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SAFEGUARDING OUR SAVINGS:
PROTECTING NEW YORKERS THROUGH THE FIDUCIARY STANDARD

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CITY OF NEW YORK

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TABLE OF CONTENTS

Executive Summary..3

History of the Fiduciary Duty 4

Changes in Retirement Savings

and Confusion among Consumers...............................6

Negative Effects of the Suitability Standard 7

Opportunities for Reform...8

Conclusion 10

Acknowledgments...12

Endnotes..12

EXECUTIVE SUMMARY

For generations, Americans have taken their hard-earned money to financial advisers to save for retirement, build a nest egg, and invest their life savings. Most have assumed that these investment professionals provide unbiased recommendations in their client-investor's best interest.

Unfortunately, for far too long, individual investors have been left in the dark about the true loyalties of many financial advisers. In short, outdated laws, regulations, and legal loopholes have made it hard for Americans to know whether advisers are following the highest investment standard—known as the fiduciary duty—in making their recommendations.

The fiduciary duty is a legal promise that all investment advice must always be in the consumer's best interest. It obligates advisers to disclose and avoid all conflicts of interests, recommend best-value investment options, provide objective analysis and investment advice, and, above all, put the client's interests before their own.

This report, from New York City Comptroller Scott M. Stringer, outlines the history and importance of the fiduciary duty and recommends immediate and concerted action by federal regulators and New York State legislators to broaden awareness of the fiduciary duty and ensure that any conflicts of interest are clearly disclosed to clients before they enter into a financial relationship with advisers.

As it is, much of America's savings are entrusted to money managers, financial advisers, and brokers governed by a more lax "suitability standard." Under this standard, advisers are allowed to guide clients towards investments carrying higher fees and expenses or "in-house" investments that may generate commissions and higher revenues for the firm, provided those investments are "suitable" to the client's stated investment objectives, means, and age.

Simply put, a suitability standard allows, and indeed frequently requires, a broker to put his or his firm's interests ahead of the client's interests.

This costs investors billions. A recent report issued by the President's Council on Economic Advisers conservatively estimates that such conflicted advice leads to lower investment returns—approximately 1 percentage point lower each year. That may not seem like much, but it adds up over time. In fact, over a lifetime, losing 1 percent of returns annually could reduce a family's savings by more than a quarter. [1] Collectively, it adds up to $17 billion in lost returns every year in Americans' Individual Retirement Accounts (IRA) alone.[2]

Last month, President Obama directed the Department of Labor (DOL) to issue a new rule that would require all retirement advisers to adhere to the fiduciary standard. The Comptroller fully supports the President's DOL proposal, which will have an enormous effect on safeguarding American's retirement savings.

The Securities and Exchange Commission (SEC) must work in concert with the DOL to apply the fiduciary standard to all personalized investment advice tendered by so-called advisers. This will ensure that all non-retirement holdings in stocks, mutual funds, and bonds are protected by the highest ethical standard of care so that when individual investors seek out a "financial adviser" or a "financial planner," a "retirement specialist" or a "broker-dealer," they can rest assured knowing that the investment professional is duty-bound to offer objective advice that is in their best interest.

There is some evidence that the SEC is considering action. Recently, SEC Chair Mary Jo White indicated her personal support for reform, stating that she believes the SEC "has an obligation" to issue a rule on the fiduciary standard.[3] It is critical that Chair White's leadership moves the SEC to issue a robust rule which applies the historic strength of the fiduciary duty across the full range of 21st century financial products and services.

While there is no substitute for federal regulatory reform, we cannot wait for Washington to act—not while millions of New Yorkers remain unaware about the standards governing the retirement and savings advice they receive. In fact, surveys show that deceptive advertising practices and industry obfuscation have led to over three-quarters of investors mistakenly believing that that all financial advisers are held to a fiduciary duty.[4]

As a result, New York should pass a state law requiring all financial advisers (including, but not limited to, broker-dealers, traders, and financial planners) to disclose—in plain language, not in fine print—whether they abide by the fiduciary standard, so that prospective clients know of potential conflicts of interest and to what party the advisers hold their ultimate allegiance.

While this law would not prevent financial advisers from operating under the weaker suitability standard, it would ensure that individual investors have the information they need to determine the motivations of their investment professional and chart the best course of action for their families.

By updating rules and regulations to better reflect the momentous changes that have taken place in the financial industry over the past half-century, we will promote the transparency and accountability that has made New York City the Financial Capital of the World, while ensuring that all Americans are empowered to make smart decisions about their financial futures.

HISTORY OF THE FIDUCIARY DUTY

While the modern incarnation of the fiduciary duty emerged from the rubble of the Great Depression, the concept of a fiduciary duty dates back to the origins of civilization. Indeed, the very word fiduciary is derived from the Latin "fiducia" meaning "to trust." The concept of the fiduciary relationship dates back to the stone tablets of Hammurabi's Code, chiseled in the 18th century B.C., which laid out the duties of "agents" responsible for investing the funds of merchants.[5] Since then, the idea of a fiduciary duty has been invoked in the Islamic legal tradition,[6] early English common law,[7] and across 20th century American securities law.

In New York State, the seminal case of *Meinhard v. Salmon* laid out the modern definition of the fiduciary duty.[8] In his majority opinion, Judge Benjamin Cardozo, then of the New York Court of Appeals, defined a fiduciary obligation to be a "duty of the finest loyalty" and famously went on to note that the legal and ethical responsibilities of a fiduciary are both exacting and absolute:

"[A fiduciary] 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. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd".[9]

Decided just before the arrival of the Great Depression, *Meinhardt* set the tone for landmark legislation designed by Congress to curb the abuses and excesses that led to the worst financial crisis in the nation's history.

The passage of the Securities Exchange Act of 1934 was an effort by President Franklin Roosevelt "to clean up thoroughly unwholesome conditions in the field of investment" by regulating the activities surrounding the sale of financial products.[10] The Act took aim at the industry of broker-dealers and put them under the regulatory authority of the newly-created Security and Exchange Commission (SEC) and the industry's self-regulator, the Financial Industry Regulatory Authority (FINRA).[11] Notably, the law did *not* mandate a fiduciary duty for broker-dealers, instead insisting only that broker-dealers provide advice and services "suitable" to their client's circumstances.

Congress applied a firmer hand when dealing with investment advisers. In 1940 Congress passed the Investment Advisers Act, mandating that all financial professionals giving investment advice for compensation have a fiduciary obligation to their clients.[12] The law's ability to establish a strict fiduciary duty for investment advisers was affirmed and extended by the Supreme Court of the United States in the 1963 case of *SEC v. Capital Gains Research Bureau*, in which the Court found that failure to disclose material facts constitutes "fraud and deceit" under the Investment Advisers Act and that the Act, as amended in 1960, barred any investment adviser from engaging in any "manipulative," "fraudulent," "deceitful," or "abusive" practices.[13]

CHANGES IN RETIREMENT SAVINGS AND CONFUSION AMONG CONSUMERS

The Securities Exchange Act and the Investment Advisers Act established two distinct professional codes—suitability and fiduciary—for broker-dealers and investment advisers, respectively. However, in the decades since the 1940s, the once distinct roles of broker-dealers and investment advisers have begun to converge.[14] Increasingly, broker-dealers are offering investment advice and financial planning services in addition to selling securities, insurance products and other investment vehicles – actions all permitted by the SEC.

This shift in the business model by many brokerage firms is the direct result of a larger transition in the retirement savings market away from defined-benefit pensions and towards defined-contribution plans, 401(k)s, IRAs, and similar vehicles.

In the early 1980s, 62 percent of private-sector workers had defined-benefit pension plans, while only 16 percent saved through a 401(k) or IRA-type plan. Thirty-five years later, these numbers have flipped. As of 2011, 69 percent of private sector employees with retirement savings are invested in private 401(k)s and IRAs, while only 7 percent of private-sector workers rely on defined-benefit plans.[15]

Over half of private sector workers lack any retirement plan at work, leaving 3.5 million New Yorkers to rely on the private market to safeguard and grow their nest egg.[16] These numbers are in addition to the many more millions of savers who privately invest hard-earned savings alongside the money they contribute towards employer-sponsored plans.

As defined-benefit and employer-sponsored plans have waned, Americans have increasingly turned to Wall Street, specifically broker-dealers, to help them invest for retirement and other purposes. As of 2013, 46.3 percent of American households owned mutual funds, the vast majority held for retirement or college savings.[17]

Some of these funds are sold by broker-dealers offering financial advice to consumers in addition to regular brokerage services – brokers who are permitted to conflate the role of the independent adviser and self-interested salesman.[18]

Indeed, within brokerages, the line between adviser/broker and salesman is extraordinarily thin. Even while representing themselves as "trusted advisers" or "customer-first advisers," brokers are often incentivized to choose the highest commission investment or to steer clients towards non-competitive in-house investments. Compensation for broker-dealers is frequently based not on the positive performance of the investment vehicles they recommend, but rather on the type of investments they can convince clients to invest in. As a former investment manager who advertised himself as financial adviser admitted, "I had to be a salesman even if what I was selling wasn't that great."[19]

It's no wonder, given these vast changes in the marketplace, that Americans are left confused by their investment choices. An extensive study of investor financial literacy conducted by the SEC found that the average investor is unequipped to make an informed choice regarding investment advice and is largely unable to distinguish between the very different roles and legal protections offered by broker-dealers and investment advisers.[20] Individuals not only have difficulty understanding the distinctions between the titles used, services offered, and fees charged by such professionals, but also are frequently unaware of whether the financial professional they have hired will act as a salesman or as an impartial adviser.

Despite this confusion, many Americans turn to a professional financial advisers to manage their retirement or other investments. It is estimated that close to half of all Americans rely on a financial service provider to manage retirement investments.[21] A survey conducted by the Consumer Federation of America demonstrates that nearly three in ten savers relied wholly on the advice of a professional before purchasing a security and that a further third "relied a great deal" on the recommendations of their adviser.[22]

Unfortunately, because of the regulatory gap between the Security Exchange Act and the Investment Advisers Act, "financial advisers," "retirement planners," and "broker-dealers" are often not bound by the fiduciary standard. Indeed, many brokers, banks, and even insurance agents are able to rebrand their services as "advisory" without being obligated to serve as fiduciaries.

These advisers are able to take advantage of customer confusion surrounding the difference between the fiduciary and suitability standards, undermining the sacred trust consumers place in the industry and hurting the majority of honest financial planners that see their role as being advocates for their clients' interests, first and foremost.

NEGATIVE EFFECTS OF THE SUITABILITY STANDARD

The regulatory loopholes that allow broker-dealers to dispense advice under the suitability standard can cost retirement savers, and by extension the U.S. economy, billions of dollars per year. Consumers can see their savings depleted by high fees, directed into inappropriate investment vehicles via rollovers, or subject to troubling conflicts of interest.

Brokers operating under the suitability standard are legally permitted to direct their clients towards high-cost, high-fee funds. Indeed, the incentive structure of many brokerage firms encourages the sale of "actively" managed, high-fee investments because of the higher commission a sale can generate for the broker-dealer. Even seemingly low fees can have an outsized effect on cumulative savings.

While there are some situations in which an individual's best interest may lie in choosing a high-fee investment, research suggests that the majority of returns commensurate with the thousands they hand over in fees and investment expenses. Historical data from Vanguard and S&P Dow Jones Indices[23] demonstrates that low-cost index funds have outperformed higher-cost, actively managed funds in every investment category over the long term. Choosing low cost investments over fee-laden funds can mean a difference of return of more than 20 percent.[24] This underperformance is even more glaring for the fact that actively managed funds can charge up to 8 or 9 times more than indexed investments in fees and costs.[25]

A comparison of large-cap U.S. actively managed equity funds to the Vanguard Total Stock Market Index Fund over a 16-year time horizon found that indexing outperformed nearly 80 percent of actively-managed funds. [26]

Even within the universe of actively managed funds, investments recommended by brokers are considerably more likely to underperform other actively managed investments sold directly to retail investors. Recent studies have hypothesized that this discrepancy in returns, even within a single category of investments, is directly attributable to a structure of skewed incentives which rewards brokers not for their investment skill but for their ability to rake in fees and commissions.[27]

This conclusion is reinforced by a revealing 2012 experiment that sent undercover auditors to financial advisers in the larger Boston area.[28] Over 284 visits, auditors presented fictional financial portfolios to advisers and recorded any recommendations made during the visit. Ultimately, the study concluded that often "adviser self-interest plays an important role in generating advice that is not in the best interest of the clients." Even if the undercover auditor presented the adviser with a well-balanced, low-fee portfolio, a majority of advisers still encouraged the purchase of high fee, actively managed funds.

High-fee investments are not the only risk to consumers from the lack of a broad fiduciary duty. In addition, rollovers, which transfer funds either from an employer sponsored pension or 401(k) into a traditional or Roth IRA, often carry higher fees with little corresponding benefit. Individuals either roll over funds by necessity after leaving employment, or by choice, after being courted by financial service companies promising high returns, low costs, and tailored investing options. In 2013, $357 billion in assets were rolled over, 11 percent higher than the $321 billion rolled over in 2012. [29]

Existing law does not demand that brokers advising clients to transition money into IRAs have to comply with the fiduciary duty. Currently, it is legally permissible for brokers to utilize cold calls, advertising, and direct mailing to urge consumers to reallocate their savings to privately administered 401(k)s even if fees are higher. Advisers and industry experts confided to the Government Accountability Office that a broker could earn $6,000 to $9,000 for maneuvering a client into the purchase of a high fee IRA, compared to only $50 to $100 if their client stayed within an existing 401(k) plan.[30] This incentive structure encouraged brokers to woefully misrepresent the comparative advantage of their product in advertising and personal solicitation by labeling IRAs as 'free' or 'no-fee', even when the products could potentially bear thousands in fees.[31]

OPPORTUNITIES FOR REFORM

Last month, President Obama directed the Department of Labor to issue a new rule that would require all retirement advisers to abide by the fiduciary standard.[32] The DOL's jurisdiction over fiduciary matters is granted through investment standards mandated by the Employee Retirement Income Security Act of 1974 (ERISA). ERISA regulates the administration of defined benefit and defined contribution retirement plans. Additionally, the IRS relies on DOL rules in the supervision and regulation of IRAs. ERISA grants DOL both the authority and responsibility to extend the reach of the fiduciary duty to retirement assets.

Under current regulation, companies offering 401(k)-type plans have a fiduciary duty to act in the interest of its beneficiaries. However, the financial advisers administering the plans may not have the same obligation. Indeed, some mutual funds and large 401(k) providers often use their clout to stock 401(k)s with in-house investment vehicles and funds, without any regard to fund performance or investor benefit.[33]

The DOL is currently working on a proposal amending the definition of "fiduciary" under ERISA and dramatically expanding the categories of financial professionals obligated to operate under a fiduciary standard. The rule, currently being reviewed by the Office of Management and Budget has the potential to entirely reform safeguards surrounding retirement investments. This rule change would have an enormously positive impact on the lives and pocketbooks of Americans. Under the anticipated rule, advice surrounding pensions, 401(k)-type plans and rollovers would be governed by the fiduciary standard, a change which could save billions of dollars in American retirement investments.[34]

While the DOL rulemaking process is welcome news, more must be done at the federal and state level to expand fiduciary duty and provide consumers with transparent, accessible information about their financial advisers.

In addition to the DOL proposal, the SEC should issue a uniform fiduciary rule designed to protect investors with non-retirement savings in the marketplace. Broker-dealers who advertise investment advice services or offer investment advice should be regulated under the strict fiduciary standards to which all other advisers are held under the 1940 Investment Advisers Act.[35]

Drawing a clear and unqualified line between brokers and advisers will mean that consumers would be less likely to fall prey to conflicts of interest that drain retirement accounts. By aligning the 1934 Securities Exchange Act to the fiduciary standard established under the 1940 Investment Advisers act, any firm—whether or not classed as a broker-dealer or adviser—that offers investment advice will be obliged to offer only services that are consistently and objectively in their clients' interests.

Brokerages that do not wish to comply with the fiduciary duty can opt to strictly confine their activities to purely facilitating transactions and account management would be subsequently unaffected by the rule change.

In 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act gave the SEC the authority to propose this type of rule change. However the SEC has yet to reach a decision on the establishment of a universal fiduciary standard nearly five years after Dodd-Frank was signed into law by President Obama.

As a result, while there is no substitute for federal rulemaking by both the DOL and the SEC, the Empire State should not wait for Washington to act.

Given the slow pace of real and progressive reform efforts at the SEC, New York should pass a law to improve transparency and ensure that investors are aware of the standard of care provided by their investment professional and have the information they need to make an informed judgment in the best interest of their families.

In the coming months, Comptroller Stringer will seek to advance legislation that will require all broker-dealers, advisers and traders to disclose whether they abide by a fiduciary standard, in plain language, so that prospective clients know in advance if compensation is earned from the sale of specific financial products, and to what party the advisers hold their ultimate allegiance.

Non-fiduciaries would have to confirm both aloud and in writing that, "I am not a fiduciary. Therefore, I am not required to act in your best interests, and am allowed to recommend investments that may earn higher fees for me or my firm, even if those investments may not have the best combination of fees, risks, and expected returns for you."[36]

Clear, unambiguous disclosures can help guide consumer's choices about investment advice. Surveys conducted by the American Association of Retired Persons (AARP) suggest that disclosure detailing whether advisers or brokers were operating under the suitability standard or fiduciary standard has a dramatic effect on consumer confidence in proffered investment advice.[37] While individuals should be able to choose whatever investments suit their particular needs—including, potentially, higher fee investments—those decisions should only be made with all available information, including whether and to what extent their broker will benefit from a particular investment choice.

Requiring this plain-language, unambiguous statement in advertising and at frequent intervals during the advisory relationship can help reduce consumer confusion and improve the investment security of all New Yorkers.[38]

While disclosure alone cannot absolutely safeguard hard-won savings, in the absence of federal regulation covering both retirement accounts and non-retirement portfolios, New Yorker's deserve some balance in the all too asymmetric relationship currently existing between consumer and client. Disclosure may be only a first step, but an absolutely critical one, to ensuring that consumers can safely harness the enduring dynamism of the American economy in order to grow their savings.

CONCLUSION

Signing the Investor Advisers Act of 1940, President Franklin Roosevelt made reference to "the bleak days of 1929, when the market crash swept away the veil which up to then had hidden the 'behind-the-scenes' activity of our high financiers and showed all too clearly the sham and deceit which characterized so many of their actions." Utilizing the full power of the Federal Government, Roosevelt demanded and achieved change.

Now, seven years removed from the financial crisis of 2008, the SEC and the DOL must again take action. While it is easy to be heartened by a resurgent economy, a retirement crisis looms in the future, making federal action to safeguard the hard-won savings of Americans critically necessary. This report urges both the DOL and the SEC to take quick action to redefine the role of the fiduciary for the 21st century.

Should the federal government delay, or fail to act, States must proceed. Franklin Roosevelt recognized this imperative when as Governor of New York he faced the beginning of the Great Depression. While the federal government equivocated and delayed with its response to the nation's greatest financial crisis, Governor Roosevelt demanded immediate action:

> ***By a process of elimination, if by nothing else, the responsibility also rests upon the State. It is idle for us to speculate upon actions which may be taken by the Federal Government; […] it is true that the Federal Government may take action to eradicate some of the basic causes of our present troubles; […] The State of New York cannot wait for that.*** [39]

In safeguarding the investments of its citizen, New York cannot wait. Over the coming months, Comptroller Stringer will continue to advocate for immediate reform to protect our citizens' hard-earned savings.

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