SIFMA's Proposed "New Federal Fiduciary Standard": Consumer Protection … or "A Wolf in Sheep's Clothing"?

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July 21, 2009

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On July 17, 2009, the Securities Industry and Financial Markets Association ("SIFMA") announced that its Private Client Group Steering Committee unanimously supports a new federal fiduciary standard for broker-dealers and investment advisors who provide personalized investment advice, embracing a proposal advanced by the Obama administration a week earlier in a draft of the "Investor Protection Act of 2009." Does this shift in direction by SIFMA, the lobbying arm of many broker-dealer firms, pose a radical change in business models for broker-dealer firms and their registered representatives? Or is the "new federal fiduciary standard" something else, in disguise?

Arms-Length vs. Fiduciary Relationships in the Retail Securities Industry

Understanding this issue, and how it might affect the securities industry, requires a review of some of the history of the "debate" over fiduciary standards of conduct for financial planning and investment advisory activities. The Securities and Exchange Act of 1934, and regulations promulgated thereunder by FINRA, have been interpreted to apply a "suitability standard" to the activities of broker-dealers (BDs) and their registered representatives (RRs). The application of the suitability standard, along with rules mandating certain forms of disclosures, reflects a modest modification of the purely commercial, arms-length nature of the relationship between a product salesperson and the customer. Even in arms-length relationships, the Restatement (Second) of Contracts provides that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." More particularly as to BDs, the U.S. Securities and Exchange Commission has applied the "shingle theory" in holding that every BD and RR owes to its customers a duty to deal fairly with customers. *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3814 (3d ed. rev. 2004), which states that under the "shingle theory … even a dealer at arm's length implicitly represents when he or she hangs out a shingle that he or she will deal fairly with the public." The shingle theory is a contractual theory, not a fiduciary theory. *See id.* Except for the protections of suitability and other highly specific rules, for the customers of BDs as a general rule *caveat emptor* applies; in other words, customers are not entitled to "trust" their BD and RR. Instead, customers must take action to protect their own interests.

In contrast, the Investment Advisers Act of 1940 was construed (based on the 1963 U.S. Supreme Court decision of *SEC vs. Capital Gains Research Bureau*) to apply broad fiduciary duties to registered investment advisors (RIAs) and their investment advisor representatives (IARs). The fiduciary standard of conduct has been called "the highest standard of conduct under the law." In American law, it has generally been held to give rise to two major duties – the duty of due care and the duty of loyalty. A third duty – that of utmost good faith – is sometimes held to exist, mostly as a "gap-filler" by courts in fashioning relief in which a breach of the other two duties does not clearly exist.

Understanding the Scope of Fiduciary Duties. The fiduciary duty of due care in turn gives rise to several specific obligations. Among them is the investment advisor's fiduciary duty to the client to exercise – with good judgment, knowledge, and due diligence – that degree of care ordinarily possessed and exercised in similar situations by a competent professional properly practicing in his or her field. Additionally, under the duty of due care (as well as other specific federal laws) an investment advisor shall maintain the confidentiality of client information.

Embedded within the duty of loyalty are three specific rules: (1) the "no conflict" rule ("a fiduciary must not place itself in a position where its own interests conflict with those of its client"); (2) the "no profit" rule ("a fiduciary must not profit from its position at the expense of the client"); and (3) the "undivided loyalty" rule ("a fiduciary owes undivided loyalty to its client and therefore must not place itself in a position where his or her duty toward one client conflicts with a duty that it owes to another client.")

The fiduciary duty of loyalty is better understood by a description of the investment advisor's specific duties, arising thereunder, as derived from various judicial and administrative decisions:

(A) The investment advisor shall at all times place and maintain its client's best interests first and paramount to those of the investment advisor;

(B) The investment advisor shall not, through either false statement nor through omission, mislead its clients;

(C) The investment advisor shall affirmatively provide full and fair disclosure of all material facts to its client prior to a client's decision on a recommended course of action, including but not limited to: (1) all material fees and costs associated with any investment, securities and insurance products recommended to a client, expressed with specificity for the particular transaction contemplated; and (2) all of the material benefits, fees and any other material compensation paid to the investment advisor (and additionally those benefits, fees and other material compensation paid to the investment advisor representative) or to any firm or person with whom he or she or it may be affiliated, expressed with specificity for the particular transaction which is contemplated.

(D) The investment advisor is under an affirmative obligation to reasonably avoid those conflicts of interest which would impair the independent and objective advice rendered to the client. As to any remaining conflicts of interest which are not reasonably avoided, the investment advisor shall ensure the intelligent, independent and informed consent of its client is obtained with regard thereto. In any event, any proposed arrangement in which a conflict of interest remains should be prudently managed in order that the client's best interests are preserved and that the proposed arrangement is substantively fair to the client.

The last sentence in this elaboration of the fiduciary duty of loyalty has provoked some controversy. Some securities law attorneys, in an apparent misconstruction of the *SEC vs. Capital Gains Research Bureau* decision, believe that all an investment advisor must do, when a conflict of interest exists, is to undertake full disclosure of that conflict. If the client proceeds, that is all that is required. This is an incorrect understanding of the fiduciary duty of loyalty. To avoid a conflict of interest, the *informed consent* of the client is required. The investment advisor must ensure such informed consent, which can only be obtained if the client understands both the existence of the conflict of interest and its material ramifications. And, if an investment advisor proposes a course of action to the client which would harm the client (*i.e.*, not be the best course of action, but something less), no client who truly understands the conflict of interest and its ramifications would consent to such harm.

The application of these broad fiduciary duties and rules is dependent upon the nature of the fiduciary relationship. For example, in trustee-beneficiary arrangements, a violation of the "no profit" rule often leads to the transaction which gave rise to the unpermitted profit being voidable at the discretion of the beneficiary. In contrast, in the corporate context fiduciary duties are limited by the "business judgment rule."

The Broker-Dealer Exclusion from the Advisers Act: Recent Developments

Currently, for a broker-dealer's activities to be exempt from the Advisers Act the advice provided must be "solely incidental" to a securities transaction for which no "special compensation" is received.

In March 2007 the U.S. Court of Appeals ruled in *Financial Planning Association vs. SEC* that fee-based brokerage accounts were not permitted to be excluded from the purview of the Investment Advisers Act of 1940, as the compensation received amounted to "special compensation" (anything other than a commission, which brings into question the propriety of 12b-1 fee payments under Class C shares when advisory services are provided).

Following extensive lobbying by the broker-dealer community, in September 2007 the SEC responded with a Temporary Rule and a Proposed Rule which provided major relief from the restrictions imposed by the Advisers Act and its potential reach. In the Temporary Rule (which expires at the end of 2009) the SEC permitted an expansion of principal trading by providing that prior consent need not be obtained to each transaction. This decision was met with disbelief, as it appeared to greatly expand the Advisers Act grant of statutory relief on principal trading beyond the bounds set by statute, and because of the likelihood that principal trading can be utilized to "dump securities" on unsuspecting clients and/or lead to greater profits to securities dealers at the expense of their clients.

Also in September 2007 the SEC re-proposed a definition of "solely incidental" language for the broker-dealer exclusion from the Advisers Act. In so doing, the SEC was viewed by many to ignore the maxim that "words have meaning." Relying upon this definition of "solely incidental," the SEC proposed a "Special Rule" which provided, in essence, that a dual registrant could be an investment advisor as to an investment advisory account and a registered representative (not bound by fiduciary duties) as to a brokerage account, for the same client, at the same time. This was widely criticized in many parts of the investment advisor community as ignoring the legal principle that fiduciary duties are imposed as a status of the advisor, which cannot be waived by the client easily, and that fiduciary duties apply to the whole of the relationship. In essence, the SEC's rule was criticized for permitting the wearing of "two hats" at the same time, or the "switching of hats" back and forth, and the "removal of the fiduciary hat" at will, all in circumstances in which client confusion would result and long-standing principles of fiduciary law would be ignored.

The SEC never finalized the "Special Rule" it proposed in September 2007. However, it has become a common business practice in many dually registered firms for a financial plan to be prepared under a "fiduciary hat" and under investment advisor regulation, then for the fiduciary hat to be removed and the product sales "non-fiduciary hat" adopted in order to sell products under a broker-client relationship. The ability to undertake this switching of roles, without running afoul of the continued application of the Advisers Act and its fiduciary duties, is highly suspect. These attempts to switch to non-fiduciary roles are also perilous, given the other major source of fiduciary duties for dual registrants – state common law which applies fiduciary duties to *relationships* based upon trust and confidence. It should be noted that state common law is generally not preempted by federal securities regulation nor rules arising thereunder (except in specific instances, such as not permitting certain class actions against corporate boards, etc.).

Against this backdrop is the continued confusion of consumers as to whether they may trust their "financial advisor" or not. The cause of "consumer confusion" as to the roles and duties of BDs and RIAs has been the SEC itself – in refusing over the past few decades, through a series of actions and inactions – to apply the Advisers Act to the advisory activities engaged in by broker-dealers. In her testimony before a U.S. Senate committee in March 2009, Barbara Roper, Director of Investor Protection for the Consumer Federation of America, stated: "brokers have been given virtually free rein to label their salespeople as financial advisors and financial consultants and to offer extensive personalized investment advice without triggering regulation under the Investment Advisers Act. As a result, customers of these brokers are encouraged to believe they are in an advisory relationship but are denied the protections afforded by the Advisers Act's fiduciary duty … Had the SEC implemented the Investment Advisers Act consistent with the clear intent of Congress, this would be the situation we find ourselves in today."

Today's Rapidly Evolving Legislative Landscape. Currently there are several measures making their way through Congress which may significantly impact upon registered investment advisors (RIAs) and their investment advisor representatives (IARs) as well as broker-dealers (BDs) and their registered representatives (RRs).

1. CFPA. The Consumer Financial Protection Act creates the Consumer Financial Protection Agency ("CFPA"). Much of the focus of this bill is on mortgage and other products which are not regulated by the U.S. Securities and Exchange Commission. The bill would permit the CFPA to formulate mandatory consumer disclosures. "Standardized products" may also be required to be offered aside other products. While the bill appears to not affect securities regulation, it has been reported that state-registered RIAs could be regulated by the CFPA. Another interpretation of the bill leads to the conclusion that all IARs, whether of state-registered or federal-registered RIAs, could come under the CFPA's jurisdiction. The broker-dealer community is nervous about this bill, as evidenced by the testimony of SIFMA's Randolph C. Cook before the House Financial Services Committee on July 17th, in which SIFMA opposed the creation of the CFPA and questioned whether the legislative language clearly excepted out all securities products and services which otherwise fell under the jurisdiction of the SEC.

2. 401k Legislation. Another piece of legislation working its way through Congressional committees deals with the regulation of ERISA accounts – and IRA accounts. The Conflicted Investment Advice Prohibition Act of 2009 was reported out of a subcommittee to the House Committee on Education and Labor in June 2009. It amends the Pension Protection Act of 2006 to provide that only "independent investment advisors" can provide advice with respect to participants in 401k plans. Level compensation arrangements would be required of such investment advisors, and the marketing or sale of proprietary mutual funds or other investment products of affiliates would be prohibited. This would reverse a January 2009 "Final Rule" (the implementation of which has been delayed until November 2009) by the U.S. Department of Labor that would have

permitted "fiduciary advisors" to recommend mutual funds of investment companies affiliated with their BD or RIA firm, as long as the financial advisors themselves received "level compensation" (despite the obvious pressure they would receive to sell proprietary funds).

3. Financial Planning As A Separate Profession? While not proposed in any draft legislation, the Financial Planning Coalition has advanced the concept of a "professional regulatory organization" for all financial planners – including those who either hold out as financial planners or who actually engage in two or more of the material elements of financial planning. If financial planners are to be separately regulated on an individual (as opposed to firm) basis, questions exist as to the application of *bona fide* fiduciary duties upon financial planners by any enabling legislation which may be introduced to authorize such professional regulation, especially given the provisions of the next piece of legislation to be discussed.

4. FINRA as an SRO for Investment Advisors; SEC Registration Threshold for RIAs to $100m? One of the arguments the broker-dealer industry has utilized in the past is that BD regulation and the suitability standard are more protective of consumers, as these regulations are more robustly enforced by FINRA than investment advisor regulation is enforced by the SEC. While clearly the fiduciary standard is a much higher standard of conduct and more protective of consumers than the suitability doctrine, the fact remains that the SEC, even before the creation of its Office of Compliance Inspections and Enforcement (OCIE) in 1995, has been challenged to find the resources to undertake the frequent and robust examinations of all of the investment advisors and investment companies which it oversees. Taking advantage of the Madoff and other scandals, SIFMA and FINRA have advocated this year that FINRA be given jurisdiction over SEC-registered investment advisors, as to compliance and inspection activities. While none of the legislative proposals promulgated to date contain any language which would authorize FINRA oversight over RIAs, it has been rumored that a "deal" has been cut. This "deal" (which I cannot confirm) would provide FINRA with oversight over SEC-registered RIAs, while at the same time raising the assets-under-management threshold for SEC registration to $100 million.

5. Investor Protection Act of 2009. Key to the debate over the standards of conduct applicable to BDs and RIAs, and the "harmonization" of such standards, is the "Investor Protection Act of 2009" which was proposed by the Obama Administration on July 10, 2009.

Reaction to the Investor Protection Act of 2009

Some background to this legislation is in order. In its testimony before the Senate Committee on Banking on March 10, 2009, the Securities Industry and Financial

Markets Association (SIFMA) called for both broker-dealers and RIAs to be held to a "universal standard of care" expressing "fundamental principles of fair dealing." I criticized that proposal as an "attempt to race to the bottom – at or near the bare minimum of standards which the law requires in all arms-length relationships." [*See* "SIFMA's 'Universal Standard of Care': Gordon Gekko Meets Pontius Pilate," part of the April 17, 2009 "Update" at www.fiduciarynow.com.] Since that time, the rhetoric and suggested legislative language has evolved.

The Investor Protection Act of 2009 essentially gives the SEC the power and authority to establish "in substance" a "sole interests" of the consumer standard of conduct for both BDs and RIAs. Unfortunately, this means by implication that the SEC could determine who is not subject to the standard, and could permit "switching of the hats," "removal of the fiduciary hat," etc.

A broad coalition of consumer and financial planning groups (NAPFA, CFP Board, FPA, IAA, Consumer Federation of America, Fund Democracy, NASAA) on July 14, 2009 submitted a letter to Congress (available on NAPFA's web site under Press / "Industry Comments") expressing concern that the fiduciary standard applicable to RIAs would be effectively lowered by this proposal, and they called for retention of the high fiduciary standard of conduct currently applicable to RIAs.

SIFMA took a far different view. Its July 17, 2009 Press Release stated: "'SIFMA wants to deliver clear, understandable reforms and strong, consistent protections for America's investors,' said SIFMA President and CEO Timothy Ryan. 'Under this new, federal fiduciary standard, it won't matter who is giving the advice – broker or advisor – investors will be protected by the exact same federal fiduciary standard when receiving the same services.' Embracing proposals laid out by the Obama administration July 10, SIFMA believes that individuals receiving personalized investment advice should be protected by the same standard, no matter who provides it. The administration's legislation states these two groups should, 'act solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer or investment advisor providing the advice.'"

The Investor Protection Agency of 2009 would permit the SEC to lower the current *bona fide* fiduciary standard of conduct applicable to RIAs to something far less, and would authorize the SEC to provide multiple exceptions as to the application of fiduciary standards. This was aptly explained in the testimony of the Consumer Federation of America's Travis Plunkett on July 17th before the House Financial Services Committee:

> "The legislation risks … delegating to the SEC the job of writing rules to implement the fiduciary duty requirement and giving it broad leeway in doing so. While this may seem to be a logical approach, for investors to receive the full benefits of the President's plan, the SEC will have to get right the very issues it has mishandled for at least two decades. After all, the investor confusion this

> legislation is designed to address is not the inevitable result of industry changes; rather, it is the direct result of anti-investor policy decisions by the SEC over many years ... However, to better ensure that the legislation delivers on the administration plan's promise of a full scale fiduciary duty for all investment advice, and not the 'fiduciary duty lite' some in the brokerage industry have sought, some revision of the legislative language appears necessary. Specifically, the words fiduciary duty of care and loyalty that are referenced in the President's plan should be included in the legislative language itself, so that the fiduciary duty exists in law and not simply through the adoption of SEC rules. The 'in substance' language in the legislation, which could be used to justify watering down that standard, should be removed. In addition, the SEC should be required, not simply authorized, to adopt the appropriate standards. Finally, Congress should clarify, preferably through the legislation itself but if not through accompanying report language, that: 1) the intent is to ensure no weakening of the fiduciary duty that currently applies to advisors and 2) that a fiduciary duty, once entered into, cannot easily be abandoned; brokers who are covered by a fiduciary duty when giving advice cannot escape that requirement when selling the products to implement that advice."

In its written testimony to the House Financial Services Committee, SIFMA argued that investors should have the "choice to define or modify relationships with their financial services provider based upon the investor's preference" ... as a means of preserving investor choice. Under one interpretation of SIFMA's proposal, Wall Street firms could have their customers sign away the fiduciary standards of conduct by simply signing a lengthy, incomprehensible, multi-page, small print agreement when they enter into a relationship with a broker. This is contrary to fiduciary law, which clearly provides that blanket waivers of fiduciary standards are not permitted. Fiduciary standards of conduct are imposed by law on relationships based on trust and confidence, in recognition of the fact that consumers lack the ability to bargain for the correct standard of conduct. Hence, broad fiduciary duties, imposed by statutory law (the current Advisers Act) or state common law upon such relationships, are generally not subject to blanket waivers.

SIFMA stated that: "Yet another way to support choice, innovation and service is to provide firms with appropriate relief from the SEC's current prohibitions against principal trading, which in today's liquid and transparent markets no longer make sense ...." Yet the Investors' Working Group (which was co-chaired by two former SEC Chairmen) noted in its July 15, 2009 Report that "Proprietary trading creates potentially hazardous exposures and conflicts of interest." The real reason for SIFMA's advocacy of principal trading expansion is that it is far more profitable to Wall Street firms than agency trades. And there is no denying that principal trading can cause substantial harm to individual investors - including dumping of unwanted securities on individual investors and charging mark-ups and mark-downs that result in less favorable pricing than agency trades.

Also, SIFMA advocated for preemption of state common law, which applies broad fiduciary duties on those advisors in relationships based upon trust and confidence with their clients, in favor of a weaker fiduciary standard. In essence, the Wall Street firms SIFMA represents desire to do away with centuries of common law in which fiduciaries have been held to act in their clients' best interests at all times. While SIFMA argues against having "51 different standards" of fiduciary conduct, in actuality there are few differences in how fiduciary duties are applied by the various states upon the activities of investment advisors and financial planners. (Some differences exist as to when fiduciary duties are applied under the common law to investment advisory activities, for in some states the test for application is a bit harder. However, once fiduciary duties are applied, all court decisions I have reviewed do not appear to vary the broad fiduciary duties of due care and loyalty under fiduciary law. Indeed, there are very few inconsistencies in *how* fiduciary duties are applied to investment and financial advisors.)

The Pace of Legislation. On July 17, I learned that the Investor Protection Act of 2009 would not likely be fully marked up by the House Financial Services Committee and sent to the House Floor until after the August recess. The U.S. Senate is currently tied up with health care reform legislation, and is unlikely to consider all aspects of financial services reform until mid-September. While Congressional leaders strongly desire to see a comprehensive financial services reform legislation passed by the end of this year, one or more elements of the legislation may be delayed into 2010.

This is the time to act. Once the committees approve legislative language, it will be extremely difficult to obtain changes to it (absent large amounts of money and influence in D.C.). Hence, those who advocate changes to the content of legislation, and specifically to the standards of conduct which will apply in the future to broker-dealers and registered investment advisors, should reach out to their Senators and Representatives, as well as to the leaders of their industry organizations, with all deliberate speed.

Closing Thoughts: The Importance of a True Fiduciary Standard

A fiduciary relationship has increasingly been embraced by modern society and promoted by public policy in situations where consumers are hopelessly outgunned by the vastly superior knowledge of the advisor. Public policy strongly favors the adoption of fiduciary standards for financial intermediaries serving retail investors in advisory relationships. Maintaining and restoring trust is essential to successful investing in our capital markets.

SIFMA’s embrace of the language contained in the Investor Protection Act of 2009 seeks to abandon the principles-based regime of fiduciary standards of conduct, a regulatory scheme which grew out of the financial abuses of the 1930’s and which has been developed through both legislation and court decisions ever since, and return to a far less rigorous standard. SIMFA advocates a standard of conduct that does not rise to the level of fiduciary protection of consumers, even though it is called a "fiduciary" standard of conduct.

This is a dangerous development, not just for consumers but for the integrity of fiduciary law itself.

In today's modern financial world financial advisors are specialists. Armed with superior knowledge about the inner workings of the capital markets and often complex financial products (and the many different means through which financial intermediary fees and costs can be hidden from full disclosure), it is far too easy for financial services intermediaries to take advantage of their clients. In contrast, the fiduciary standard restores balance and protects the consumer by mandating that financial advisors act in the best interests of their clients – at all times.

Nearly all consumers of financial and investment advisory services lack the requisite knowledge to fend for themselves. Attempts to narrow the knowledge gap through financial literacy, while important, cannot overcome this disparity. We can no more ask the American consumer of financial services to become a knowledgeable financial and investment advisor than we can ask the same person to perform brain surgery.

While the enhanced prospectus and other disclosures our regulators require are indeed important, a huge amount of academic research in recent years leads to the inescapable conclusion that, due to various behavioral biases consumers possess, disclosures are largely ineffective (and seldom read). Moreover, few consumers possess the resources to hire knowledgeable monitors to observe and report on the conduct of their financial advisor. Fiduciary duties, imposed on all investment and financial advisors to individual investors, overcome the inherent ineffectiveness of disclosures, and provide consumers with the ability to trust their financial advisor to act in the consumer's best interest, not their own, as to matters consumers do not fully understand.

Why, in today's complex world, does SIFMA continue to advocate for a lowering of the fiduciary standard of conduct? The answer is clear. Gordon Gekko, the high-wheeling character from Oliver Stone's 1987 film, *Wall Street*, expressed the long-standing attitude of Wall Street itself when he said, "Greed is good." Over 20 years after this film came out, and after scandal upon scandal involving Wall Street's major brokerage firms, and especially after the actions of these firms caused a financial crisis (leading to a continued global recession and harm to billions around the world), the Gordon Gekkos of the world still want the freedom to fleece the American consumer. Wall Street wants the freedom to continue to engage in activities which threaten not only the financial future of hundreds of millions of Americans, but indeed our American way of life.

Our fellow citizens deserve more. The financial world is far more complex than that which existed in 1940. Faced with increased responsibility for accumulating and managing their own "nest eggs," American consumers need trusted advisors to guide them. Yet, because of the excesses of unfettered capitalism, most consumers do not work with fiduciaries, and instead are blind to the fact that the returns the capital markets offer significantly evaporate before them, as it is estimated that 30% or more of these returns are diverted to Wall Street firms through an array of often hidden fees and costs. This diversion of profits provides the fuel for the multi-million dollar bonuses many of Wall Street's executives receive (and, it appears, still demand), even after they caused an economic crisis of a severity not seen since the Great Depression.

America deserves more. Americans need a true profession of personal financial advisors, bound together by a calling of service to the public and to their clients. Our fellow citizens deserve fiduciary counsel from those who serve only one master – the client. Congress should act to apply broad, *bona fide* fiduciary duties – the highest duties existing under the law – to all those who provide financial and investment advice. If we permit unfettered capitalism to run amok as SIFMA suggests, Americans will face a dark and gloomy financial future. Instead, Congress and the Obama administration should act to restore trust in our financial institutions through the maintenance and active application of fiduciary standards of conduct.

If Congress does not act quickly to amend the language of the Investor Protection Act of 2009, the bill should be re-titled the "Investor Harm Act of 2009."

SIFMA's embrace of the language of the Investor Protection Act of 2009 is a "wolf in sheep's clothing," and seeks to pull the wool over the eyes of an unsuspecting Congress and the American people. The tragic abuses of Wall Street in the 1930s led to important reforms in our securities laws, which today our Congress stands ready to abandon. That would be a folly and an even greater tragedy, especially if Congress does so at the behest of the Wall Street firms SIFMA represents.

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