weight of authority holds that franchise agreements do not give rise to fiduciary ... relationships between the parties." *GNC Franchising, Inc. v. O'Brien*, 443 F.Supp.2d 737, 755 (W.D. Pa., 2006).

[8] *Meinhard v Salmon*, 249 NY 458, 464 (N.Y. 1928).

[9] *Caveat emptor* is Latin for 'Let the buyer beware.' In its purest form at common law, in the absence of fraud, misrepresentation or active concealment, the seller is under no duty to disclose any defect; it therefore provides a safe harbor to a seller to not to disclose any information to a buyer. *See* Alex M. Johnson, Jr., "An Economic Analysis Of The Duty To Disclose Information: Lessons Learned From The Caveat Emptor Doctrine" (2007), available at http://law.bepress.com/cgi/viewcontent.cgi?article=9154&context=expresso. It means that a customer should be cautious and alert to the possibility of being cheated. The doctrine supports the idea that buyers take responsibility for the condition of the items they purchase and should examine them before purchase. This is especially true for items that are not covered under any warranty. *See, e.g. SEC v. Zandford*, 535 U.S. 813 (2002).

[10] "When parties deal at arm's length the doctrine of caveat emptor applies, but the moment that the vendor makes a false statement of fact, and the falsity is not palpable to the purchaser, he has an undoubted right to implicitly rely upon it. That would indeed be a strange rule of law which, when the seller has successfully entrapped his victim by false statements, and was called to account in a court of justice for his deceit, would permit him to escape by urging the folly of his dupe was not suspecting that he (the seller) was a knave." *Holcomb v. Zinke*, 365 N.W.2d 507, 511 (N.D., 1985).

contractual forms exist, or even certain products are prohibited. For example, even state common law compels affirmative disclosure of adverse material facts in diverse contexts.[11]

1.3.2. In arms-length, commercial relationships, the level of trust or confidence reposed by the customer in the other party is not exceptional. "Mere subjective trust does not transform arms-length dealing into a fiduciary relationship."[12] "Absent express agreement of the parties[13] or extraordinary circumstances, however, parties dealing at arms-length in a commercial transaction lack the requisite level of trust or confidence between them necessary to give rise to a fiduciary obligation."[14] Ordinary "buyer-seller relationships" do not give rise to the imposition of fiduciary duties upon the seller.[15]

1.3.3. Yet, it must be recognized that *commercial good faith* is always required in contract performance. Actors in arms-length relationships are always subject to the requirement of "mere good faith and fair dealing"[16] in the performance of their obligations; this doctrine is fundamental to all commercial

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[11] It is well settled that fraud may occur without the making of a false statement. *Dvorak v. Dvorak*, 329 N.W.2d 868 (N.D.1983). The suppression of a material fact, which a party is bound in good faith to disclose, is equivalent to a false representation. *Verry v. Murphy*, 163 N.W.2d 721 (N.D.1969).

[12] *Exxon Corp. v. Breezevale Ltd.*, 82 S.W.3d 429 (Tex. App., 2002).

[13] *Pension Committee v. Banc of America Securities*, 592 F.Supp.2d 608, 624 (S.D.N.Y., 2009) ("a fiduciary relationship may arise where the parties to a contract specifically agree to such a relationship ….").

[14] *Pension Committee v. Banc of America Securities*, 592 F.Supp.2d 608, 624 (S.D.N.Y., 2009) ("no fiduciary duties arise where parties deal at arm's length in conventional business transaction"); *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423, 460 (S.D.N.Y., 2006), *citing Nat'l Westminster Bank, U.S.A. v. Ross*, 130 B.R. 656, 679 (S.D.N.Y.1991) ("Where parties deal at arms length in a commercial transaction, no relation of confidence or trust sufficient to find the existence of a fiduciary relationship will arise absent extraordinary circumstances." (*citing, inter alia, Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 738-39 (2d Cir.1984); *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, N.A.*, 731 F.2d 112, 122 (2d Cir. 1984))), *aff'd, Yaeger v. Nat'l Westminster*, 962 F.2d 1 (2d Cir.1992) (table); *Beneficial Commercial Corp. v. Murray Glick Datsun, Inc.*, 601 F.Supp. 770, 772 (S.D.N.Y. 1985) ("[C]ourts have rejected the proposition that a fiduciary relationship can arise between parties to a business transaction." (*citing Grumman Allied Indus., Inc.*, 748 F.2d at 738-39; *Wilson-Rich v. Don Aux Assocs., Inc.,* 524 F.Supp. 1226, 1234 (S.D.N.Y.1981); *duPont v. Perot,* 59 F.R.D. 404, 409 (S.D.N.Y.1973))); *WIT Holding Corp. v. Klein*, 282 A.D.2d 527, 724 N.Y.S.2d 66, 68 (App.Div.2001) ("Under these circumstances, where the parties were involved in an arms-length business transaction involving the transfer of stocks, and where all were sophisticated business people, the plaintiff's cause of action to recover damages for breach of fiduciary duty should have been dismissed.").

[15] *In re Prudential Ins. Co. of America Sales Prac.*, 975 F.Supp. 584 (D.N.J., 1996), where, in a case involving sales by life insurance agents of variable appreciable life insurance products as "investment plans," the court stated: "An essential feature and consequence of a fiduciary relationship is that the fiduciary becomes bound to act in the interests of her beneficiary and not of herself. Obviously, this dynamic does not inhere in the ordinary buyer-seller relationship. Thus, 'the efforts of commercial sellers — even those with superior bargaining power — to profit from the trust of consumers is not enough to create a fiduciary duty. If it were, the law of fiduciary duty would largely displace both the tort of fraud and much of the Commercial Code.' *Committee on Children's Television, Inc., v. General Foods Corp.*, 35 Cal.3d 197, 221, 197 Cal.Rptr. 783, 789, 673 P.2d 660, 675 (1983) (en banc)." *In re Prudential Ins. Co. of America Sales Prac.* At 616.

[16] *See GNC Franchising, Inc. v. O'Brien*, 443 F.Supp.2d 737, 755 (W.D. Pa., 2006) ("A party bound by a fiduciary duty must advance the interests of the *cestui que* trust above its own and act scrupulously in the other's interests. Imposition of this degree of duty—*i.e.,* selfless service as opposed to merely good faith and fair dealing—would generally be inapplicable as between parties to a commercial relationship knowingly entered into for each party's own profit").

In arms-length relationships, the burden of proof of lack of fair dealing rests on the person alleging that the other party acted in such manner. This contrasts with the burden of proof where a fiduciary relationship exists, where the burden of proof of fair dealing rests with the fiduciary. *See ABN Amro Mortgage Group, Inc. v. Pristine Mortgage, LLC,* No. CV 04-4005389 (CT 9/8/2005) (CT, 2005) ("The significance of the establishment of a fiduciary relationship is twofold. First, the burden of proving fair dealing shifts to the fiduciary. Secondly, the standard of proof for establishing fair dealing is not the ordinary standard of fair preponderance of evidence but requires proof of clear and convincing evidence.")

transactions.[17] Good faith requires that each party perform their respective obligations and enforce their rights honestly and fairly.[18]

1.3.4. While there is no general duty to disclose material facts in arms-length transactions, actual or "common law" fraud is prohibited in the formation of commercial relationships. There is generally no duty to undertake full disclosure of material facts in the negotiation of commercial contracts,[19] except where one party's superior knowledge renders non-disclosure of an essential fact inherently unfair[20] or a "special relationship" exists.[21] Instead, actors in commercial relationships generally possess a duty to undertake diligent inquiry in order to ascertain facts.[22] However, if disclosures are

[17] The doctrine of good faith requires that the parties also perform their respective obligations and enforce their rights honestly and fairly. *See* Restatement (Second) Contracts (1981) at §205, "Duty of Good Faith and Fair Dealing," stating: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." The *Comment* to this section adds: "Good faith is defined in Uniform Commercial Code § 1-201(19) as 'honesty in fact in the conduct or transaction concerned.' 'In the case of a merchant' Uniform Commercial Code §2-103(1)(b) provides that good faith means 'honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.' The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness. Failure to abide by the duty of good faith may constitute fraud (in the event of intentional misrepresentation) or breach of contract."

[18] For example, the Uniform Commercial Code, adopted by every state except Louisiana, explicitly imposes a good faith obligation on the performance and enforcement of every contract falling within its scope. UCC § 1-304, as amended (2003). Essentially, the Restatement of Contracts adopts the view that "bad faith in performance" is a violation of the good faith obligation. As stated by Professor Emily S.H. Hough: "The subcategories of bad faith in performance further delineated by Summers include 'evasion of the spirit of the deal,' 'lack of diligence and slacking off,' 'willfully rendering only 'substantial performance,'' 'abuse of power to determine compliance,' and 'interfering with or failing to cooperate in the other party's performance.'" All of these subcategories contemplate cases in which judges would feel comfortable using their discretionary and equitable powers to find a breach of good faith where the express language of the contract might not otherwise support a claim for breach of contract." Houh, Emily, "The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessell?" Utah Law Review, 2005. Available at SSRN: http://ssrn.com/abstract=622982.

[19] *See Southern Intermodal Logistics, Inc. v. Smith & Kelly Co*., 190 Ga.App. 584, 379 S.E.2d 612, 613-4 (1989) ("While concealment of material facts may amount to fraud when the concealment is of intrinsic qualities the other party could not discover by the exercise of ordinary care ... in an arms-length business or contractual relationship there is no obligation to disclose information which is equally available to both parties").

[20] *Henneberry v. Sumitomo Corp. of America*, 415 F.Supp.2d 423 (S.D.N.Y., 2006), stating: "Even absent the existence of a fiduciary relationship, however, a party's duty to disclose a material fact to another party it is negotiating with is triggered where 'one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge.' *Grumman Allied Indus., Inc*., 748 F.2d at 739 (*quoting Aaron Ferer & Sons Ltd*., 731 F.2d at 123; Jana *L. v. W. 129th St. Realty Corp*., 22 A.D.3d 274, 802 N.Y.S.2d 132, 134 (App.Div.2005) ('It is well established that, absent a fiduciary relationship between the parties, a duty to disclose arises only under the `special facts' doctrine `where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair.'' (*quoting Swersky v. Dreyer & Traub*, 219 A.D.2d 321, 643 N.Y.S.2d 33, 37 (App.Div. 1996)." *Henneberry* at 461.

[21] *See Giles v. General Motors Acceptance Corp*., 494 F.3d 865, 881 (9th Cir., 2007) ("Nevada also recognizes "special relationships" giving rise to a duty to disclose, such that '[n]ondisclosure . . . become[s] the equivalent of fraudulent concealment.' *Mackintosh v. Jack Matthews & Co*., 109 Nev. 628, 855 P.2d 549, 553 (1993). In order to prove the existence of a special relationship, a party must show that (1) 'the conditions would cause a reasonable person to impart special confidence' and (2) the trusted party reasonably should have known of that confidence. *Mackintosh v. Cal. Fed. Sav. & Loan Ass'n*, 113 Nev. 393, 935 P.2d 1154, 1160 (1997) (per curiam). '[T]he existence of the special relationship is a factual question . . . .' *Id.*)

[22] *See Burger King Corp. v. Austin*, 805 F.Supp. 1007, 1019 (S.D. Fla., 1992) ("Florida law additionally charges a claimant with knowledge of all facts that he could have learned through diligent inquiry ... In absence of a fiduciary relationship, mere nondisclosure of material facts in an arm's length transaction is ordinarily not actionable misrepresentation unless some artifice or trick has been employed to prevent the representee from making further independent inquiry, though non-disclosure of material facts may be fraudulent where the other party does not have an equal opportunity to become appraised of the facts."), *citing Taylor v. American Honda Motor Co*., 555 F.Supp. 59, 64 (M.D.Fla.1982).

undertaken by a party, the statements made must be truthful and complete[23] or actual fraud[24], also called "common law fraud," exists. And, while commercial good faith does not automatically extend to the area of contract negotiations, misrepresentations made during the formation of a contract may constitute either actual fraud or breach of contract.[25] To put it much more simply, don't lie, cheat, deceive or steal – even in commercial arms-length relationships.

1.4. No fiduciary obligations exist in most arms-length relationships. "An arms-length relationship can support no implied-in-law fiduciary obligations."[26]

1.4.1. The standard of conduct expected of the actors in arms-length relationships has been described by the courts as the "morals of the marketplace."[27]

1.4.2. In contrast, the fiduciary obligation is much more than the duties found for actors in arms-length relationships. Professor Deborah DeMott asserts that "[t]he fiduciary's duties go beyond mere fairness and honesty; they oblige him to act to further the beneficiary's best interests."[28]

1.5. Fiduciary-entrustor (*i.e.*, fiduciary-client) relationships are completely different from arms-length relationships; the fiduciary represents not the seller of a product, but rather the client alone. The other type of relationship is the fiduciary-entrustor relationship. In this type of relationship the provider of services (either management of assets, or the provision of advice) adopts a wholly different role. The fiduciary becomes bound by fiduciary duties of due care, loyalty and utmost good faith to the entrustor (the "client" in our context of investment or financial advice). The fiduciary, in essence, "steps into the shoes" of the client, and makes the decisions (or provides the advice) as if the fiduciary was the client. In other words, the fiduciary is bound to act in the sole or best interests of the client.

1.6. Understanding the true nature of the fiduciary-client relationship.

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[23] *See Playboy Enterprises v. Editorial Caballero,* 202 S.W.3d 250, 260 (Tex. App., 2006), stating: "In addition to situations where there is a fiduciary or confidential relationship … a duty to speak may arise in an arms-length transaction in at least three other situations: (1) when one voluntarily discloses information, he has a duty to disclose the whole truth; (2) when one makes a representation, he has a duty to disclose new information when the new information makes the earlier representation misleading or untrue; and (3) when one makes a partial disclosure and conveys a false impression, he has the duty to speak."

[24] "Actual fraud is where one person causes pecuniary injury to another by intentionally misrepresenting or concealing a material fact which from their mutual position he was bound to explain or disclose." Charles Sweet, *A Dictionary of English Law* (1883).

[25] Waller, Spencer Weber and Brady, Jillian G., "Consumer Protection in the United States: An Overview; Strengthening the Consumer Protection Regime" (2007), available at SSRN: http://ssrn.com/abstract=1000226. Private actions alleging actual fraud form an important, though often expensive and difficult, avenue for protection of the rights of a contracting party. "A consumer may file a lawsuit for deceit or fraud when a vendor intentionally conceals a material fact or makes a false representation of a material fact, knows that the representation is false, and meant to induce the consumer to act based on the misrepresentation. In order for the consumer to be successful in court, a plaintiff must also reasonably rely on the misrepresentation and suffer damage as a result of the reliance. Deceit can occur when a vendor makes a direct false statement, or when a misrepresentation is achieved through silence, concealment, half-truths, or ambiguity about a good. While misrepresentation of product facts may bring legal action, mere puffery and sales representative opinions are generally not subject to lawsuits for deceit." *Id.* at p. 13.

[26] *Marine, Inc. v. Brunswick Corporation*, No. 07-13907 Non-Argument Calendar (11th Cir. 5/14/2008) (11th Cir., 2008) , at p.5; *see Taylor Woodrow Homes Florida, Inc. v. 4/46-A Corp.*, 850 So.2d 536, 541 Fla. 5th DCA 2003 ("When the parties are dealing at arm's length, a fiduciary relationship does not exist because there is no duty imposed on either party to protect or benefit the other."). *See also Greenberg v. Chrust*, 198 F.Supp.2d 578, 585 (S.D.N.Y., 2002) ("parties to arms length commercial contracts do not owe each other a fiduciary obligation").

[27] *In re Auto Specialties Mfg. Co.,* 153 B.R. 457, 488 (Bankr. W.D. Mich., 1993) (Courts have described the standard of conduct to which a non-fiduciary will be held in the vernacular as the 'morals of the marketplace'").

[28] Deborah DeMott, "Beyond Metaphor: An Analysis of Fiduciary Obligation" (1988) Duke Law Journal 879 at 888.

1.6.1. The fiduciary standard of conduct flows from the requirement of the fiduciary "to adopt the principal's goals, objectives, or ends."[29] "It is what makes fiduciary law unique and separates fiduciaries from other service providers."[30] As Professor Arthur Laby explained:

> Some even use the phrase 'alter ego' to reference the fiduciary norm. This personalizes the duty in a particular way. The fiduciary must appropriate the objectives, goals, or ends of another and then act on the basis of what the fiduciary believes will accomplish them – a happy marriage of the principal's ends and the fiduciary's expertise. The fiduciary does not eliminate its own legal personality, rather it must consider the principal's delegation of authority to the fiduciary from the perspective of fidelity to the principal's objectives as the fiduciary understands them.[31]

As further explained by Professor Laby, "What generally sets the fiduciary apart from other agents or service providers is a core duty, when acting on the principal's behalf, to adopt the objectives or ends of the principal as the fiduciary's own."[32]

1.6.2. In contrast to arms-length relationships, the law imposes upon one party to some relationships the status of a fiduciary. This form of relationship is called the "fiduciary relationship" or "fiducial relationship." One upon whom fiduciary duties are imposed is known as the "fiduciary" and is said to possess "fiduciary status." The fiduciary standard of conduct is consistently described by the courts as the "highest standard of duty imposed by law."[33]

1.6.3. The term "fiduciary" comes to us from Roman law, and means "a person holding the character of a trustee, or a character analogous of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires."[34] Indeed, the Latin root of the word fiduciary – *fiduciarius* – means one in whom trust – *fiducia* - reposes. Legal usage in many jurisdictions also developed an overlay - an implication of a particular relationship of confidence between the fiduciary and those who had placed their trust in that person.

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[29] A fiduciary is "a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking." RESTATEMENT (2D) AGENCY § 13 comment (a) (1958). "[T]he general fiduciary principle requires that the agent subordinate the agent's interests to those of the principal and place the principal's interests first as to matters connected with the agency relationship." RESTATEMENT (3D) AGENCY § 8.01 cmt. b (2007). *See also* Laby, Arthur B., "The Fiduciary Obligation as the Adoption of Ends," Buffalo L. Rev 99, 103 (2008), available at available at: http://ssrn.com/abstract=1124722. *See also Varity Corp. v. Howe*, 516 U.S. 489, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996), in which the U.S. Supreme Court, applying ERISA, stated that: "There is more to plan (or trust) administration than simply complying with the specific duties imposed by the plan documents or statutory regime; it also includes the activities that are *"ordinary and natural means" of achieving the "objective" of the plan*. Bogert & Bogert, supra, § 551, at 41-52. Indeed, the primary function of the fiduciary duty is to constrain the exercise of discretionary powers which are controlled by no other specific duty imposed by the trust instrument or the legal regime. If the fiduciary duty applied to nothing more than activities already controlled by other specific legal duties, it would serve no purpose." *Id.* (*Emphasis added.*)

[30] Laby, *supra* n.65, at 130.

[31] Laby, *supra* n.65, at 135.

[32] Arthur B. Laby, *SEC v. Capital Gains Research Bureau* and the Investment Advisers Act Of 1940, 91 Boston Univ. L.Rev. 1051, 1055 (2011).

[33] *See, generally* BLACK'S LAW DICTIONARY 523 (7th ed. 1999) ("A duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another."); *also see F.D.I.C. v. Stahl*, 854 F.Supp. 1565, 1571 (S.D. Fla., 1994) ("Fiduciary duty, the highest standard of duty implied by law, is the duty to act for someone else's benefit, while subordinating one's personal interest to that of the other person); *and see Perez v. Pappas*, 98 Wash.2d 835, 659 P.2d 475, 479 (1983) ("Under Washington law, it is well established that 'the attorney-client relationship is a fiduciary one as a matter of law and thus the attorney owes the highest duty to the client.'"), *cited by Bertelsen v. Harris*, 537 F.3d 1047 (9th Cir., 2008); *also see Donovan v. Bierwirth*, 680 F. 2d 262, 272, n.8 (2nd Cir., 1982) (fiduciary duties are the "highest known to law").

[34] BLACK'S LAW DICTIONARY, 5th Edition (1979)].

1.6.4. At the beginning of the nineteenth century, in *Gibson*, 31 Eng. Rep. 1044 (1801), the court, while explaining the decision to rescind the sale of an annuity by an attorney to his client, announced that "[one] who bargains in matter of advantage with a person placing confidence in him is bound to sh[o]w, that a reasonable use has been made of that confidence; a rule applying to trustees, attorneys or anyone else." The courts eventually settled on "fiduciary" to denominate relationships of trust and confidence and denominated the doctrine (applied in *Gibson*) regulating these confidential relationships as "constructive fraud." By the mid-nineteenth century, the doctrine of constructive fraud was said to arise from some peculiar confidential or fiduciary relation between the parties.

1.6.5. More recently, Justice Philip Talmadge of the State of Washington Supreme Court summarized the core aspects of current fiduciary relationships:

> A fiduciary relationship is a relationship of trust, which necessarily involves vulnerability for the party reposing trust in another. One's guard is down. One is trusting another to take actions on one's behalf. Under such circumstances, to violate a trust is to violate grossly the expectations of the person reposing the trust. Because of this, the law creates a special status for fiduciaries, imposing duties of loyalty, care, and full disclosure upon them. One can call this the fiduciary principle.[35]

1.6.6. A breach of fiduciary duty constitutes "constructive fraud" under state common law.

1.6.6.1. To prove a breach of fiduciary duty, a plaintiff must show that he or she and the defendant had a fiduciary relationship, that the defendant breached its fiduciary duty to the plaintiff, and that this resulted in an injury to the plaintiff or a benefit to the defendant.

1.6.6.2. For example, in fiduciary relationships the failure to disclose material facts while seeking a release has been held to be actionable as fraudulent concealment. *See, e.g., Pacelli Bros. Transp. v. Pacelli*, 456 A.2d 325, 328 (Conn. 1982) ('the intentional withholding of information for the purpose of inducing action has been regarded ... as equivalent to a fraudulent misrepresentation.'); *Rosebud Sioux Tribe v. Strain*, 432 N.W. 2d 259, 263 (S.D. 1988) ('The mere silence by one under such a [fiduciary] duty to disclose is fraudulent concealment.')" (*Ibid.*)

1.6.6.3. Why does "fraud" occur in this context, where there is not an overt misrepresentation of a fact, but only an omission? "Where a fiduciary relationship exists, facts which ordinarily require investigation may not incite suspicion (*see, e.g., Bennett v. Hibernia Bank*, 164 Cal.App.3d 202, 47 Cal.2d 540, 560, 305 P.2d 20 (1956), and do not give rise to a duty of inquiry (*id*., at p. 563, 305 P.2d 20). Where there is a fiduciary relationship, the usual duty of diligence to discover facts does not exist. *United States Liab. Ins. Co. v. Haidinger-Hayes, Inc*., 1 Cal.3d 586, 598, 83 Cal.Rptr. 418, 463 P.2d 770 (1970)' *Hobbs v. Bateman Eichler, Hill Richards, Inc*., 210 Cal.Rptr. 387, 164 Cal.App.3d 174 (Cal. App. 2 Dist., 1974).

1.6.6.4. It is not necessary for the plaintiff to prove causation to prevail on claims of certain breaches of fiduciary duty. It is the agent's disloyalty, not any resulting harm, that violates the fiduciary relationship.

1.6.7. "There is a crucial distinction between surrendering control of one's affairs to a fiduciary or confidant or party in a position to exercise undue influence and entering an arms length commercial agreement, however important its performance may be to the success of one's business."[36] The "fiduciary

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[35] *Von Noy v. State Farm Mutual Automobile Insurance Company*, 2001 WA 80 (WA, 2001) (J. Talmadge, concurring opinion).

[36] *Ettol, Inc. v. Elias/Savion Advertising, Inc.*, 811 A.2d 10, 23 (Pa. Super. Ct., 2002), stating: "Most commercial contracts for professional services involve one party relying on the other party's superior skill or expertise in providing that particular service. Indeed, if a party did not believe that the professional possessed specialized expertise worthy of trust, the contract would most likely never take place. This does not mean, however, that a fiduciary relationship arises merely because one party relies on and pays for the specialized skill or expertise of the other party. Otherwise, a fiduciary relationship would arise whenever one party had any marginally greater level of skill and expertise in a particular area than another party. Rather, the critical question is whether the relationship goes beyond mere reliance on superior skill, and into a relationship characterized by "overmastering influence" on one side or "weakness, dependence, or trust, justifiably reposed" on the other side. *Basile v. H & R Block,* 777 A.2d

relationship" is distinct from arms-length relationships, as those whom the law classifies as fiduciaries must carry on their dealings with beneficiaries at a level high above ordinary commercial standards.

1.6.8. Perhaps the most famous judicial expression of fiduciary duties is Justice Cardozo's famous lines expressing a lofty vision of the duties owed by fiduciaries. "Generations of corporate lawyers have been schooled in its memorable language finding broad fiduciary obligations on managers of other peoples' money."[37]

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions [citation omitted]. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court. [38]

1.6.9. As Professor Langbein observed, "Courts have boasted of their "stubbornness and inflexibility," their "[u]ncompromising rigidity,"in applying the sole interest rule."[39]

1.7. Advice providers are often fiduciaries. As Professor Arthur Laby notes, "Historically, providing advice has given rise to a fiduciary duty owed to the recipient of the advice. Both the *Restatement (First)* and *Restatement (Second) of Torts* state, "[a] fiduciary relation exists between two persons when one of them is under a duty to act for *or to give advice* for the benefit of another upon matters within the scope of the relation" [citing *Restatement (Second) Of Torts* § 874 *cmt. a* (1979) (citation omitted) (*emphasis added*); *Restatement (First) Of Torts* § 874 *cmt. a* (1939) (citation omitted) *(emphasis added*)].

1.8. The use of the term "best interests" is found in numerous judicial decisions to describe the duty of a fiduciary, not those of a salesperson. This use of the term "best interests," primarily to describe the fiduciary duty of loyalty (the most distinguishing feature of the fiduciary principle), is found in numerous judicial decisions. This author's recent search of a U.S. case law database revealed 963 judicial opinions in which the terms "fiduciary" and "best interests" appeared in the same decision. In addition, there are numerous decisions in other common-law countries, such as the United Kingdom and Australia, that also utilize the term "best interests" to describe the salient feature of the fiduciary obligation.

1.8.1. For example, one U.S. court, recently opining on ERISA's fiduciary duty of loyalty, stated: "ERISA imposes a duty of loyalty on fiduciaries. *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.), cert. denied, 459 U.S. 1069, 74 L. Ed. 2d 631, 103 S. Ct. 488 (1982) (Friendly, J.). A trustee violates his duty of loyalty when he enters into substantial competition with the interests of trust beneficiaries. *Restatement (Second) of Trusts*, § 170, *comment p* … under the law of trusts, a fiduciary is generally prohibited, not just from acting disloyally, but also from assuming a position in

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95, 101 (Pa.Super.2001). A confidential relationship is marked by such a disparity in position that the inferior party places complete trust in the superior party's advice and seeks no other counsel, so as to give rise to a potential abuse of power." *Id.*

[37] Georgakopoulos, Nicholas L.,Meinhard v. Salmon and the Economics of Honor(April 1998). Available at SSRN: http://ssrn.com/abstract=81788 or DOI: 10.2139/ssrn.81788.

[38] *Meinhard vs. Salmon*, 164 N.E. 545 (N.Y. 1928). "Justice Cardozo held that a nonmanaging partner could share in a deal that the owner of the property the partnership managed had offered to the managing partner although the deal would begin after the termination of the partnership's 20-year term and included significant property beyond what the partnership had managed. Meinhard provides a workable definition of fiduciary duties as requiring the obligated party to act with the 'finest loyalty' to the owner's interests." Ribstein, Larry E., "The Structure of the Fiduciary Relationship" (January 4, 2003). U Illinois Law & Economics Research Paper No. LE03-003. Available at SSRN: http://ssrn.com/abstract=397641 or DOI: 10.2139/ssrn.397641

[39] John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929, 932 (March 2005). [*Emphasis added.*]

which a temptation to act contrary to the *best interests* of the beneficiaries is likely to arise. *Grynberg* at 1319; 2 Scott on Trusts § 170, pp. 1297-98 (1967)."[40] [*Emphasis added.*]

1.8.2. In describing an attorney's fiduciary duty of loyalty to a client, a court stated: "public policy requires that he not be subjected to any possible conflict of interest which may deter him from determining the best interests of the client … a client's right to the undivided loyalty of his or her attorneys must be protected … The duty of both the associate and the successor attorney is the same: to serve the *best interests* of the client."[41] [*Emphasis added.*]

1.8.3. For example, in explaining the duty of loyalty owed by a board of directors to the corporation, the instruction to a lay jury reads: "Each member of the … board of directors is required to act in good faith and in a manner the director reasonably believes to be in the *best interests* of the corporation when discharging his or her duties."[42] [*Emphasis added.*]

1.8.4. In describing the fiduciary duty of the director of a corporation to the corporation and its shareholders, a court opined: "The duty of loyalty 'mandates that the *best interest* of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.' *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 362 (Del. 1993) (*citing Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) and *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984)); *see also Diedrick v. Helm*, 217 Minn. 483, 14 N.W.2d 913, 919 (Minn. 1944). The classic example is when a fiduciary either appears on both sides of a transaction or receives a substantial personal benefit not shared by all shareholders. *Id*."[43] [*Emphasis added.*]

1.8.5. Similarly, "[t]he duty of loyalty requires that the *best interests* of the corporation and its shareholders take precedence over any self-interest of a director, officer, or controlling shareholder that is not shared by the stockholders generally."[44] [*Emphasis added.*]

1.8.6. Also, "[I]n dealing with corporate assets [the corporate officer] was required to act in the *best interests* of the corporation and he was prohibited from using either his position or the corporation's funds for his private gain."[45] [*Emphasis added.*]

1.8.7. While there have been many judicial elicitations of the fiduciary standard, more recent and concise recitation of the fiduciary principle can be found in dictum within the 1998 English (U.K.) case of Bristol and West Building Society v. Matthew, in which Lord Millet undertook what has been described as a "masterful survey" of the fiduciary principle:

> A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principle is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of the fiduciary obligations. They are the defining characteristics of a fiduciary.[46]

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[40] *Salovaara v. Eckert*, 94 Civ. 3430 (KMW), U.S. D.C. SDNY, 1996 U.S. Dist. LEXIS 323 (1996).

[41] *Beck v. Wecht*, No. S099665, Supreme Court Of California, 28 Cal. 4th 289; 48 P.3d 417; 121 Cal. Rptr. 2d 384; 2002 Cal. LEXIS 4197; 2002 Cal. Daily Op. Service 5812; 2002 Daily Journal DAR 7326 (2002).

[42] *Schultz v. Scandrett*, #27158, Supreme Court of South Dakota, 2015 SD 52; 866 N.W.2d 128; 2015 S.D. LEXIS 85 (June 24, 2015).

[43] *DQ Wind-Up, Inc. v. Kohler*, Court File No. 27-CV-10-27509, Minnesota District Court, County Of Hennepin, Fourth Judicial District, 2013 Minn. Dist. LEXIS 118 (2013).

[44] *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

[45] *Levin v. Levin*, 43 Md. App. 380, 390, 405 A.2d 770 (1979).

[46] *Bristol and West Building Society v Mothew* [1998] EWCA Civ 533.

1.9. Numerous law review articles and academic texts also reflect on the fiduciary's obligation to act in the client's (entrustor's) "best interests."

1.9.1. "Tracing this doctrine back into the womb of equity, whence it sprang, the foundation becomes plain. Wherever one man or a group of men entrusted another man or group with the management of property, the second group became fiduciaries. As such they were obliged to act conscionably, which meant *infidelity to the interests of the persons* whose wealth they had undertaken to handle. In this respect, the corporation stands on precisely the same footing as the common-law trust." Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 336 (1939). [*Emphasis added.*]

1.9.2. "The underlying purpose of the duty of loyalty, which the sole interest rule is meant to serve, is to advance *the best interest* of the beneficiaries … There can be no quibble with the core policy that motivates the duty of loyalty. Any conflict of interest in trust administration, that is, any opportunity for the trustee to benefit personally from the trust, is potentially harmful to the beneficiary. The danger, according to the treatise writer Bogert, is that a trustee 'placed under temptation' will allow 'selfishness' to prevail over the duty to benefit the beneficiaries. 'Between two conflicting interests,' said the Illinois Supreme Court in an oft-quoted opinion dating from 1844, 'it is easy to foresee, and all experience has shown, whose interests will be neglected and sacrificed' …" [*Emphasis added.*]

1.9.3. "The duty of loyalty requires a trustee 'to administer the trust solely in the interest of the beneficiary' … The underlying purpose of the duty of loyalty, which the sole interest rule is meant to serve, is to advance the best interest of the beneficiaries … The law is accustomed to requiring that attorneys zealously pursue their clients' interests and that they not indulge interests that may conflict with those of a particular client without first disclosing the potential conflict to the client and receiving the client's approval. There are some conflicts that cannot be overcome by the client's permission where the conflicted attorney would have to avoid the conflict entirely or quit the representation of the client. Law firms vigorously monitor potential conflicts between attorneys and clients. The rules of professional responsibility go to great lengths to define the appropriate standard of conduct for attorneys and describe what constitutes a conflict and how an attorney, law firm, and client should handle it. These strictly enforced standards of conduct cover every facet of the attorney-client relationship and leave very little to chance in a court's ex post determination of whether an attorney has breached her fiduciary duties. While fiduciary duties may apply to the relationship and zealous advocacy is clearly required, *the obligation an attorney owes a client is … quite thoroughly described in codes of conduct that have grown ever more complete and sophisticated over time."* John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929 (March 2005). [*Emphasis added.*]

1.10. The U.S. Securities and Exchange Commission has also utilized the term "best interests" frequently to describe the fiduciary obligation of investment advisers.

1.10.1. "An essential feature and consequence of a fiduciary relationship is that the fiduciary becomes bound to act in the interests of her beneficiary and not of herself." *In re Prudential Ins. Co. of America Sales Prac*., 975 F.Supp. 584, 616 (D.N.J., 1996).

1.10.2. In the SEC's 2011 "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act," the SEC staff cited *Transamerica Mortgage Advisors, Inc*., 444 U.S. 11, 17 (1979), stating: "The duty of loyalty requires an adviser to serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own."[47]

1.10.3. We also see the term "best interests" used to describe the legal obligations arising for those who provide personalized investment advice to retail customers. On January 22, 2011, the SEC's Staff, fulfilling the mandate under §913 of the Dodd-Frank Act, released its Study on the regulation of broker-dealers and investment advisers. The overarching recommendation made in the Study is that

[47] SEC Staff Study, dated Jan. 21, 2011, at p.22 (available at http://sec.gov/news/studies/2011/913studyfinal.pdf.)

the SEC should adopt a uniform fiduciary standard for investment advisers and broker-dealers that is no less stringent than the standard under the Advisers Act. Specifically, the Staff recommended the following: "[T]he standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." SEC Staff, Study on Investment Advisers and Broker-Dealers ii (2011) [hereinafter SEC Staff Study], available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

1.10.4. In its 1940 Annual Report, the U.S. Securities and Exchange Commission noted:

> If the transaction is in reality an arm's-length transaction between the securities house and its customer, then the securities house is not subject' to 'fiduciary duty. However, the necessity for a transaction to be really at arm's-length in order to escape fiduciary obligations, has been well stated by the United States. Court of Appeals for the District of Columbia in a recently decided case: '[T]he old line should be held fast which marks off the obligation of confidence and conscience from the temptation induced by self-interest. He who would deal at arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector. He cannot commingle his trusteeship with merchandizing on his own account….

Seventh Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1941, at p. 158, citing *Earll v. Picken* (1940) 113 F. 2d 150.

1.10.5. The SEC also "has held that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship exists, imposing a particular duty to act in the customer's best interests and to disclose any interest the broker-dealer may have in transactions he effects for his customer … [broker-dealer advertising] may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business … Where the relationship between the customer and broker is such that the former relies in whole or in part on the advice and recommendations of the latter, the salesman is, in effect, an investment adviser, and some of the aspects of a fiduciary relationship arise between the parties." 1963 SEC Study of the Securities Industry, citing various SEC Releases.

1.11. <u>The U.S. Department of Labor's "Conflict of Interest" and Related Prohibited Transactions Correctly Applied the Term Best Interests, but this was not followed by NAIFA.</u>

1.11.1. The U.S. Department of Labor proposed to make substantive changes to PTE 84-24, which relates to the sale of fixed-interest annuity contracts (and, before the changes, to fixed indexed annuities). Most importantly, the proposal provided that, in order to qualify for the exemption, insurance and annuity agents must adhere to new "Impartial Conduct Standards." 2015 Proposed PTE 84-24, 80 Fed. Reg. 22,010, 22,018 (Apr. 20, 2015). Under those standards, the insurance agent and insurance company would be required to act "in the best interest of the plan [or] IRA" and to ensure that statements about investment fees, material conflicts of interest, and other matters directly relevant to the investment decision are not misleading. *Id*. The Department further proposed that an insurance agent or insurance company would be deemed to "act in the '[b]est [i]nterest' of the plan or IRA" when "the fiduciary acts with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances and needs of the [p]lan or IRA, without regard to the financial or other interests of the fiduciary, any affiliate or other party." *Id*. at 22,020. These conditions parallel the duties of prudence and loyalty found in title I of ERISA. *See* 29 U.S.C. § 1104(a)(1).

1.11.2. The Working Group's proposal falls far short of the imposition of Impartial Conduct Standards, and the suggested modifications contained in NAIC Model #275 draft dated 11/24/17 do not reflect an accurate view of the obligations arising under the "best interests" fiduciary standard of conduct.

1.12. A NAIFA Executive Acknowledged, in Sworn Testimony Before Congress, that the Term "Best Interests" Relates to the Obligation of Fiduciaries.

1.12.1. In a December 2, 2015 hearing before the Subcommittee On Health, Employment, Labor, And Pensions, of the U.S. House Education and Workforce Committee, Mr. Jules O. Gaudreau, Jr., ChFC, CIC testified, on behalf of the National Association of Insurance and Financial Advisors (NAIFA), under oath: "We already believe that we do engage in the best interests of our clients; we take an ethics pledge on their behalf."[48]

1.12.2. Subsequently, U.S. Representative Suzanne Bonomaci addressed testimony in an earlier hearing, noting that industry executives all responded affirmatively when she inquired, "Just to be clear, does everyone agree that a 'best interests' standard means a 'best interests' fiduciary standard?"[49] Each of the industry executives then answered in the affirmative.

1.13. FINRA's various proposals to advance the use of "best interests" to essentially describe the suitability obligation of broker/dealer firms and their registered representatives, with a slight modification requiring "casual disclosure" of conflicts of interest, is both unfortunate and could cause great harm.

1.13.1. Recent efforts by certain actors in the securities industry – including SIFMA and FSI (lobbyist organizations for broker-dealer firms) and FINRA (the self-regulator of broker-dealers, whose members are all broker-dealer firms) – seek to redefine the fiduciary duty of loyalty as a weak disclosure-only requirement. These initiatives included, at first, a "new federal fiduciary standard" or "uniform standard of care," which has more recently evolved into the advancement of a "best interests" standard that is, in reality, preserving only the profits and "best interests" of broker-dealer firms (and not the "best interests" of their clients). These proposals are contrary to centuries of developed law on fiduciary-client relationships and should be soundly rebuffed. Permit me to contrast and compare a proposal advanced by SIFMA, FSI, and FINRA with a true fiduciary standard, first exploring just a few of the many efforts FINRA has made over the years to keep the standards of conduct for brokers low, and FINRA's attempt to promote a deceptive new "best interests" standard.

1.13.2. FINRA's Efforts to Promote an Illusory "Best Interests" Standard:

1.13.2.1. *"I am a stock and bond broker. It is true that my family was somewhat disappointed in my choice of profession."* – Binx Bolling, The Moviegoer (1960)[50]

1.13.2.2. FINRA recently advanced a "best interests" standard. Yet, the reality is that a great deception is occurring by this brokerage-owned "self-regulatory organization," in which a true fiduciary standard is resisted as FINRA, along with brokerage lobbying organizations SIFMA and FSI. Instead, these organizations seek to re-define a centuries-old, strict legal standard to a new suitability regime, together with casual disclosure of conflicts of interest combined with securing the customer's uninformed consent. In so doing, FINRA endorses an exacerbation of consumer confusion as it seeks to further obfuscate the merchandizing role of broker-dealer firms.

1.13.2.3. In touting a new "best interests" standard that falls far short of a true fiduciary standard of conduct, FINRA perpetuates a 75-year history of opposing the substantial raising of standards of conduct for brokerage firms and their registered representatives. In so doing, FINRA continues its long-standing failure to live up to the hopes of Senator Maloney, who once stated that his Maloney Act of 1938 (which led to the establishment of NASD, now known as

[48] Hearing, video record at 1:14.

[49] Hearing, video record at 1:44.

[50] Walter Percy, The Moviegoer (New York: Ivy Books, 1960), pg. 6.

FINRA) had, as its purpose, "the promotion of truly professional standards of character and competence."[51]

1.13.2.4. In his May 27, 2015 address to broker-dealer firm executives gathered at the 2015 FINRA Annual Conference, former FINRA Chair and CEO Richard Ketchum inquired of brokers whether "the time has come to require broker-dealers, when recommending a security or strategy to retail investors, to ensure that the recommendation is in the 'best interest' of the investor." Mr. Ketchum went on to equate the "best interest" standard with the "fiduciary standard," noting that the standard has existed under the law for centuries. Mr. Ketchum then outlined what a "best interest" standard for brokers would look like, based upon the principles involving "consent" by the customer to conflicts of interest, procedures to "manage" conflicts of interest, "more effective disclosure" to customers, and that firms undertake "fee leveling" for registered representatives.[52]

1.13.2.5. Yet, despite Mr. Ketchum's apparent support for a fiduciary standard, in the same speech he opposed the U.S. Department of Labor's proposed rule-making, calling it "problematic" with the necessity of "contractual interpretations" by jurists and further questioning "how a judicial arbiter would analyze whether a recommendation was in the best interests of the customer 'without regard to the financial or other interests' of the service provider." Yet FINRA's objections appear to this observer to be nonsensical, in light of history. The fiduciary duty of loyalty, often referred to as requiring the adviser to act in the "best interests" of a client, has – as Mr. Ketchum stated – been applied in various legal contexts for hundreds of years. Additionally, judges and arbitrators have, for centuries, interpreted contracts.

1.13.2.6. Moreover, the additional DOL requirement that FINRA unfathomably objects to, that firms and advisers act "without regard to the financial or other interests" of the service provider, is derived from Section 913 of the Dodd Frank Act. It is the language that must be applied by the SEC, if and when the SEC moves to adopt a fiduciary standard for brokers.[53] Moreover, in the eyes of this observer, this additional language much more clearly establishes a clear test for judicial finders of fact than the vague suitability standards, and this language provides concrete guidance for both brokers and their registered representatives.

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[51] Senator Francis T. Maloney, Regulation of the Over-the-Counter Security Markets, Address at the California Security Dealers Association, Investment Bankers Association, National Association of Securities Dealers 2 (Aug. 22, 1939) (transcript available in the SEC Library at 11 SEC Speeches, 1934-61).

[52] "First, the best interest standard should make clear that customer interests come first and that any remaining conflicts must be knowingly consented to by the customer … Second, any such proposal should include a requirement that financial firms establish carefully designed and articulated structures to manage conflicts of interest that arise in their businesses. This would include creating an ongoing process to specifically identify any conflicts that might impact their provision of fair and effective investment advice and develop written supervisory procedures to address how those conflicts would be eliminated or managed. Third, any best interest standard should also begin by applying know-your-customer and suitability standards as 'belt and suspenders' backstops, similar to what is contained in FINRA's rules. Fourth, there should be more effective disclosure provided to investors. Broker-dealers should be required to provide customers an ADV-like document annually that provides clear, plain English descriptions of the conflicts they may have and an explanation of all product and administrative fees. Moreover, the firms' representatives should provide either point of sale disclosures regarding relevant conflict, risk and fee issues relating to a recommendation, or, in the alternative, follow up any discussion involving a recommendation with a written or email communication that memorializes the conversation by describing the key contractual terms and fees entailed in the product. Such communication, including a balanced explanation of the benefits of the product or strategy recommended as well as the potential adverse risk scenarios that the customer should be aware of, would be critical to ensure that the investor had a clear understanding of the benefits, risks and costs of the recommended investment."

[53] Section 913(g) of The Dodd Frank Act, "STANDARD OF CONDUCT," provides in pertinent part: ''(1) IN GENERAL.—The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."

1.13.2.7. In widely criticized 2011 and 2012 releases, FINRA already opined (contrary to decades if not centuries of established jurisprudence, and contrary to its NASD's and FINRA's own written standards) that a "best interests" standard already existed for brokers. In 2012 guidance to brokers regarding FINRA Rule 2111 ("Suitability"), FINRA stated that, "In interpreting FINRA's suitability rule, numerous cases explicitly state that 'a broker's recommendations must be consistent with his customers' best interests.'"[54] FINRA's statement was largely seen as a movement toward a fiduciary standard, as found under the Investment Advisers Act of 1940.[55] But FINRA's true intentions were later revealed. In its July 17, 2015 comment letter[56] to the U.S. Department of Labor, FINRA revealed the ugly truth that it's interpretation of "best interests" falls far below that required by a bona fide fiduciary duty of loyalty. FINRA stated:

> FINRA has publicly advocated for a fiduciary duty for years and agrees with the Department that all financial intermediaries, including broker-dealers, should be subject to a fiduciary 'best interest' standard … At a minimum, any best interest

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[54] FINRA Rule 2111 (Suitability) Frequently Asked Questions 7.1., page 11, providing:

> Q7.1. Regulatory Notice 11-02 and a recent SEC staff study on investment adviser and broker-dealer sales-practice obligations cite cases holding that brokers' recommendations must be consistent with their customers' "best interests." What does it mean to act in a customer's best interests? [Notice 12-25 (FAQ 1)]
>
> A7.1. In interpreting FINRA's suitability rule, numerous cases explicitly state that "a broker's recommendations must be consistent with his customers' best interests." The suitability requirement that a broker make only those recommendations that are consistent with the customer's best interests prohibits a broker from placing his or her interests ahead of the customer's interests. Examples of instances where FINRA and the SEC have found brokers in violation of the suitability rule by placing their interests ahead of customers' interests include the following:
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> - A broker whose motivation for recommending one product over another was to receive larger commissions.
> - A broker whose mutual fund recommendations were "designed 'to maximize his commissions rather than to establish an appropriate portfolio' for his customers."
> - A broker who recommended "that his customers purchase promissory notes to give him money to use in his business."
> - A broker who sought to increase his commissions by recommending that customers use margin so that they could purchase larger numbers of securities.
> - A broker who recommended new issues being pushed by his firm so that he could keep his job.
> - A broker who recommended speculative securities that paid high commissions because he felt pressured by his firm to sell the securities.
>
> The requirement that a broker's recommendation must be consistent with the customer's best interests does not obligate a broker to recommend the "least expensive" security or investment strategy (however "least expensive" may be quantified), as long as the recommendation is suitable and the broker is not placing his or her interests ahead of the customer's interests. Some of the cases in which FINRA and the SEC have found that brokers placed their interests ahead of their customers' interests involved cost-related issues. The cost associated with a recommendation, however, ordinarily is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable.
>
> The customer's investment profile, for example, is critical to the assessment, as are a host of product- or strategy-related factors in addition to cost, such as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. These are all important considerations in analyzing the suitability of a particular recommendation, which is why the suitability rule and the concept that a broker's recommendation must be consistent with the customer's best interests are inextricably intertwined."

[Citations omitted.]

[55] "[I]t appears that FINRA is not waiting for the SEC to implement Dodd-Frank fiduciary or regulatory harmonization rules. As attested by Rules 2090 and 2111, basic elements of fiduciary practices now are cropping up in broker-dealer regulation … for the most part, the new rules appear designed to move broker compliance along roughly parallel lines to traditional wealth management practices under the 1940 Act." IMCA's *Legislative Intelligence* (June 2012), p.1.

[56] FINRA, comment letter to the U.S. Department of Labor (July 17, 2016), available at http://www.dol.gov/ebsa/pdf/1210-AB32-2-00405.pdf.

standard for intermediaries should meet the following criteria … The standard should require financial institutions and their advisers to:

- act in their customers' best interest;
- adopt procedures reasonably designed to detect potential conflicts;
- eliminate those conflicts of interest whenever possible;
- adopt written supervisory procedures reasonably designed to ensure that any remaining conflicts, such as differential compensation, do not encourage financial advisers to provide any service or recommend any product that is not in the customer's best interest;
- obtain retail customer consent to any conflict of interest related to recommendations or services provided; and
- provide retail customers with disclosure in plain English concerning recommendations and services provided, the products offered and all related fees and expenses."[57]

These criteria closely follow upon SIFMA's more detailed proposal for a new "best interests" standard that would modify FINRA's suitability rule.[58] As will be discussed

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[57] *Id.*

[58] SIFMA, Proposed Best Interest of the Customer Standard for Broker-Dealers (June 2015), providing in pertinent part for a reformulation of FINRA's suitability rule:

SIFMA'S Proposed Best Interests of the Customer Standard for Broker-Dealers. The following SIFMA mark-up of existing FINRA Rules is intended to be fairly streamlined and high-level in order to focus attention on, and promote discussion about, the core elements of a proposed best interests of the customer standard for broker-dealers. Missing from this treatment are, among other things, key details about how the standard would operate under various scenarios, and the content, timing and manner of disclosures and consents, if any, all of which are of critical significance to SIFMA's members.

2111. Suitability The Best Interests of the Customer

a. A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for in the best interests of the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

i. The best interests standard. A best interests recommendation shall:

1. Reflect the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the customer's investment profile (defined above). The sale of only proprietary or other limited range of products by the member shall not be considered a violation of this standard.

2. Appropriately disclose and manage investment-related fees. See ***Manage investment-related fees*** below.

3. Avoid, or otherwise appropriately manage, disclose, and obtain consents to, material conflicts of interest, and otherwise ensure that the recommendation is not materially compromised by such material conflicts. See ***Manage material conflicts of interest*** below.

ii. Manage investment-related fees. A member shall ensure that investment-related fees incurred by the customer from the member are reasonable, fair, and consistent with the customer's best interests. Managing investment-related fees does *not* require recommending the least expensive alternative, nor should it interfere with making recommendations from among an array of services, securities and other investment products consistent with the customer's investment profile.

iii. Manage material conflicts of interests. A member or associated person shall avoid, if practicable, and/or mitigate material conflicts of interest with the customer. A member or associated person shall disclose material conflicts of interest to the customer in a clear and concise manner designed to ensure that the customer understands the implications of the conflict. The customer shall be given the choice of whether or not to waive the conflict, and must provide consent, as provided in Rule 2260 (Disclosure). Notwithstanding the disclosure of, and customer consent to, any material conflict, a recommended transaction or investment strategy must nevertheless be in the best interests of the customer.

iv. Provide required disclosures. A member or associated person shall provide and/or otherwise make available to the customer, among other things: 1) account opening disclosure, 2) annual disclosure, and 3) webpage disclosure, as provided in Rule 2260 (Disclosure).

b. A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in Rule 4512(c), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decisionmaking authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.

2260. Disclosures

a. Account opening disclosure. A member or associated person shall disclose to the customer, at or prior to the opening of the customer account, or prior to recommending a transaction or investment strategy, if earlier, the following:

• the type of relationships available from the broker-dealer and the standard of conduct that would apply to those relationships;

• the services that would be available as part of the relationships, and information about applicable direct and indirect investment-related, fees;

below, the requirements of FINRA's suggested "best interests" standard do not impose a *bona fide* fiduciary duty of loyalty upon brokers. What FINRA really wants the broker to be able to do, by its comment and its support for an illusory "best interests" standard, is to continue to recommend virtually any product, under the failed suitability standard, even when that product is nowhere close to being the best product in the marketplace.

1.13.2.8. In the early 20th Century, FINRA's suitability standard was originally designed to mitigate the duty of due care that all service providers possess, in recognition that a broker should not be liable for the default of a security merely for performing "trade execution" services.[59] Inexplicably, however, the suitability standard was expanded in the 1970's to brokers' recommendations of investment managers (including mutual fund providers). In turn this has led to a wide plethora of pooled investment vehicles, often expensive, and often with "hidden" revenue-sharing. The result has been widespread harm to investors, given the substantial academic research demonstrating the close relationship between high mutual fund fees and costs and lower returns. Moreover, individual Americans are unable to recover from brokers due to a breach of the duty of due care, since brokers do not possess such a duty – even though nearly every other service provider in the United States possesses such a duty.

1.13.2.9. "Suitability" is a standard that is lower than the typical standard of due care seen by providers of services, such as plumbers, contractors, electricians, etc. Suitability does not require "due care." For example, suitability does not generally require registered representatives to recommend a lower cost product with identical risk and return characteristics, if one is available.

1.13.2.10. FINRA's statements over the past few years have often been contradictory. FINRA stated to brokers in its earlier release regarding Rule 2111 that brokers' recommendations must be consistent with the "best interests" of their customers. Yet, just last year, FINRA stated to the U.S. Department of Labor: "We recognize that imposing a best interest standard requires rulemaking *beyond what is presently in place for broker-dealers*."[60] [*Emphasis added*.]

1.13.2.11. In essence, FINRA has long sought to assure the public that protections exist under FINRA regulations, that simply don't exist. In 2005, FINRA opposed the application of the Advisers Act's fiduciary duties upon brokers who provided fee-based accounts, even though FINRA acknowledged that, "[f]rom a retail client's perspective, the differences between investment

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• material conflicts of interest that apply to these relationships, including material conflicts arising from compensation arrangements, proprietary products, underwritten new issues, types of principal transactions, and customer consents thereto; and

• disclosure about the background of the firm and its associated persons generally, including referring the customer to existing systems, such as FINRA's BrokerCheck database.

b. Annual disclosure. A member shall disclose to the customer annually a good faith summary of investment-related fees incurred by the customer from the member or associated person with respect to all products and services provided during the prior year (or such shorter period as applicable).

c. Webpage disclosure. A member's webpage shall provide disclosure that is concise, direct and in plain English, following a layered approach that provides supplemental information to the customer. A member's webpage shall include access to all account opening disclosure. Paper disclosure shall be provided to customers that lack effective Internet access or that otherwise so request.

d. Customer consent. Customer consent to material conflicts of interest or for other purposes as appropriate may be provided at account opening.[1] Existing customers with accounts established prior to the effective date of the best interests standard shall be deemed to have consented to the material conflicts of interest, if any, disclosed to the customer, upon continuing to accept or use account services.

e. Disclosure updates. Updates to disclosures, if necessary or appropriate, may be made through an annual notification that provides a website address where specific changes to a member's disclosure are highlighted.

[1] Customer consent to principal transactions, for example, could be provided at account opening."

[59] *See, e.g.* Arthur Laby, *Fiduciary Obligations of Broker-Dealers,* 55 Vill.L.Rev. 701, 733-4 ("Although brokers historically provided advice to their customers, advice rendered in the past was relatively less significant in the context of the overall relationship than it is today … A history of the Merrill Lynch firm explains that, in the early part of the twentieth century, many brokerage firms did not do much more than execution—their sales forces were primarily intermediaries arranging trades on secondary markets—and the information available to investors seeking advice was rather meager. Open a modern description of the activities of broker-dealers and advice often is paramount.") (*Citations omitted.*)

[60] FINRA Comment Letter to DOL, July 17, 2015, at p. 3.

advisory services and traditional brokerage services are almost imperceptible."[61] Stating that "brokerage investors are fully protected"[62] FINRA even questioned the need for additional disclosures to investors. Also, in a widely criticized statement, FINRA also expressed in 2005 that the SEC's proposed disclosure for fee-based accounts "implies that customer's rights, the firm's duties and obligations, and the applicable fiduciary obligations are greater with respect to an investment adviser account than they are with respect to a brokerage account. As we have previously discussed, this is simply not the case."[63] FINRA's statement is clearly erroneous, as everyone and their mother agree that the fiduciary standard is a higher standard than the suitability standard.

1.13.3. Why FINRA's "Best Interest" Standard Fails to Meet the Fiduciary Standard

1.13.3.1. While much of FINRA's proposal is general, including its apparent requirement to "avoid conflicts of interest," upon close inspection, FINRA's proposal to the DOL that a new "best interest" standard be adopted is but an attempt to undermine fiduciary law. This is evidenced most in FINRA's requirements on how a conflict of interest is to be managed, when it is not avoided.

1.13.3.2. For example, under a bona fide fiduciary standard, all compensation of the fiduciary must be disclosed to the client, and must be reasonable. Under FINRA's proposed standard there is annual disclosure of a product's fees and expenses, but not of the compensation of the broker-dealer firm.

1.13.3.3. Under a true fiduciary standard of conduct, when a conflict of interest is unavoidable, the fiduciary must ensure client understanding of the conflict of interest. Yet, under FINRA's proposal, it appears only that the broker-dealer must "inform" the client of the conflict. Moreover, broker-dealers have long advocated in opposing fiduciary standards mere "casual disclosures" of conflicts of interest, such as "our interests might not be aligned with yours," rather than the full and frank disclosure required of a fiduciary.[64]

1.13.3.4. Nor is there is any requirement in FINRA's proposal that the client's consent be "informed" – a key requirement of fiduciary law before client waiver of a conflict of interest can take place. Nor is there a requirement that the client provide informed consent prior to each and every transaction. Rather, FINRA would only require brokers to "obtain client consent" to conflicts of interest. Such consent is often given with little or no understanding by the customer of the ramifications to the client of the broker's conflict of interest. Indeed, this "mere consent" is often found buried in a mountain of paperwork presented to the client upon the opening of an account. Accordingly, such "mere consent" does not come close to meeting the "informed consent" requirement of fiduciary law.

1.13.3.5. It is fundamental that no client would ever provide informed consent to be harmed.

1.13.3.6. Finally, FINRA's proposed "best interest" standard does not require, even in the presence of informed consent, that the transaction remain substantively fair to the client (as fiduciary law

[61] FINRA Comment Letter to U.S. Securities and Exchange Commission, July 11, 2005, re: "Certain Broker-Dealers Deemed Not to Be Investment Advisers," Securities Exchange Act Release No. 40980; File No. S7-25-99, at p.2.

[62] *Id.* at p.5.

[63] *Id.*

[64] Any disclosure, by a fiduciary, must be full and frank: "If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all its stark significance." *See* "Will the Investment Company and Investment Advisory Industry Win an Academy Award?" remarks of Kathryn B. McGrath, Director of the SEC Division of Investment Management, at the 1987 Mutual Funds and Investment Management Conference (McGrath Remarks), *citing* Scott, The Fiduciary Principle, 37 Calif. L. Rev. 539, 544 (1949).

requires).[65] Rather, there is only a requirement that the transaction be in accord with the client's "best interest" – and this term is so mis-defined that, as discussed above, it does not represent a bona fide fiduciary obligation.

1.13.4. FINRA's proposed "best interests" standard remains ill-defined and subject to much interpretation. While, it appears that FINRA's "best interest" proposal would permit broker-dealers to still represent product manufacturers; the broker-dealer firm would still function as a "seller's representative" rather than a "buyer's representative" as a true fiduciary would. Under FINRA's "best interest" proposal it appears that broker-dealers would easily be able to place their own interests above that of the client.

1.13.5. FINRA's "best interest" proposal, if it were to be adopted, would significantly weaken long-standing fiduciary principles. It would mislead our fellow Americans to believe that their best interests were paramount when, in fact, the principle of caveat emptor would still apply.

1.14. Similarly, the ACLI previously advanced, to this Working Group, a similar proposal for a uniform standard of care. As stated in the Working Group's minutes of its August 6, 2017 meeting:

> Steve Toretto (Pacific Life) provided an overview of the American Council of Life Insurers' (ACLI) "Uniform Standard of Care" proposal. He said the proposal's goal is to ensure common uniform definitions, common disclosure requirements and common guiding elements among the states, the SEC and the DOL for the entities and individuals they regulate as each proceeds to develop new standards of care or revise their existing standards of care.

1.15. The Insured Retirement Institute similarly proposed, at the Working Group's August 6, 2017 meeting, a "best interests" standard at the same meeting:

> Jason Berkowitz (Insured Retirement Institute—IRI) highlighted the NAIC's work regarding Model #275. He stressed that it is still worth the effort to have the model's 2010 revisions adopted by each state. Mr. Berkowitz discussed the value of annuity products. He said the current annuity suitability standard in Model #275 works, but the NAIC has the opportunity through the proposed work of the Working Group to make it better. He noted that the best interest standard and the suitability standard are already similar. Mr. Berkowitz also expressed support for Mr. Hughes' comments that the states and federal regulators should work together.

1.16. The Working Group has apparently been led by those who oppose a true fiduciary standard down a path likely to lead the Working Group to be criticized for fraud, as the Working Group appeared to have followed the erroneous recommendations of the ACLI. The ACLI's recommendations were soundly criticized by the Working Group's consumer advocates:

> [T]he model proposed by ACLI fails to meet any of these key criteria. It fails to define the proposed best interest standard in a way that draws a clear distinction between best interest and suitability. In fact, the ACLI proposal specifically uses language drawn from FINRA guidance on its suitability standard to define best interest. The inference that ACLI is

[65] This last requirement looks not at the procedures undertaken, but rather casts view upon the transaction itself. It requires that, even if the previous steps are followed, at all times the proposed transaction must be and remain substantively fair to the client.

If an alternative exists which would result in a more favorable outcome to the client, this would be a material fact which would be required to be disclosed, and a client who truly understands the situation would likely never gratuitously make a gift to the advisor where the client would be, in essence, harmed. In the absence of integrity and fairness in a transaction between a fiduciary and the client or beneficiary, it will be set aside or held invalid. *Matter of Gordon v. Bialystoker Center and Bikur Cholim*, 45 N.Y. 2d 692, 698 (1978) (2006 WL 3016952 at *29). As stated by Professor Frankel, "if the bargain is highly unfair and unreasonable, the consent of the disadvantaged party is highly suspect. Experience demonstrates that people rarely agree to terms that are unfair and unreasonable with respect to their interests." Frankel, Tamar, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209.]

> advocating a standard that is no stronger than the existing suitability standard is reinforced by their failure to include any meaningful restrictions on conflicts of interest in its proposed approach. Instead, the ACLI proposal would give firms a choice of disclosing, managing, or avoiding conflicts. The predictable outcome is industrywide practice of addressing conflicts through disclosure alone, despite overwhelming evidence that such an approach is ineffective in protecting consumers from the harmful impact of conflicts.

"Comments of NAIC Consumer Representative and Consumer and Worker Advocates to the NAIC Annuity Suitability Working Group Regarding "Best Interest" Amendments to the NAIC Suitability in Annuity Transactions Model Regulation (dated July 31, 2017)

1.16.1. As noted in the "Comments of NAIC Consumer Representative and Consumer and Worker Advocates to the NAIC Annuity Suitability Working Group Regarding "Best Interest" Amendments to the NAIC Suitability in Annuity Transactions Model Regulation (dated July 31, 2017), "Relabeling "suitability" as 'best interest' would be a sham … a true best interest standard imposes a heightened obligation to eliminate or avoid conflicts of interest – obligations not present under the suitability standard." In its 11/24/17 proposal, the Working Group may not have provided these comments sufficient weight, for the Working Group apparently has yet to achieve a full understanding of the term "best interest" and its established utilization under the law.

1.17. Understanding How to Abide by a Bona Fide Fiduciary Duty of Loyalty When A Conflict of Interest is Present: *Disclosure Alone is Insufficient.*

1.17.1. Under the fiduciary duty of loyalty, as developed over centuries of case law, there is a duty to not possess a conflict of interest, and to not profit off of the client. In other words, fiduciaries owe the obligation to their client to not be in a position where there is a substantial possibility of conflict between self-interest and duty.[66] This is called the "no-conflict" rule, derived from English law. Fiduciaries also possess the obligation not to derive unauthorized profits from the fiduciary position. This is called the "no profit" rule, also derived from English law.[67]

1.17.2. If a conflict of interest is not avoided[68] and does exist, mere disclosure to the client of the conflict, followed by mere consent by a client to the breach of the fiduciary obligation, does not suffice.[69] Under the law, we state that this is not sufficient to create either a "waiver" of the client or to "estop" the client from pursuing a claim for breach of fiduciary duty. If this were the case, fiduciary obligations – even core obligations of the fiduciary – would be easily subject to waiver. Instead, to create an estoppel situation, preventing the client from later challenging the validity of the transaction that occurred, the fiduciary is required to undertake a series of steps.

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[66] *In the Matter of Dawson-Samberg Capital Management, Inc., now known as Dawson-Giammalva Capital Management, Inc. and Judith A. Mack*, Advisers Act Release No. 1889 (August 3, 2000), citing *SEC v. Capital Gains Research Bureau*, 375 U.S. at 191-92.

[67] *See* Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Release Nos. 34-58264; IC-28345 (July 30, 2008), at 23: "Second, investment advisers, as fiduciaries, generally are prohibited from receiving any benefit from the use of fund assets …."

[68] "Avoidance is perhaps the best solution to conflict situations. Persons having a duty to exercise judgment in the interest of another must avoid situations in which their interests pose an actual or potential threat to the reliability of their judgment. Although avoidance of conflict situations is an important duty of decision-makers, a flat prescription to avoid all conflicts of interest is not only mistaken, but also unworkable. On the one hand, not all conflicts of interest are avoidable. Some conflict situations are embedded in the relation, while others occur independently of decision-maker's will." Fiduciary Duties and Conflicts of Interest: An Inter-Disciplinary Approach (2005), at p.20, available at http://eale.org/content/uploads/2015/08/fiduciary-duties-and-conflicts-of-interestaugust05.pdf.

[69] "[D]isclosure is an effective response if it does not affect the decision-maker's judgment process and if the beneficiary is able to correct adequately for that biasing influence. Psychological research shows that neither of these conditions may be met. Sometimes both parties may be worse off following disclosure." *Id., citing* Daylian M. Cain, George Loewenstein, and Don A. Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest" (2005) 34 Journal of Legal Studies 1 at 3.

1.17.3. First, disclosure of all material facts to the client must occur. [For some commentators on the fiduciary obligations of investment advisers, they err is stating that this is all that is required. Often this erroneous conclusion is derived from wishful misinterpretations of the landmark decision of *SEC v. Capital Gains Research Bureau*[70] and is also contrary to established SEC precedent[71].]

1.17.4. Second, the disclosure must be affirmatively made and timely undertaken. In a fiduciary relationship, the client's "duty of inquiry" and the client's "duty to read" are limited; the burden of ensuring disclosure is received is largely borne by the fiduciary. Disclosure must also occur in advance of the contemplated transaction. For example, when a conflict of interest is present, disclosure via receipt of a prospectus following a transaction is insufficient, as this does not constitute timely disclosure.[72]

1.17.5. Third, the disclosure must lead to the client's understanding. The fiduciary must be aware of the client's capacity to understand, and match the extent and form of the disclosure to the client's knowledge base and cognitive abilities.[73]

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[70] In this case, the only requirement that the SEC focused on was disclosure. While the U.S. Supreme Court stated that disclosure of the conflict was required, the Court also indicated that more was required.

[71] 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, *the adviser's fiduciary duties are not discharged merely by such disclosure and consent*." *Rocky Mountain Financial Planning, Inc*. (pub. avail. March 28, 1983). [*Emphasis added*.]

[72] As stated in an early decision by the U.S. Securities and Exchange Commission: "[We] may point out that no hard and fast rule can be set down as to an appropriate method for registrant to disclose the fact that she proposes to deal on her own account. The method and extent of disclosure depends upon the particular client involved. The investor who is not familiar with the practices of the securities business requires a more extensive explanation than the informed investor. The explanation must be such, however, that *the particular client is clearly advised and understands* before the completion of each transaction that registrant proposes to sell her own securities." [*Emphasis added.*] *In re the Matter of Arleen Hughes*, SEC Release No. 4048 (1948).

The burden of affirmative disclosure rests with the professional advisor; constructive notice is insufficient. *See also British Airways, PLC v. Port Authority of N.Y. and N.J*., 862 F.Supp. 889, 900 (E.D.N.Y.1994) (stating that the burden is on the client's attorney to fully inform and obtain consent from the client); *Kabi Pharmacia AB v. Alcon Surgical, Inc*., 803 F.Supp. 957, 963 (D.Del.1992) (stating that evidence of the client's constructive knowledge of a conflict would not be sufficient to satisfy the attorney's consultation duty); *Manoir-Electroalloys Corp. v. Amalloy Corp*., 711 F.Supp. 188, 195 (D.N.J.1989) ("Constructive notice of the pertinent facts is not sufficient."). A client of a fiduciary is not responsible for recognizing the conflict and stating his or her lack of consent in order to avoid waiver. *Manoir-Electroalloys*, 711 F.Supp. at 195.

The duty to disclose is an affirmative one and rests with the advisor alone. Clients do not generally possess a duty of inquiry. "The [SEC} Staff believes that it is the firm's responsibility—not the customers'—to reasonably ensure that any material conflicts of interest are fully, fairly and clearly disclosed so that investors may fully understand them." *See, e.g.,* SEC's "Staff Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (Jan. 21, 2011), p.117.

[73] *See, e.g.,* Julia Smith, Out with "TCF" and in with "fiduciary"?, Butterworths Journal of International Banking and Financial Law (June 2012), P.344 [U.K.] ["In order to obtain B's fully informed consent: A must make full and frank disclosure of all material facts which might affect B's consent (*New Zealand Netherlands Society Oranje Inc v Kuys* [1973] 1 WLR 1126 at 1132) and the extent of disclosure required depends upon the sophistication and intelligence of B (*Farah Construction Pty Ltd v Say-Dee Pty Ltd* [2007] HCA 22 at [107] to [108]). A must disclose the nature as well as the existence of the conflict (*Wrexham Assoc Football Club Ltd v Crucialmove Ltd* [2007] BCC 139 at [39]).] The burden of establishing informed consent lies on the fiduciary (*Cobbetts LLP v Hodge* [2009] EWHC 786).

Consent is only informed if the client has the ability to fully understand and evaluate the information. For example, many complex products (such as CMOs, structured products, options, security futures, margin trading strategies, alternative investments and the like) are appropriate only for sophisticated and experienced investors. It is not sufficient for a firm or an investment professional to make full disclosure of potential conflicts of interest with respect to such products. *The firm and the investment professional must make a reasonable judgment that the client is fully able to understand and evaluate the product and the potential conflicts of interest that the transaction presents*. Fiduciary law reposes this burden – to ensure client understanding - on the advisor / fiduciary. It is <u>not</u> the client's responsibility.

1.17.6. Fourth, the intelligent, independent and informed consent of the client must be affirmatively secured.[74] Silence is not consent. Also, consent cannot be obtained through coercion nor sales pressure.[75]

1.17.7. Fifth, at all times, the transaction must be substantively fair to the client. If an alternative exists which would result in a more favorable outcome to the client, this would be a material fact which would be required to be disclosed, and a client who truly understands the situation would likely never gratuitously make a gift to the advisor where the client would be, in essence, harmed.

1.17.8. These requirements of the common law are derived from judicial decisions over hundreds of years.[76] While these requirements are strict,[77] they are intentionally so. The strict fiduciary duties aim to prevent or protect against the disease of temptation.

1.18. Why is Disclosure So Ineffective as a Means of Consumer Protection?

1.18.1. The fiduciary standard exists because for centuries jurists have understood that fiduciary status must exist in certain relationships in order to mitigate the chance of harm. In more recent years academic research has revealed the limits of disclosure, as well as disclosure's perverse effects.

1.18.2. Academic researchers have long known that emotional biases limit consumers' ability to close the substantial knowledge gap between advisors and their clients. Insights from behavioral science further 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 this information can be used effectively. This is in large part due to many behavioral biases that limit the effectiveness of any form of disclosure.

1.18.3. Note as well that, as Professor Robert Prentice has written, "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."[78]

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[74] The consent of the client must be "intelligent, independent and informed." Generally, "fiduciary law protects the [client] by obligating the fiduciary to disclose all material facts, requiring an *intelligent, independent consent* from the [client], a substantively fair arrangement, or both." Frankel, Tamar, Fiduciary Law, 71 Calif. L. Rev. 795 (1983). [*Emphasis added*.]

[75] There must be no coercion for the informed consent to be effective. The "voluntariness of an apparent consent to an unfair transaction could be a lingering suspicion that generally, when entrustors consent to waive fiduciary duties (especially if they do not receive value in return) the transformation to a contract mode from a fiduciary mode was not fully achieved. Entrustors, like all people, are not always quick to recognize role changes, and they may continue to rely on their fiduciaries, even if warned not to do so." Tamar Frankel, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209.

[76] *See, e.g.*, Sitkoff, Robert H., The Fiduciary Obligations of Financial Advisors under the law of Agency, available at http://www.thefiduciaryinstitute.org/wp-content/uploads/2013/07/Robert-H-Sitkoff.pdf ["The common law of agency imposes fiduciary duties of loyalty, care, and a host of subsidiary rules that reinforce and give meaning to the broad standards of loyalty and care as applied to specific circumstances …."] *See also*, *e.g., Restatement (Third) of Agency* §8.06 & *cmts. b, c* (2006).

[77] The procedures for resolving conflicts of interest vary depending upon the nature of the fiduciary relationship. For example, in the context of business partnerships, contracting out of certain fiduciary obligations might be permitted, as both parties are usually believed to be sophisticated (or, at least, wise enough to secure legal counsel to assist in the negotiation of partnership agreements). An employee is an agent (fiduciary) to his or her employer, yet it is the employer – not the fiduciary – in such instance who likely possesses the greater knowledge and sophistication; hence, notice to the employer of conflicts of interest the employee may possess may be all that is required. In contrast, the fiduciary duty is applied much more strictly when the knowledge and expertise of the parties is usually vastly different, such as in the case of a trustee and the beneficiary of the trust. Contrasted with trustees, the fiduciary duty of loyalty is required somewhat less strictly when the fiduciary is an attorney or investment adviser; but the application of fiduciary duties is much more stringent than in the case of business partners or employees acting in fiduciary capacities. "Although one can identify common core principles of fiduciary obligation, these principles apply with greater or lesser force in different contexts involving different types of parties and relationships." Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, Duke L.J. 879 (1988).

[78] 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

1.18.4. Moreover, as observed by Professors Stephen J. Choi and A.C. Pritchard, "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."[79]

1.18.5. As a result, much of the training of registered representatives involves how to establish a relationship of trust and confidence with the client. Once a relationship of trust is formed, customers will generally accede to the recommendations made by the registered representative, even when that recommendation is adverse to the customers' best interests.

1.18.6. The SEC'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[80] the details of disclosure documents that regulation delivers. However, under 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[81] and lack of knowledge of our complicated financial markets, to comprehend the disclosures provided, yet alone undertake sound investment decision-making.

1.18.7. As stated by Professor (and former 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."[82]

1.18.8. Other 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 …."[83]

1.18.9. 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

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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).

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

[80] 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 ….").

[81] 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).

[82] Parades at p.3.

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

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."[84]

1.18.10. We must acknowledge that, if disclosures were effective, fiduciary law would not exist. There would be no fiduciary duties imposed upon trustees, or attorneys, or others in a relationship of trust and confidence with their entrustor in which a substantial difference in either power or knowledge exists. Fiduciary duties are imposed because disclosures are effective. And this fiduciary standard must not be permitted to be weakened and to become a disclosure-only standard, as this would upend centuries of jurisprudence.

2. **The use of the term "best interests" in the regulation could lead to a finding of fiduciary status for insurance producers (brokers/agents) under general principles of state common law, exposing them to a higher duty of due care, loyalty and utmost good faith and the potential liability resulting therefrom.**

2.1. The broad fiduciary duties of a broker or insurance agent toward his or her customer are more likely to be found by courts when a *confidential relation* exists, as may occur when personalized investment advice is provided. In the United States, our state courts have long applied broad fiduciary duties upon those in relationships of "trust and confidence" with entrustors. As stated by one early 20th Century court:

> In equity the court looks to the relationship of the parties -- the reliance, the dependence of one upon the other. Where a relationship of confidence is shown to exist, where trust is justifiably reposed, equity scrutinizes the transaction with a jealous eye; it exacts the utmost good faith in the dealings between the parties, and is ever alert to guard against unfair advantage being taken by the one trusted.[85]

2.2. Under state common law it has long been recognized that the use of a title denoting an advisory role is a significant factor in determining that fiduciary status exists – even for insurance agents.

2.2.1. *Koehler, 1985*. A U.S. District Court in 1985 held that a fiduciary relationship existed in part because of a defendant's status as financial planner to a client. In *Koehler v. Pulvers*, 614 F. Supp. 829 (USDC, Cal, 1985) the defendant, CSCC, was primarily in the business of real estate syndication, but also in business under the name Creative Financial Planning. As stated in the decision, "The developer defendants obtained investment capital from the public by posing as financial planners ... The financial planners typically had a background in either insurance or real estate sales … As an alleged financial planning company, CSCC, dba Creative Financial Planners, contacted potential investors by conducting Creative Financial Planning seminars open to the public. Utilizing a slick presentation… CSCC attempted to lure investment capital out of savings accounts, home equity, insurance policies, and other conservative investment vehicles and into the speculative real estate ventures it controlled … At the seminars, CSCC offered to draft a 'Coordinated Financial Plan' for attendees at little or no charge. Individuals who accepted this offer received recommendations to purchase limited partnership or trust deed interests in CSCC controlled partnerships and project ...." The court also noted, "Most of the plaintiffs are and were unsophisticated investors. Few had a preexisting relationship with the developer defendants at the time they purchased their securities ... [the investors] relied upon the misrepresentations discussed in detail below. This reliance was reasonable in part because of the developer defendants' purported disinterested financial planner status."

2.2.2. *Cunningham (1990).* Insurance agents who introduced themselves as "investment counselors or enrollers" and who tailored retirement plans for each person depending on the individual's financial position, and who led the customers to believe that an investment plan was being drafted for each

[84] 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).

[85] *Jothann v. Irving Trust Company*, 151 Misc. 107; 270 N.Y.S. 721, *citing Wendt v. Fischer*, 215 A.D. 196; 213 N.Y.S. 351 (1926).

customer according to each customer's needs, was held by a federal court, apply Iowa state common law, to lead to the possible imposition of fiduciary status. *Cunningham vs. PLI Life Insurance Company*, 42 F.Supp.2d 872 (1990).

2.2.3. *Mathias (2002).* "In the fall of 1985, plaintiff, having recently divorced and relocated to Columbus, Ohio, sought investment advice from Thomas J. Rosser. At the time, Rosser was a licensed salesman for Great Lakes Securities Company and held himself out as a financial advisor … [T]he evidence established that Rosser was a licensed stockbroker and held himself out as a financial advisor, and that plaintiff was an unsophisticated investor who sought investment advice from Rosser precisely because of his alleged expertise as a broker and investment advisor. Further, Rosser testified that plaintiff had relied upon his experience, knowledge, and expertise in seeking his advice. Therefore, we conclude that plaintiff presented sufficient evidence to establish that she and Rosser were in a fiduciary relationship." *Mathias v. Rosser*, 2002 OH 2531 (OHCA, 2002). The court further noted, that under Ohio law, a fiduciary relationship is "a relationship in which one party to the relationship places a special confidence and trust in the integrity and fidelity of the other party to the relationship, and there is a resulting position of superiority or influence, acquired by virtue of the special trust." *Id.*

2.2.4. *Williams (2006).* In a case arising from Oregon, a self-employed insurance seller and licensed financial planner took advantage of his position as a financial advisor to gain the trust of an 87-year-old man, Stubbs, convincing the elderly man to grant him a power of attorney, with which the financial planner stole about $400,000. The court held that the licensed financial planner was employed as a fiduciary, specifically noting that the elderly man relied upon the fiduciary as a financial advisor and estate planner. *U.S. v. Williams*, 441 F.3d 716, 724 (9th Cir. 2006).

2.2.5. *Hatleberg (2005).* When a bank held out as either an "investment planner," "financial planner," or "financial advisor," the Wisconsin Supreme Court held that a fiduciary duty may arise in such circumstances. *Hatleberg v. Norwest Bank Wisconsin*, 2005 WI 109, 700 N.W.2d 15 (WI, 2005).

2.2.6. *Graben (2007).* A dual registrant crossed the line in "holding out" as a financial advisor, and in stating that ongoing advice would be provided, and other representations, and in so doing the dual registrant, who sold a variable annuity, and was found to have formed a relationship of trust and confidence with the customers to which fiduciary status attached. "Obviously, when a person such as Hutton is acting as a financial advisor, that role extends well beyond a simple arms'-length business transaction. An unsophisticated investor is necessarily entrusting his funds to one who is representing that he will place the funds in a suitable investment and manage the funds appropriately for the benefit of his investor/entrustor. The relationship goes well beyond a traditional arms'-length business transaction that provides 'mutual benefit' for both parties." *Western Reserve Life Assurance Company of Ohio vs. Graben*, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007).

3. **NAIC should take care to not mix two relationships under the law that so many jurists and commentators have opined simply cannot be reconciled: the fiduciary-entrustor relationship and the salesperson-customer relationship.**

3.1. If the seller of an insurance or annuity product were to represent that she or he was "acting in the best interests" of the client, such a representation could be a significant factor in deciding that a fiduciary relationship exists under state common law. *See Yenchi vs. Ameriprise Financial, Inc.,*161 A.3d 811; 2017 Pa. LEXIS 1405 (Sup.Ct. Pa. 2017) (wherein an insurance agent sold a whole life insurance product to a customer, and the court expressly noted – in finding that no fiduciary status existed - that the insurance agent never represented to the customer that he would act in the customer's "best interests"). Similarly, if a representation is made by an insurance agent that she/he is to act in the customer's "best interests," it would follow that this representation would lead to the imposition of fiduciary status under state common law; in addition, such a representation could give rise to contractual liability, as an agreed-upon term of a contract, or could form the basis for liability under common law (actual) fraud.

3.2. "The obligation of loyalty [understood as the obligation to act with the proper motive] is irreducible and cannot be put on a scale. It applies, or it does not, to a particular decision."[86]

3.3. The sale of an annuity product, especially in circumstances where the salesperson has limited offerings and/or is otherwise incapable of discharging her or his duty to undertake "a thorough, careful, and impartial investigation focused on the best interests of" the entrustor (client). *Donovan v. Bierwirth*, 680 F.2d 263, at 271-72, 276 (2d Cir. 1982) The existence of restrictions on a captive insurance agent that effectively prohibit such an investigation to proceed, in order to make a recommendation to the client that is in the client's best interests, is incompatible with the fiduciary relationship and would require the insurance agent to withdraw from the engagement. *See Leigh v. Engle*, 727 F.2d 113, 125 (7th Cir. 1984) ("Where the potential for conflicts is substantial, it may be virtually impossible for fiduciaries to discharge their duties with an 'eye single' to the interests of the beneficiaries …").

3.4. As the Virginia Supreme Court long ago stated: "It is well settled as a general principle, that trustees, agents, auctioneers, and all persons acting in a confidential character, are disqualified from purchasing. The characters of buyer and seller are incompatible, and cannot safely be exercised by the same person. *Emptor emit quam minimo potest; venditor vendit quam maximo potest*. The disqualification rests, as was strongly observed in the [English] case of the *York Buildings Company v. M'Kenzie*, 8 Bro. Parl. Cas. 63, on no other than that principle which dictates that a person cannot be both judge and party. No man can serve two masters. He that it interested with the interests of others, cannot be allowed to make the business an object of interest to himself; for, the frailty of our nature is such, that the power will too readily beget the inclination to serve our own interests at the expense of those who have trusted us."[87]

3.5. The observation that a person cannot wear two hats and continue to adhere to his or her fiduciary duties was echoed early on by the U.S. Supreme Court, "The two characters of buyer and seller are inconsistent."[88] The U.S. Supreme Court also observed: "If persons having a confidential character were permitted to avail themselves of any knowledge acquired in that capacity, they might be induced to conceal their information, and not to exercise it for the benefit of the persons relying upon their integrity. The characters are inconsistent."[89]

3.6. Why should an advisor not attempt to wear two hats? Simply put, because persons are weak. Economic incentives matter a great deal, and drive a person's actual conduct. Persons are simply unable to not have their advice be affected by the economic temptations (such as for additional compensation) that might exist. As the U.S. Supreme Court opined in its landmark 1963 decision, *SEC vs. Capital Gains Research Bureau*, "the rule … includes within its purpose the removal of any temptation to violate them …This Court, in discussing conflicts of interest, has said: 'The reason of the rule inhibiting a party who occupies confidential and fiduciary relations toward another from assuming antagonistic positions to his principal in matters involving the subject matter of the trust is sometimes said to rest in a sound public policy, but it

[86] Lionel Smith, "The Motive Not the Deed", in *Rationalizing Property, Equity, and Trusts: Essays in Honour of Edward Burn* (London: LexisNexis UK, 2003) 53 at 77.

[87] *See, e.g., Carter v. Harris*, 25 Va. 199, 204; (Va. 826). The U.S. common law is derived from the laws of England, which law continues to influence the development of U.S. law. In the cited early case, the English court stated: "the rule [prohibiting one from acting as both fiduciary and seller] was founded in reason and nature, and prevailed wherever any well-regulated administration of justice was known; that the disability rested on the principle which dictated that a person cannot be both judge and party, and serve two masters; that he who is intrusted with the interest of others, cannot be allowed to make the business an object to himself, because, from the frailty of human nature, one who has power will be too readily seized with an inclination to serve his own interest at the expense of those for whom he is intrusted; that the danger of temptation does, out of the mere necessity of the case, work a disqualification " nothing less than incapacity being able to shut the door against temptation, when the danger is imminent and the security against discovery great; that the wise policy of the law had therefore put the sting of disability into the temptation, as a defensive weapon against the strength of the danger which lies in the situation; that the parts which the buyer and seller have to act, stand in direct opposition to each other in point of interest; and this conflict of interest is the rock, for shunning which the disability has obtained its force, by making that person who has the one part intrusted to him, incapable of acting on the other side."

[88] *Wormley v. Wormley*, 21 U.S. 421; 5 L. Ed. 651; 1823 U.S. LEXIS 290; 8 Wheat. 421 (1823).

[89] *Michoud v. Girod*, 45 U.S. 503; 11 L. Ed. 1076; 1846 U.S. LEXIS 412; 4 HOW 503 (1846).

also is justified in a recognition of the authoritative declaration that no man can serve two masters; and considering that human nature must be dealt with, the rule does not stop with actual violations of such trust relations, but includes within its purpose the removal of any temptation to violate them … we [previously] said: 'The objection … rests in their tendency, not in what was done in the particular case … The court will not inquire what was done. If that should be improper it probably would be hidden and would not appear.'"[90]

4. **NAIC's use of the term "best interests" could potentially amount to the NAIC's endorsement of fraud.**

4.1. The use of the term "best interests" implies duties encompassing due care, loyalty, honesty and integrity, and should not be utilized lightly. Nor should the term "best interests" be utilized as puffery. As Judge Paul Crotty recently cautioned: "Goldman's arguments in this respect are Orwellian. Words such as 'honesty,' 'integrity,' and 'fair dealing' apparently [in Goldman's eyes] do not mean what they say; [Goldman says] they do not set standards; they are mere shibboleths. If Goldman's claim of 'honesty' and 'integrity' are simply puffery, the world of finance may be in more trouble than we recognize."[91]

4.2. When we are dealing with the fiduciary standard of conduct, and its requirement that the fiduciary act in the "best interests" of the entrustor (client), we should not accept half-truths and deception. If the fiduciary standard is to possess meaning, we must hold firms and persons accountable to their words, and not regard these important words as mere "puffery."

4.3. Should an insurance producer be permitted to hold out as acting in the customer's "best interest" but then be permitted to offer biased advice would be tantamount to fraud. As stated by Professors James Angel and Douglas McCabe: "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."[92]

4.4. The NAIC's improper use of the term "best interests" may well lead to an inadvertent government endorsement of, or the undertaking of, fraudulent misrepresentation. Section 525 of the Restatement (Second) of Torts provides the general rule for fraudulent misrepresentation: "One who fraudulently makes a misrepresentation of fact, opinion, intention, or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation."

To prove common law fraud in most states, the plaintiff must show that:

- the defendant made a material false representation or failed to communicate a material fact, which had the effect of falsifying statements actually made
- the defendant did this intentionally (the defendant knew that the representation or omission constituted a falsehood) or recklessly (the defendant made the representation without regard to whether it was true or false)
- the defendant intended that the plaintiff act on it
- the plaintiff did, in fact, rely on the representation or omission to his or her detriment.

A representation is material if either a substantial likelihood exists that a reasonable person would attach importance to it in making a decision or the person who made the representation has reason to know that the plaintiff is likely to regard it as important in making a decision, even though a reasonable person would not so regard it.

[90] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180; 84 S. Ct. 275; 11 L. Ed. 2d 237; 1963 U.S. LEXIS 2446 (1963) (citations omitted).

[91] Judge Paul Crotty in *Richman v. Goldman Sachs Group, Inc*., 868 F. Supp. 2d 261 (S.D.N.Y. 2012).

[92] James J. Angel, Ph.D., CFA and Douglas McCabe Ph.D., "Ethical Standards for Stockbrokers: Fiduciary or Suitability?" (Sept. 30, 2010). Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1686756.

Fraudulent misrepresentation by omission may be actionable if the defendant has a duty to the plaintiff to disclose material facts and fails to do so, and if this failure results in a false impression being conveyed to the plaintiff.

4.5. This is a brazen, unjustified attempt by lobbyists to redefine the English language. As discussed previously, the move by lobbying organizations SIFMA, FSI, and NAIFA to promote a new "best interests standard" is nothing more than a brazen, and somewhat bizarre, attempt to usurp the common understanding of both lay persons, as well as practitioners, attorneys, and jurists, by a wholly unjustified and imminently harmful redefinition of the term "best interests."

4.6. The use of the term "best interests" to describe a standard of conduct that falls far short of the fiduciary obligation would amount to fraud, as all of the elements of fraud would be present:

- a material false representation of a material fact (by falsely advancing the belief that an insurance producer would act in the customer's "best interest," even though no reliance can actually be placed upon the insurance producer by the customer, and the relationship remains an arms-length relationship, not a bona fide fiduciary relationship under the law);
- intentionally made (to enhance the marketing and promotion of insurance producer's products);
- with the intention that consumers act upon it (through reliance, upon the insurance producer, to the detriment of the consumer);
- leading to such actual reliance on the misrepresentation.

All the elements of intentional misrepresentation – *i.e.,* actual fraud, are present.

Moreover, when a definition is not present in the statute, "the plain and ordinary meaning is derived from the dictionary." *Cox v. Dir. Of Revenue*, 98 S.W.3d 548, 550 (Mo. banc 2003). "Fraud" is defined as "[a] knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment." *Black's Law Dictionary* 731 (9th ed. 2009). "Deceit" is defined as "[t]he act of intentionally giving a false impression." *Id.* at 465. It is also defined as "[a] false statement of fact made by a person knowingly or recklessly with the intent that someone else will act upon it."

Neither NAIC nor its Working Group should be a participant in, nor an endorser of, such fraudulent activity.

4.7. The draft regulation, if adopted by a state as a regulation, may well violate state securities laws and/or other consumer protection laws which prohibit deceit and fraud. For example, Missouri securities legislation makes it unlawful for persons to engage in practices or a course of business that "operates or would operate as fraud or deceit." § 409.5-502(a) (emphasis added); cf. 17 C.F.R. § 240.10b-5(c). This language "quite plainly focuses upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible."[93] This same approach has been followed in other states.[94]

5. **The use of the term "advisor" in the regulation implies a relationship of trust and confidence between an insurance producer and customer, when in fact none exists the vast majority of the time.**

5.1. In its proposed regulation, the Working Group uses the term "advisor" to describe an insurance producer. This is ill-advised and misleading to consumers.

5.2. It is no secret that, over the years, the brokerage industry and insurance agents have morphed away from the use of the traditional "stockbroker" or "registered representative" titles and toward those titles that emphasize that an advisory relationship exists, such as "financial advisor" or "wealth manager" and "estate planner." Hence, it is not surprising that typical investors are confused about the nature of the services offered by their financial professionals. In survey after survey, consumers have indicated that they do not understand the key distinctions between investment advisers and broker-dealers: their duties, the

[93] *Aaron v. Sec. & Exch. Comm*'n, 446 U.S. 680, 697, 100 S.Ct. 1945, 1955, 64 L.Ed.2d 611 (1980).

[94] *See, e.g., Secretary of State v. Tretiak*, 22 P.3d 1134, 1141 (Nev.2001).

services they offer, or Consumers attribute their confusion in large part to the brokers' use of titles such as "financial advisor" and "financial consultant." This confusion is exacerbated by advertisements from broker-dealer firms, such as those that claim:

> "Our Clients' Interests Always Come First"[95]
>
> "Our financial advisors are committed to putting your investing needs, wants and priorities first."[96]
>
> "We address every dimension of your life and your goals—investments, business, passion and legacy—to develop a plan that's truly personalized for you. It's precisely what you need today, and always. Advice. Beyond investing."[97]

5.3. <u>The SEC long cautioned broker-dealer firms to not disguise their merchandizing role.</u>

5.3.1. The SEC itself has long been aware that the public is confused by use of confusing titles, including a thorough study of the issue in 2008.[98] As this and many other studies clearly indicate, there is no doubt that the vast majority of the public has been left confused as to the role of their "financial advisor" – with whom consumers are entrusting their life savings.[99] In fact, in previous decades the SEC strongly cautioned brokerage firms against the use of titles or other forms or promotion or advertising that might mislead investors.

5.3.2. For example, very early on the SEC took a hard line on representations made by brokers. In its 1940 Annual Report, the U.S. Securities and Exchange Commission noted: "If the transaction is in reality an arm's-length transaction between the securities house and its customer, then the securities house is not subject' to 'fiduciary duty. However, the necessity for a transaction to be really at arm's-length in order to escape fiduciary obligations, has been well stated by the United States. Court of Appeals for the District of Columbia in a recently decided case: '[T]he old line should be held fast which marks off the obligation of confidence and conscience from the temptation induced by self-interest. He who would deal at arm's length must stand at arm's length. *And he must do so openly as an adversary, not disguised as confidant and protector*. He cannot commingle his trusteeship with merchandizing on his own account…'"[100] [*Emphasis added.*]

5.3.3. Again, in its 1963 comprehensive report on the securities industry, the SEC also stated that it had "held that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship exists, imposing a particular duty to act in the customer's best interests and to disclose any interest the broker-dealer may have in transactions he effects for his customer … *[broker-dealer advertising] may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business* … Where the relationship

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[95] The first "Business Principal" of Goldman Sachs, from their web site, retrieved Dec. 22, 2017.

[96] Merrill Lynch web site, retrieved Dec. 22, 2017.

[97] UBS web site, retrieved Dec. 22, 2017.

[98] In 2008 the RAND Study reported: "Even after being presented with fact sheets, [survey] participants were confused by the different titles. They noted that the common job titles for investment advisers and broker-dealers are so similar that people can easily get confused over the type of professional with which they are working." Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, and Farrukh Suvankulov of the RAND Corporation, "*Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*," at p.111. This Rand Study was sponsored by the United States Securities and Exchange Commission,

[99] "Many find the standards of care confusing, and are uncertain about the meaning of the various titles and designations used by investment advisers and broker-dealers. Many expect that both investment advisers and broker-dealers are obligated to act in the investors' best interests. The Commission has sponsored studies of investor understanding of the roles, duties and obligations of investment advisers and broker-dealers that similarly reflect confusion by retail investors regarding the roles, titles, and legal obligations of investment advisers and broker-dealers …" SEC Staff, "Study on Investment Advisers and Broker-Dealers (As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act)" (January 2011).

[100] Seventh Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1941, at p. 158, citing *Earll v. Picken* (1940) 113 F. 2d 150.

between the customer and broker is such that the former relies in whole or in part on the advice and recommendations of the latter, the salesman is, in effect, an investment adviser, and some of the aspects of a fiduciary relationship arise between the parties." [*Emphasis added*.][101]

5.3.4. Yet, and despite the substantial authority already existing (under previous SEC pronouncements, as well as case law), in 2005 the SEC, in the ill-fated "Merrill Lynch Rule" final rule (subsequently overturned by the courts on other grounds), declined to police the use of titles by non-fiduciaries. The SEC stated, in its 2005 issuing release:

> [W]e share the concern that there is confusion about the differences between broker-dealers and investment advisers, and … we believe that some of that confusion may be a result of broker dealer marketing (including the titles broker-dealers use) … We have decided not to include in rule 202(a)(11)-1 any other limitations on how a broker-dealer may hold itself out or titles it may employ without complying with the Advisers Act."[102]

5.3.5. However, despite the 2005 pronouncement above, those at the SEC have continued to note the problems caused by the inappropriate use of titles. In 2012 the SEC Investor Advisor Committee highlighted this problem, stating: "In addition, many broker-dealers use titles such as financial adviser for their registered representatives and market themselves in ways that highlight the advisory aspect of their services … Although they are subtler and more difficult to measure, than the harm that results from outright fraud, these types of harm can nonetheless have a significant impact on investors' financial well-being."[103] From discussions this author has had recently with SEC staff, it appears that the SEC is again looking at the utilization of, and deceptive nature of, titles.

5.4. <u>Under state common law, the use of titles that denote a relationship of trust and confidence is a significant factor in finding that fiduciary status exists.</u> See discussion in section 3, above.

5.5. <u>The NAIC should instead act to limit the use of titles that denote a relationship of trust and confidence.</u>

5.5.1. Terms such as ''financial advisor'' and ''financial consultant'' are among the many generic terms that describe what various persons in the financial services industry do, including banks, trust companies, insurance companies, and commodity professionals." Therein, as highlighted in the 2008 Rand Study and the 2012 Investment Advisor Committee report, lies the problem. *The broad-scale use of misleading titles does not justify their continued usage.*

5.5.2. Separate studies by the Public Investors Arbitration Bar Association (PIABA) released in March 2015 ("Major Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of A Fiduciary Duty") and by the Consumer Federation of America released in January 2017 ("Financial Advisor or Investment Salesperson: Brokers and Insurers Want to Have it Both Ways") show that while many organizations market themselves to the public as trusted 'advisors' or related terms, it is a different story when it comes to defending that position in arbitration hearings. In that context, suddenly they are just salespersons and owe the client no fiduciary duty.

5.5.3. Appropriate titles for use by non-fiduciary insurance producers could range from "salesperson" to "broker" to "insurance agent" but may not include terms that suggest a level of advice beyond that of stimulating the sale of product.

5.5.4. It is appropriate to require this simple statement of responsibility: "Say what you do; do what you say."

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[101] 1963 SEC Study, citing various SEC Releases.

[102] SEC Release No. 34-51523, IA-2376: Certain Broker-Dealers Deemed Not To Be Investment Advisers (Apr. 12, 2005). This rule set forth above, contained in its rule-making (which rule was subsequently overturned by the U.S. Court of Appeals, D.C. Circuit. *Financial Planning Ass'n vs. SEC*, Case No.04-1242 (March 30, 2007), in which the court found: "By seeking to exempt broker-dealers beyond those who receive only brokerage commissions for investment advice, the SEC has promulgated a final rule that is in direct conflict with both the statutory text and the Committee Reports."

[103] "(Draft) Recommendation of the Investor as Purchaser Subcommittee Broker-Dealer Fiduciary Duty," available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation.pdf.

5.5.5. If a person uses a title denoting a relationship of trust and confidence – i.e., a *fiduciary relationship* – without accepting at all times the fiduciary duties which flow therefrom, that person should be held to account. The use of such a title in such instances is a misrepresentation; it is a title that is designed to mislead the consumer. And the use of such title is intentional – it is designed to result in a commercial advantage to the user of the title. There is another name for "intentional misrepresentation" under the law – "fraud."

6. **The disclosure of the specific amount of cash compensation should be broadened to all annuity sales, not be limited to those instances wherein insurance producers receive above three (3) percent of the amount invested, and should be stated in dollar terms and in writing to the customer.**

6.1. For example, a 2.75% commission for a $1,000,000 investment in an equity-indexed annuity is $27,500. Such compensation is material and should be disclosed.

6.2. As explained above, fees and costs matter. Investors in fixed-rate annuities and fixed indexed annuities should be informed of the amount of cash compensation received by any insurance broker, agent, or other intermediary, prior to the purchase thereof.

7. **In no event should the regulation restrain the use of "best interests" by limiting the obligation through specific rules stated that producers need not recommend the least expensive annuity or the annuity with a higher payout rate. The regulation should not seek to confine the fiduciary obligation to the effect that there is no obligation to recommend the "best" annuity available in the marketplace. These restraints are not reflective of the overwhelming academic research in this area concluding that fees and costs matter a great deal to investment returns. Moreover, the regulation's language is an ill-advised attempt to provide a rules-based regulatory restriction upon the principles-based broad fiduciary duty of due care, for those who are fiduciaries.**

7.1. A person obligated to act in the best interests (i.e., as a fiduciary) of another should not be able to abdicate responsibility for complying with the requirement to undertake a reasonable investigation of available products in the marketplace, when providing advice.

7.2. The Working Group has been misled as to what the U.S. Department of Labor's recent regulations require. In its B.I.C.E. exemption imposes upon both firms and their advisers an extremely strong fiduciary duty of "loyalty" that *cannot* be disclaimed by the firm or advisor, nor waived by the client. Under B.I.C.E. and its Impartial Conduct Standards, recommendations must be undertaken to clients "without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party"[104] and in adherence to the dictates of the "prudent investor rule."

7.2.1. The DOL stated: "[F]or example, an Adviser, in choosing between two investments, could not select an investment because it is better for the Adviser's or Financial Institution's bottom line …."[105]

7.2.2. Moreover, neither the firm or adviser may seek to limit its liability by disclaiming their core fiduciary duty or loyalty, nor may the firm seek to have the client waive the fiduciary duties owed to the client.[106]

7.2.3. The DOL's Impartial Conduct Standards also incorporate, as part of a firm's and adviser's fiduciary duty of due care, the tough "prudent investor rule" (hereafter, "PIR").[107]

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[104] "The phrase 'without regard to' is a concise expression of ERISA's duty of loyalty, as expressed in section 404(a)(1)(A) of ERISA and applied in the context of advice." 81 Fed.Reg. 21,026 (April 8, 2016).

[105] 81 Fed.Reg. 21,027 (April 8, 2016).

[106] "Section II(f)(1) prohibits all exculpatory provisions disclaiming or otherwise limiting liability of the Adviser or Financial Institution for a violation of the [B.I.C.E.] contract's terms, and Section II(g)(5) prohibits Financial Institutions and Advisers from purporting to disclaim any responsibility or liability for any responsibility, obligation, or duty under Title I of ERISA to the extent the disclaimer would be prohibited by Section 410 of ERISA." 81 Fed.Reg. 21,042 (April 8, 2016).

[107] "[A] Financial Institution and Adviser act in the Best Interest of a Retirement Investor when they provide investment advice 'that reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with

7.2.3.1. The PIR has a decades-long history of interpretation, as it is the core of a trustee's duty to manage investment under trust law, and it is codified in most states as a version of the Uniform Prudent Investor Act.

7.2.3.2. The PIR requires the adviser to manage risk across the investor's portfolio, and to consider the risk and return objectives of the portfolio in making decisions. The duty to diversify investments and to avoid idiosyncratic risk is emphasized, in keeping with the findings of modern portfolio theory.

7.2.3.3. Additionally, under the PIR, the firm and adviser possess a duty avoid waste. In other words, there exists a duty to minimize the costs incurred by the client when determining which investment products to select. "[F]iduciaries … ordinarily have a duty to seek … the lowest level of risk and cost for a particular level of expected return."[108] In the particular context of mutual funds and other pooled investment vehicles, advisers must pay "special attention" to "sales charges, compensation, and other costs" and should "make careful overall cost comparisons, particularly among similar products of a specific type being considered for a … portfolio."[109] Put simply, "[w]asting [clients'] money is imprudent."[110]

7.2.4. As recognized by the U.S. Department of Labor, the preferred method of complying with one's fiduciary duty of loyalty is to seek, in advance of any investment recommendations, the client's agreement to a reasonable "level fee" arrangement. Such fee structures include asset-under-management fees, annual fixed fees, project-based fixed fees, hourly fees, subscription fees, and combinations thereof. After securing the client's agreement on fees, the adviser should not recommend any investment product that would provide the adviser with additional compensation, absent an agreement to offset other fees the adviser receives.

7.2.4.1. This is because, under state common law, a "fiduciary who receives compensation from an entity whose investment products the fiduciary recommends presumptively breaches the duty of loyalty … [T]he common law … tolerates authorized conflicts of interests, provided that the [adviser] acts fairly and in good faith in pursuit of the beneficiary's best interest."[111]

7.2.4.2. Unlike ERISA's statutory "sole interests" fiduciary standard (where conflicts of interest are prohibited), under B.I.C.E.'s "best interests" standard a conflict of interest is permitted to exist. Yet, even then, when additional fees are received by a firm then the conduct of the firm and adviser "will be subject to especially careful scrutiny."[112]

7.2.4.3. If additional fees and costs are received from the recommendation of a particular investment, such additional compensation is necessarily derived from the product's costs. And here's the rub … the academic research is strong and compelling - higher product fees and costs result, on average, in lower returns for investors.[113]

7.2.4.4. Hence, under B.I.C.E. the test for receipt of additional compensation is a tough one. "[A]n Adviser, in choosing between two investments, could not select an investment because it is

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like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.'" 81 Fed.Reg. 21,053 (April 8, 2016).

[108] *Restatement (Third) of Trusts* § 90 *cmt. f(1)*, at 308; see id. § 88 cmt. a, at 256 (trustee has "a duty to be cost-conscious").

[109] *Restatement (Third) of Trusts* § 90 *cmt. m*, at 332.

[110] *Uniform Prudent Investor Act* § 7 & *cmt.*, 7B U.L.A. 37 (2006).

[111] Schanzenbach, Max M. and Sitkoff, Robert H., Fiduciary Financial Advisers and the Incoherence of a 'High-Quality Low-Fee' Safe Harbor (September 16, 2015). Northwestern Law & Econ Research Paper No. 15-18. Available at http://ssrn.com/abstract=2661833, *citing see Restatement (Third) of Trusts* § 78 *cmt. c(2)*; Jesse Dukeminier & Robert H. Sitkoff, *Wills, Trusts, and Estates* 591, 593 (9th ed. 2013).

[112] *See Restatement (Third) of Trusts § 37 cmt. f(1)*; *see also* Dukeminier & Sitkoff, in footnote above, at 593.

[113] For a list of academic articles, please see Rhoades, Scholarly Financial Blog, "Part 3: Professional and Other Fees Matter" (Jan. 1, 2016), located at http://scholarfp.blogspot.com/2016/01/who-moved-my-cheese-future-of-financial_1.html

better for the Adviser's or Financial Institution's bottom line, even though it is a worse choice for the Retirement Investor."[114] Furthermore, under B.I.C.E. "full disclosure is not a defense to making an imprudent recommendation or favoring one's own interests at the Retirement Investor's expense."[115]

8. **Given the U.S. Congress' move to classify equity indexed annuities (also known as "fixed indexed annuities) (hereafter "EIAs") as insurance products, and given the existence of fixed-interest-rate deferred or immediate annuities ("fixed annuities"), and the ongoing utilization of these products as investments, particularly for retirees, the NAIC should consider regulation of how the products are recommended or sold. Such regulation might involve:**

   8.1. **A segregation of the roles of "insurance advisor" (fiduciary) versus "insurance salesperson," with appropriate regulation for each and separate and distinct titles for each.**

      8.1.1. Several of the states possess licensure for those who counsel on insurance needs and products for clients, as a fiduciary and representing the client, when these persons do not engage in product sales. The fiduciary role of an "insurance counselor" should be distinguished from that of an "insurance agent."

   8.2. **For insurance salespeople, the adoption of additional disclosure obligations, such as those contained in the proposed revisions to Model #275.**

      8.2.1. For example, given the low-interest rate environment currently (which may or may not persist, for many years or decades, under various economist projections, and which may persist for insurance companies as to their payout rates for some time given the long-term nature of their current bond holdings), and given that the past 25 years interest rates were on average much higher, and given that the returns of EIAs are often tied to the ability to utilize interest earned to purchase option contracts, additional disclosure obligations could be imposed on EIAs. For example, insurance producers might be required to illustrate: (a) the performance of the various accounts (tied to different indexes) over each of the past ten years; and (b) how such performance contrasts to any past performance illustrations provided by the producer to other customers.

      8.2.2. Given the extremely high importance to the consumer of the financial strength of the insurance company when purchasing a fixed-interest-rate annuity or EIA, affirmative disclosure should occur of all of the financial strength ratings assigned by rating agencies. In addition, the Comdex score should be prominently disclosed. Such ratings should also be explained to consumer adequately, such as by indicating the percentage of insurance companies (as to those that issue fixed annuity products) that have received such ratings.

      8.2.3. The compensation to be paid to the insurance broker, any other intermediary, and to the insurance agent, should be disclosed, not just in percentage terms but in actual dollar amounts.

      8.2.4. Insurance companies should more clearly set forth on quarterly statements provided to consumers the cash surrender value of the annuity, and the future dates on which drops in the surrender percentage fee will occur.

      8.2.5. For EIAs, disclosure should be undertaken of the extent of participation in each of the last twenty years of gains from the index. The index's returns (inclusive of dividends) should be listed, along with the actual returns of the EIA, on a year-by-year basis. If the EIA has only been in existence for less than twenty years, only those years in existence should be utilized; however, if the same

[114] 81 Fed. Reg. 21,027 (Apr. 8, 2016). However, "[d]ifferential compensation between categories of investments could be permissible as long as the compensation structure and lines between categories were drawn based on neutral factors that were not tied to the Financial Institution's own conflicts of interest, such as the time or complexity of the advisory work, rather than on promoting sales of the most lucrative products." *Id.* at 21,037.

[115] 81 Fed. Reg. 21,028 (Apr. 8, 2016).

insurance company had a different EIA prior thereto, then those EIA returns should be shown instead (with appropriate disclosure of any distinctions).

8.2.6. In addition, the average of actual returns of EIA products should be shown, for each year, since the inception of EIA products. It is common knowledge that EIA products often fail to perform as represented to consumers, and such disclosures of information are necessary.

8.3. **For insurance producers who either actually undertake the delivery of investment advice, or who hold themselves out as advisors (or similar terms), the regulation can be modified to state such producers become fiduciaries, under general principles of state common law, when they enter into a relationship of trust and confidence with a client.**

8.3.1. As discussed in Section 5 above, insurance agents who utilize titles that evoke in consumers an expectation that an advisory, as opposed to a sales, relationship exist, should be held accountable for creating such expectation of reliance through imposition of broad fiduciary duties.

8.4. **The formulation of regulations (or proposed legislation) permitting insurance agents to waive commissions from the sales of annuity products (thereby reducing the costs to investors, and providing a means for all annuities to be evaluated on their merits by disinterested, fiduciary financial advisors who truly act in their client's best interests). Additionally, the formation of regulations (or proposed legislation) permitting the ability of insurance agents to specify (within the maximum range permitted by the annuity product provider) the amount of any commission to be paid, thereby permitting insurance agents to negotiate in advance with the client as to the amount of reasonable compensation to be paid, and then shop for annuities as a fiduciary to and representative of the client under a "levelized commission/compensation" mechanism; this also permits insurance agents to ensure that the amount of compensation received is "reasonable" for the services provided as required by a bona fide fiduciary standard of conduct.**

8.4.1. Some of the states have adopted legislation permitting insurance agents to waive commissions on the sale of insurance and/or annuity products. But in many of the states the insurance producer's commissions may not be rebated.

8.4.1.1. This is anti-competitive. In today's modern age of financial services, there no longer remains a rational reason for this legal requirement.

8.4.1.2. The current anti-rebating statutes and practices reduce the availability of no-load insurance products for use by fiduciary advisors who choose to be paid directly by the client, instead.

8.4.1.3. The current anti-rebating statutes and practices reduce the availability of products that can be utilized by those insurance producers who desire to adopt a level-fee approach, as a means of adhering better to fiduciary obligations. This would track the evolving marketplace for financial services, in which actors are increasingly held to fiduciary obligations.

8.4.1.3.1. For example, the Certified Financial Planner Board of Standards, Inc. has recently proposed modifications to its own standards of conduct requiring that the 80,000+ holders of the Certified Financial Planner™ certification be fiduciaries at all times when providing investment recommendations. By the various states moving to permit lower commissions and/or the rebating of commissions, Certified Financial Planners™ would be able to comply with the new regulations without unduly restricting the availability of insurance and annuity products.

8.4.2. In states where legislation has been adopted, there are reports that insurance companies have informed agents that if they seek to rebate any portion of a commission, the insurance company's relationship with the agent will be terminated. This action is also anti-competitive. The Working Group should adopt regulations to address this concern. In addition, state insurance commissioners should consider taking action against these anti-competitive practices of the insurance companies.

Summary: Tread Carefully with the "Best Interests" Fiduciary Standard of Conduct, and Don't Inadvertently Sanction Deceit and Fraud.

In summary, I urge the Working Group to tread carefully. The NAIC's actions with regard to this proposal will, no doubt, be closely scrutinized.

Should the Working Group proceed with the "best interests" language, as proposed and without the core protections afforded by a bona fide fiduciary standard of conduct, substantial adverse impacts would occur:

- Consumers would be deceived.
- Greater confusion among consumers would exist in the marketplace.
- Consumers' willingness to participate in the capital markets could be undermined substantially, leading to less formation of capital and lessened U.S. economic growth.
- Great harm would result to consumers across this nation as they rely upon insurance producers based upon the "best interests" draft regulation, even though such trust and reliance should not occur (as an arms-length relationship still exists).
- The Working Group's actions could well effect an erosion of the centuries-old fiduciary principle, causing harm in many other forms of fiduciary relationships.

It is essential that the Working Group undertake the necessary steps to reverse course. The Working Group should not adopt a "best interests" standard unless that standard is a true, bona fide fiduciary standard of conduct, without "particular exceptions." In any event, the Working Group should ensure that clear distinctions exist between those engaged in arms-length sales transactions as opposed to fiduciary-client relationships. Finally, the Working Group must recognize that no man can serve two masters; the role of the product salesperson is simply incompatible with the role of a bona fide fiduciary.

I am available to meet with the Working Group to discuss these issues, and my recommendations, at the Working Group's convenience, and would appreciate the opportunity to do so.

Respectfully submitted,

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