

Applying the Five Core Principles:
Too Strong, Too Weak, Or Just Right?

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Remarks for:
Securities and Exchange Commission
Meeting with Chairman Mary L. Schapiro
September 11, 2009

Madam Chairman, I want to also thank you for taking the time to meet with the Committee for the Fiduciary Standard.

You have just heard from Blaine Aikin how we view the five core principles that comprise the essential elements of the authentic FS. I will now point out how these core principles might be applied in concrete instances. Before discussing these two examples, I will note how your expressions appear to support the spirit and the letter of these principles.

Fiduciary Duties

Your embrace and discussion in June of fiduciary duties for all who provide “personalized investment advice” could not be any more clear or conspicuous. You note that the provider “must at all times act in the best interest” of investors, “avoid conflicts of interest that impair its capacity to act in the best interest” and for unavoidable conflicts, “provide full and fair disclosure of the conflicts and obtain informed consent.”

As if this were not enough, you proceed further and note how the legal duties owed investors in the current regimes are “not consistent,” and, rather pointedly, how the fiduciary standard demands more than that which is required of an “arms length relationship” based in fair dealing.

“A fiduciary owes its customers and clients more than mere honesty and good faith alone.” In this sentiment you echo the voice of Justice Benjamin Cardozo, whose words on fiduciary duty have spoken to generations. Justice Cardozo noted the fiduciary duties’ sharp contrast with the “morals of the market place,” and “the punctilio of an honor the most sensitive is then the standard of behavior.”

These sentiments are reflected in the four “Principles of Reform” you outlined in May, where two roots of these principles are in the New Deal reforms. First, investor protection is a “touchstone”, and, second, capital markets must be efficient and competitive. You merge these two ideas, and conclude with a powerful principle:

“Markets do not work well unless investors believe they do. And investors will not believe that markets work well unless they do, in fact. That means above all, that investors must know that the information upon which they base their investment decisions is the truth, the whole truth and nothing but the truth....”

Without that essential confidence that they have truthful and complete information ... investors will avoid our financial markets for ones that are more transparent...”

Associating, as you have done, “truth” “investor confidence” and “working markets,” says so well why the fiduciary standard is vital. And why successfully applying the fiduciary standard, 1) should be at the heart of the reform agenda, and 2) requires the highest standard of disclosures as well as active investor participation, understanding and informed consent.

In our view, applying the fiduciary standard established in law, our five principles and your “Principle of Truth” is the task at hand. Here are just a couple of examples:

Proprietary Products

The Committee for the Fiduciary Standard has not taken a position on proprietary products and fiduciary care. This discussion is limited to how this task might be managed (if it is permitted) to ensure investors’ best interests are first.

The potential conflict is clear: is the judgment of the advisor regarding the benefits of this transaction to the investor impaired by the benefits of the transaction to the advisor?

The objective must be nothing short of managing this conflict as Commissioner Walter might manage it for her Aunt Millie. Meeting this burden requires a prudent process involving disclosures and due diligence meeting the highest standards.

Disclosures First. This starts with ensuring that meaningful and relevant written disclosures form the basis of a true understanding of the potential benefits and risks, as well as expenses and the advisor's compensation. The disclosure principle is plain enough. As University of Mississippi School of Law professor, Mercer Bullard, notes "Disclosures must provide (investors) with the information they need, in a form they can understand, and at a time when it is useful to them in making and assessing their investment decisions." (October 24, 2007 Testimony, Senate Committee on Aging)

Demonstrate Due Diligence. To adhere to the duty of loyalty, the advisor must have performed the necessary due diligence and found a proprietary product to be in the best interest of the investor. The advisor is accountable for the decision to recommend a proprietary product and, in order to manage the conflict, the advisor must not be motivated to recommend it by virtue of extra direct or indirect compensation.

Self-Directed Brokerage

The Committee for the Fiduciary Standard believes that brokers should not be held to a fiduciary standard for completing purely transactional business that only involves providing information that is not specific to the individual investor. Drawing a line between transactional business and personal investment advice is inherently a matter of making judgment calls, but we believe it can be effectively done, particularly if "titles" are made to comport with functions.

Titles

Those professionals who do not render advice should be identified consistent with their function -- product sales persons. For example, insurance agents should be identified as "insurance agents" and brokers identified as "brokers."

Dual registration

Consistent with concerns regarding self-directed brokerage and titles, we also believe that "switching hats" inherently breeds confusion about the role and responsibility of brokers and advisors. It should not be allowed. We are not aware of any comparable situations in other professions (doctors or lawyers) where practitioners are permitted, essentially at will, to switch their legal statuses to suit their business needs.

Special Exemptions

We believe exemptions should be either considered only in very rare circumstances or not at all. If permitted, a safe-harbor type exemption is preferred because it defaults back to the original requirements if the safe harbor criteria are not met.

Conclusion

In these and other situations, we believe the fiduciary standard can be applied fairly, equitably, and in accord with both the letter and spirit of the words of Justice Cardozo. In a manner that is neither too strong nor too weak but, we believe, is just right.

Chairman Schapiro, we applaud your leadership in addressing the key role and important requirements of fiduciary principles. Your faith in these principles helping restore investor trust and confidence is plain to see. This is particularly clear in your statement on ‘The Principle of Truth’.

Consistent with your leadership we wish to offer our assistance in ‘Putting the Fiduciary Standard First’ in regulatory reform. One strategy we offer for your consideration is the promulgation of an Investors Bill of Rights, based on our jointly held principles, and developed by interested industry groups at a meeting in Washington.

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