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The Next Great Debate:

What Every Investor/Client Needs to Know About Standard of Care

Not FDIC insured • No bank guarantee • May lose value

Private Wealth
INVESTMENT SOLUTIONS

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Today's Discussion

I. Investors Are Concerned

II. Types and Roles of the Adviser

III. The Investor Standard of Care Rules

IV. Closing the Gap: The Dodd-Frank Reform Act

V. The Trust Company Standard of Care

VI. Questions

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I. Investors are Concerned

Continued Economic and Market Volatility
"The New

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- Long-term Capital
- Dot Com Bubble
- Collapse of Enron
- Other Corporate Debacles
- Subprime Crisis
- Collapse of Lehman Brothers
- 2008 Market Downturn
- Madoff Fiduciary Scandal
- 2010 Flash Crash

Continued Economic and Market Volatility

The recent recession and market volatility have changed the playing field for investors and for the financial institutions

- Regardless of their experience, most investors' assets were impacted by the crisis in the financial markets and, as a result, investors gained a newly acquired appreciation for market volatility.

- Investors now have an increased dependence on their advisors in the post-crisis world.
  - As a result it has become increasingly important to understand the underlying characteristics of the relationship with your advisor.

  - As a valued advisor to your clients there are implications resulting from introductions you might make.

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II. Types and Roles of the Adviser

Types and Roles of Advisers

It is essential for investors to understand that there are:

- Different types of financial professionals
- Different types of service models
- Different regulatory regimes
- Different standards of care

Differences Between Financial Professionals and Service Models

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Different Types of Financial Professionals:
Many investors are confused about the roles played by various investment advisers. An investor has the choice of three basic service models to receive investment advisory services:

- Broker-Dealer
- Investment Adviser
- Trust Company

Different Types Of Service Models:

- A **broker** provides full service brokerage account and is generally compensated through the commissions that are charged when the client executes a transaction
- An **investment adviser** provides investment advisory services based on a fee for service agreement and is generally compensated through a level-fee arrangement

Different Regulatory Regimes:

- A **broker** Is governed by the Securities and Exchange Act of 1934
- An **investment adviser** Is subject to and must register as an investment adviser under the Investment Advisers Act of 1940

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III. The Investor Standard of Care Rules

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Investor Standards of Care

Over the years, the investor standard of care has evolved into three classifications:

- A Caveat Emptor/ “Buyer Beware” standard
- A suitability standard for brokers
- A fiduciary standard for investment advisers

Standards of Care Differ Between Service Models

Brokers:

Brokers are subject to a "suitability standard"

> Accounts are generally nondiscretionary, meaning that brokers may make recommendations, but the client ultimately has the final authority for all decisions
> The “suitability” obligation to the client ceases once the transaction is completed

Investment Advisers:

Investment Advisers are subject to a "fiduciary standard"

> As a fiduciary, the Investment Adviser must act in the “best interest” of the client at all times and, generally, has a continuing duty to monitor and advise the client regarding performance and material factors affecting the client's investments

> For discretionary accounts, the Investment Adviser may initiate appropriate affirmative action to further the client’s interests

Standard of Care – Statutory Background

A **commissioned-based broker** is governed by the Securities and Exchange Act of 1934

> In recommending the purchase, sale, or exchange of any security,
> A broker must have reasonable grounds for believing that the recommendation is suitable for the client
> Reasonable grounds are based on the facts disclosed by clients about their other security holdings and their financial situations and needs.

A **fee-based investment adviser** is subject to and must register as an investment adviser under the Investment Advisers Act of 1940

> As fiduciary, a fee-based investment adviser must:
  - Put the client's best interests first
  - Act with the utmost good faith
  - Make full and fair disclosure, including any conflicts of interest

Dispute Resolution for Investors

Depending on the standard of care there are different vehicles for investor recourse.

Suitability Standard – *Arbitration*

> Broker-dealer customers typically are required by contract with their broker-dealers to arbitrate any eligible dispute.

> Arbitration methods tend to be faster & less expensive (overall) than state & federal lawsuits; less formal

Fiduciary Standard – *Courts*

> Complaints are often made through the SEC first; successful resolution can occur when a firm is asked to report to the SEC

> Complaints tend to be more actionable based on the fiduciary duties

> Law suits can be costly & time-consuming

> Advisory clients may elect to have disputes arbitrated

Standard of Care: A March Through Time

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1940 Act	Merrill Rule	Code of Ethics	"Financial Advisor"	Merrill Rule Rescinded	CFP as Fiduciaries	Investor Confusion	Obama Administration Changes	Dodd-Frank Reform	SEC Staff Report
Aug-40	**June-99**	**May-04**	**Apr-05**	**Apr-07**	**May-07**	**Feb-08**	**June-09**	**July-10**	**Jan-11**
The Investment Company Act of 1940 is passed setting the stage for the investment advisory fee-based environment	With the Broker-Dealer Exception Rule, the SEC allows brokers to charge fees for services and to be exempt form the 40 Act as long as the advice is solely incidental to the brokerage services	Certified financial planners registered as investment advisers must adopt written codes of ethics under a rule adopted by the SEC	The SEC votes to allow Series 7 holders to position themselves as financial advisers	A federal appeals court shoots down the Merrill Rule by a vote of 2 to 1 ruling in favor of the Financial Planning Association against the SEC	The Certified Financial Planner ("CFP") Board revises its practice standards and the new ethics standards now require CFP designees to serve their clients as fiduciaries	The SEC contracts the RAND Corp. to conduct a study. Their findings conclude that investors are confused about the differences between investment advisers and brokers	The Executive Branch proposes that the SEC require broker-dealers offering advice to be held to the fiduciary standard	The most sweeping change to financial regulation in the U.S. since the Great Depression. It required an SEC study for proposed changes	The report considered the pros and cons of further centralizing the two systems. They concluded that further study is needed

Perception vs. Reality: A Gap Still Persists

> The recent Securities and Exchange Commission ("SEC") study finds that many retail investors do not understand and are confused by the different roles played by investment advisers and broker-dealers

> The study finds that "many investors are also confused by the standards of care that apply to investment advisers and broker-dealers when providing personalized investment advice about securities" *

> At Congressional hearings held in April 2010 to determine whether financial institutions were operating in the best interests of their clients during the “sub-prime crisis”, the investor standard of care debate became a focus

> The existing statutory framework does not address the gap between investors’ perceptions and the actual standards of care in the investment world

*** FOR IMMEDIATE RELEASE 2011-20**
Washington, D.C., Jan. 22, 2011 — The Securities and Exchange Commission submitted to Congress a staff study recommending a uniform fiduciary standard of conduct for broker-dealers and investment advisers -- no less stringent than currently applied to investment advisers under the Advisers Act .

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IV. Closing the GAP: The Dodd-Frank Reform Act

The Dodd-Frank Reform Act

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On July 21, 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Reform Act) became law

- Gave the SEC the authority to implement a "universal" best interest standard of care for both investment advisers and brokers
- Instructed the SEC to:
  - Conduct a study of the effectiveness of the current legal and regulatory structure for broker-dealer firms and investment advisory firms with respect to the provision of personalized investment advice to retail customers
  - Comment on any gaps in the legal and regulatory structure

On January 21,2011, the SEC delivered the SEC Staff Report to Congress along with two dissenting opinions from the Commissioners

- The SEC received more than 3,500 comment letters
- The SEC will not adopt a uniform fiduciary standard of conduct for broker-dealers and investment advisers *at this time*.

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The Dodd-Frank SEC Staff Report

> **SEC Staff Recommendation**

- The SEC Staff study "recommended that the Commission . . . adopt and implement uniform fiduciary standard of conduct for broker-dealers and investment advisers"

> **SEC Commissioners Dissension**

Two Commissioners dissented and indicated that the Staff Study:

- failed to adequately justify its recommendation
- did not adequately articulate the problems to be addressed
- did not recognize the risk that the Study's recommendations could adversely impact investors
- did not sufficiently define SEC challenges in examining investment advisers

> **Result: *No new rule at this time***

Casey and Paredes' opposition to the study's conclusions could make it more difficult for the SEC to implement its recommendations. At least three out of five commissioners must vote to support any new rulemaking

The Dodd-Frank SEC Staff Report:
Changes Affecting Broker Dealers

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The SEC Staff recommended only three changes in rules and regulations affecting broker-dealers:

> Prohibit certain transactions, and/or require explicit consent from clients

> Make uniform disclosures regarding conflicts of interest, including principal trading

> Implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail investors

The Dodd-Frank SEC Staff Report: *Changes Affecting Investment Advisors*

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The Staff recommendations for changes in rules and regulations will affect RIAs far more than B/Ds:

- Prohibit certain transactions and/or require explicit consent from clients
- Make uniform disclosures regarding conflicts of interest
- Implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail investors
- Adopt broker-dealer *like* supervisory requirements
- Adopt broker-dealer *like* continuing education requirements
- Adopt broker-dealer *like* books and record requirements
- A new regulatory framework for Investment Advisers:
  - Authorize SEC to charge investment advisers user fees to audit them
  - Create a new FINRA *like* regulator to supervise registered investment advisers ("RIAs")
  - Expand FINRA's authority to include RIAs

Fiduciary v Suitability: Why Investors Choose One Over the Other

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As Dodd-Frank chose to keep both standards, it is important for investors to understand how they might benefit from each.

Suitability:

Investors who take an active role in developing their portfolios, especially in security selection, would benefit most from the services of a broker. This includes transaction based investing, or tactical investment needs such as options trading

Fiduciary:

Investors who seek discretionary management should utilize investment advisors, where conflict of interests and transaction costs are minimized; other candidates who may benefit from the fiduciary standard include investors seeking asset protection.

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V. The Trust Company Standard of Care

Meinhardt v. Salmon

What is the legal duty of a fiduciary?

The answer from Justice Cardozo is still quoted today:

> "A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor most sensitive, is then the standard of behavior… Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

Each Year, the Government Reviews Fiduciary Performance

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National banks, that are regulated by the Office of the Comptroller of the Currency, must continuously demonstrate compliance with this highest fiduciary standard:

> Trust Companies must incorporate an integrated "Reg. 9" review process - where all accounts are reviewed internally on an annual basis using a disciplined fiduciary investment process.

> When a Trust Company serves as trustee, it periodically monitors adherence to the terms of the trust document as well as the stated, investment objectives for the trust.

> Internal and external auditors and Risk & Compliance review Trust Companies activities to ensure that the fiduciary standard is met.

*Regulation can be found in Code of Federal Regulations Title 12, Part 9, or more commonly referred to as 12 C.F.R.§9.4100. Title is Fiduciary Activities of National Banks and Section 4 is titled Review of Fiduciary Activities.

The Standard of Care Debate

> Lawmakers and regulators are debating the standard of care to which these various types of financial institutions and professionals will be held when delivering investment products, advice and services to their clients

> These standards can vary depending upon the type of institution and how it is regulated. One standard of care is not superior to another. The Fiduciary standard of care may be more appropriate for certain clients. There is a need in the marketplace for the continuum of standards and clients to whom each standard makes sense

> Regardless of the outcome of the current standard of care debate, choosing the most appropriate standard is one of the most important decisions an investor will make

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Questions

The Bank Fiduciary Standard of

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U.S. Trust has operated under the Bank Fiduciary Standard throughout its history

The Bank Fiduciary Standard - is the highest in the industry and includes:

- Loyalty
- Prudence
- Impartiality

The Bank Fiduciary Standard of

At U.S. Trust, the adviser must act in the sole best interest of the client and must ensure that an investment is:

> Prudent at the time of purchase

> Assessed on an ongoing basis to determine that it remains prudent

> Assessed not in isolation but in the context of the entire portfolio

> Assessed as part of an overall investment strategy that incorporates appropriate risk and return objectives

The Bank Fiduciary Standard of Care Drives Every U.S. Trust Investment Decision

This Bank Fiduciary Standard is the foundation for a consistent, disciplined investment process:

- Each fiduciary investment client has a formal Investment Policy Statement .
- Investment and asset allocation decisions are driven solely by a client's objectives.
- The fiduciary standard extends to every client that receives investment advice, whether an individual, a trust or an estate.

The Fiduciary Standard of Care Drives Every U.S. Trust Investment

Regardless of the outcome of the current standard of care debate, U.S. Trust believes that now more than ever choosing the most appropriate standard is one of the most important decision an investor will make.

Standard of Care Differ Between Service Models

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Brokers

> Brokers are subject to a "suitability standard"
  - ? The "suitability" obligation to the client ceases once the transaction is completed

Investment Advisors

> Investment Advisors are subject to a "fiduciary standard"
  - ? As a fiduciary, the investment advisor must act in the "best interest" of the client at all times and generally has the continuing duty to monitor and advise the client regarding performance and material factors affecting the client's investments

Trust Companies

> Trust Companies must act in the sole best interest of the client and must ensure that an investment is:
  - ? Prudent at the time of purchase
  - ? Assessed on an on-going basis to determine that it remains prudent
  - ? Assessed not in isolation but in the context of the entire portfolio
  - ? Assessed as part of an overall investment strategy that incorporates appropriate risk and return objectives

Disclosure

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