"Fiduciary": Much Ado about Nothing!

By John Lohr
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The most overused, misused and misunderstood word in the investment industry is "fiduciary." Independent advisors, trade organizations and self-styled “expert” groups have called for stockbrokers to adopt the “fiduciary” standard to achieve a grand leveling of the playing field for those who provide investment advice.

This is nothing more than unnecessary marketing hype – stockbrokers already have a legal duty to act as a fiduciary to their clients! And the various hurdles which have been suggested for them to achieve official “fiduciary” status are meaningless:

You don't need a specialized course to be a fiduciary.

You don't have to sign off on your “fiduciary” status in a contract with an ERISA client to be considered a fiduciary.

You don't need to be an independent financial advisor (and registered with the SEC) to be a fiduciary.

Nobody needs to put "Professional Fiduciary" or "Fiduciary Advisor" on their business cards to be a fiduciary.

Simply put, a true fiduciary is someone who has an ethical responsibility to deal prudently with somebody else’s money – which stockbrokers and all other advisors have always had.

The concept of fiduciary duty is a common-law principle that applies to parties who deal with other parties' money. The fiduciary trust principle has applied since the basis for common law was established, with the Domesday Book in 1086. ERISA codified it for employee benefit plans in 1974, and various state acts like the UPIA, UMIFA and the UTA have codified it for non-employee benefit plans since.

In deciding whether or not someone has fiduciary responsibility, federal and state courts and local arbitrators have for years applied an intricate legal theory of function over form – the “duck theory.” If it looks like a duck, walks like a duck, smells like a duck, and acts like a duck, it’s a duck. This standard applies to all money held or managed for someone else.

Fiduciary status is defined by the actions and understandings of the parties in question. If a client believes the advisor or stockbroker is acting in a fiduciary capacity and relies on that belief, the advisor or broker will be held to a fiduciary standard.

If you want our ineffective regulators or Congress to define “fiduciary,” in a helpful way don’t hold your breath. Look, for example, at what I like to call the "Empowering Everybody Provision" (PPA, 2006 through Pension Reform, 2010) and its all-encompassing definition of the meaningless term "Fiduciary Advisor," which includes:

- A registered investment advisor
- A bank through its trust department
- A savings association that is subject to periodic examination and review by a federal or state banking authority
- A state qualified insurance agency
- A broker or dealer (’34 Act registered)
- An affiliate of any of the above, and
- Employees, agents or registered representatives of all of the above.

So, are stockbrokers fiduciaries? Absolutely!

For instance, take the 1986 case, Stanton v. Shearson Lehman in which a federal court found that a brokerage firm retained to handle pension assets was an ERISA fiduciary. The firm was directly liable for failing to exercise care and prudence in supervising and training its brokers who caused a loss to an ERISA plan.

In that case, the beneficiary of two retirement funds decided to self-direct them and opened two trading accounts with a Shearson account representative. The representative made investment recommendations to the beneficiary, who then instructed that those trades be made. All told, the clients paid the firm $87,000 in commissions, and the trustees sued the firm and the broker for violating ERISA. The court ruled in favor of the trustees. "If a broker executes transactions in accordance with trustee instructions with respect to investment recommendations the broker made, then this is sufficient to warrant fiduciary responsibility and the liability thereto."

The question turned on reliance. If a client relies on advice, implements a broker's recommendations and the broker knows or should be expected to know this, then he or she will be liable for that advice.

Liability can extend to improper selection of a money manager, inadequate reporting, setting improper investment objectives, insufficient monitoring and evaluation of fund or manager performance, or even the recommendation to replace or interview new managers.

In a 1990 case, Pension Fund, etc. v. Omni Funding Group, an ERISA Pension Fund hired Omni as an investment manager to allocate $20 million of real estate investments. Omni gave $3 million to a Prudential-Bache broker for a "risk arbitrage" account in Omni's name. The account value declined; the trustees sued for breach of fiduciary duty to recoup the losses against Omni and Prudential-Bache, with whom trustees had no direct dealing. The Court followed the established doctrine that "A person is a fiduciary with respect to a plan to the extent he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys of such plan…." The court examined the question: May a "technical non-fiduciary" be liable for acts of a fiduciary in which it participates? This Court followed the majority of federal courts, which have held that all parties may be liable as participants in a breach by a plan fiduciary.

Finally, in Farm King v. Edward Jones, the court concluded that "A plan Fiduciary may not delegate such discretionary authority to a Broker Dealer in the execution of a securities transaction as to make such Broker Dealer a fiduciary with respect to that plan … without disclosing to such Broker Dealer that it will be acting as fiduciary." In the Farm King case, the brokers were not liable because they followed a prudent process.

All financial advisors, including stockbrokers, are fiduciaries. They have specific duties and responsibilities. They must make decisions on behalf of and recommendations to clients solely in the interest of the client. They must give the client all the information they require or *should* require to make an informed decision. Maintaining client confidentiality at all times, they have to answer all questions, ensure there is adequate time to resolve all issues, disclose compensation and any potential conflicts and comply with all statutes and regulations.

Fiduciaries have to provide individualized investment advice pursuant to a mutual understanding on a regular basis. This standard applies to money managers, financial advisors, brokers, and consultants. Financial advisors have a legal and ethical obligation to act with unconflicted loyalty to the client first, to deal fairly, to provide full disclosure and not to charge excessive fees. Ethical financial advisors are the Owens-Corning of the financial industry, providing the insulation to ensure client safety. Ethical advisors are the first line of defense in protecting investors from fraud.

If any advisor or stockbroker is unwilling accept the fiduciary requirements, they should exit the business quickly and find another job in another industry – preferably one that has no client contact.

John Lohr is a securities lawyer, syndicated journalist and is widely regarded as a top legal expert on fiduciary responsibility relating to the investment management profession. In 1995, he co-founded The Lockwood Group, where he served as Chief General Counsel and Corporate Secretary, as well as President of Lockwood Financial Services, Inc. He is the author of many financial books, including Somebody Else's Money (2010, Isle Press), the best-selling The Fiduciary Sale (2003, Isle Press), and The Last Investment Book You Will Ever Need (Forthcoming, 2010, Isle Press).