

Fiduciary Duty in an Age of Consumerism

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On April 6, 2016, the U.S. Department of Labor (DOL) established a fiduciary duty principle—the requirement that investment advisers and brokers who give advice to clients holding retirement plans place the interests of investors first. One of the recent press reports on the rule headlined its story: **FINALLY, JOHN BOGLE’S DREAM OF A FIDUCIARY STANDARD WILL COME TRUE.**

Yes, the new rule is complex, but previous comments from the fund industry have made it considerably more workable, with disclosures that are more practical and easier for advisers and brokers to follow. Nonetheless, the DOL fiduciary standard continues to face powerful adversaries. The U.S. Chamber of Commerce, as usual, places business interests ahead of consumer interests and, along with eight other groups, has filed a federal lawsuit seeking to block implementation of the new rule.

But I strongly support the rule. I’ve arguably been campaigning for it ever since I wrote my senior thesis at Princeton University 65 years ago. There, I wrote at length about the use of mutual fund shares by fiduciaries and retirement plans, suggesting that such use “seems destined to increase in the future.” But far more broadly, I wrote that, “*the prime responsibility* [of mutual funds] *must always be to their shareholders.*” And that’s precisely what our industry’s governing statute, the Investment Company Act of 1940, demands: Funds must be “organized, operated, [and] managed” in the interests of their shareholders, *rather than* in the interests of their directors, officers, investment advisers, or underwriters (distributors).

The opinions expressed in this speech do not necessarily represent the views of Vanguard’s present management.

The 1971 Challenge

In 1971, even more pointedly, speaking to the partners of Wellington Management Company—where I served as chief executive from 1965 through early 1974—I expressed my focus on fiduciary duty in much sharper terms. In a section of my remarks entitled, “The Challenge of Fiduciary Duty,” I said:

“We live in a world that is increasingly intolerant, not only of conflicts of interest, but even the appearance of conflicts. It is hard to argue either that this trend is baneful or that it is likely to abate. For this is but one aspect of the “consumerism” whose impact pervades almost every aspect of our society, and certainly is not limited to the world of money management. It seems beyond question that consumerism, along with the entire thrust of the legislative, regulatory, and judicial overview of our profession will play a critical role in how we conduct our affairs in the years ahead.”

And then—yes, 45 years ago—I pulled out all the stops. The next section of my talk was entitled, “A Man Cannot Serve Two Masters.”

“Listen, for example, to Justice Harlan Fiske Stone, speaking in 1934:

‘I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of the mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that a man cannot serve two masters . . . the development of the corporate structure so as to vest in small groups control over the resources of great members of small and uninformed investors, make imperative a fresh and active devotion to that principle. Yet, those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those who interests they purport to represent . . . consider only last, if at all, the interests of those whose funds they command, suggest how far we have ignored the necessary implications of that principle.’

I then continued:

“I endorse that view, and at the same time reveal an ancient prejudice of mine: All things considered, absent a demonstration that the enterprise has substantial capital requirements that cannot be otherwise fulfilled, it is undesirable for professional enterprises to have public stockholders. This constraint is as applicable to money managers as it is to doctors, or lawyers, or accountants, or architects. In their cases,

as in ours, it is hard to see what unique contribution public investors bring to the enterprise. They do not, as a rule, add capital; they do not add expertise; they do not contribute to the well-being of our clients. Indeed, it is possible to envision circumstances in which the pressure for earnings and earnings growth engendered by public ownership is antithetical to the responsible operation of a professional organization. Although the field of money management has elements of both, differences between a business and a profession must, finally, be reconciled in favor of the client.

. . . If it is a burden to our fund and counsel clients to be served by a public enterprise [which Wellington Management Company then was], should this burden exist in perpetuity? And if we believe that it is in the interest of our fund and counsel clients that our firm should be owned by its active executives and not by the public, shouldn't we work to solve this problem in a way that is equitable to all? What a great objective to be accomplished by 1976!"

Mutualization?

I then turned to the options available for a publicly-held fund manager which sought to free itself of those burdens:

"I wish there were a simple way to accomplish what I am talking about, let alone to describe it. But, let me say that a variety of options may open up as the legal atmosphere clears. For example, there may be 'mutualization' whereby the funds acquire the management company."

As far as I can recall, this was my first use of the term *mutualization*.

Only three years later, as it turned out, the set of challenges that I had described in 1971 was resolved in September 1974 by the mutualization of the operations of Wellington Fund and her sister funds. The incorporation of The Vanguard Group of Investment Companies represented a totally new and hitherto untried mutual fund structure. Vanguard was the first—and is still the only—mutual fund complex that is truly *mutual*. The whole idea was to give our mutual funds the power and freedom to put the interests of their own shareholders first; to be managed on an "at-

cost,” basis; and to operate with complete independence from their investment adviser. How would that work in practice? After an examination that lasted from 1977 until 1981, here’s how the SEC expected it to work, as described in its decision on the Vanguard plan:

The Vanguard plan is consistent with the provisions, policies, and purposes of the Act. It actually furthers the Act’s objectives by ensuring that the Funds’ directors, with more specific information at their disposal concerning the cost and performance of the Funds, are better able to evaluate the quality of those services.

The plan will foster improved disclosure to shareholders, enabling them to make a more informed judgment as to the Funds’ operations. In addition, the plan clearly enhances the Funds’ independence, permitting them to change investment advisers more readily as conditions may dictate. The plan also benefits each fund within a reasonable range of fairness.

Specifically, the Vanguard plan . . . enables the Funds to realize substantial savings from advisory fee reductions; promotes savings from economies of scale; provides the Funds with direct and conflict-free control over distribution functions; (and) promotes a healthy and viable mutual fund complex within which each fund can better prosper.

The approval of Vanguard’s structure by the five commissioners of the SEC was unanimous. It was the final stamp of approval on what proved to be a new way of operating a fund complex that would ultimately lead to a major reordering of the fund industry. The rest, as they say, is history.

“A Journey of a Thousand Miles”

With that history as background, where are we today? In my view, the formation of Vanguard and its “shareholder first” structure marks the beginning of a long arc that is bending toward fiduciary duty. As it is said, “a journey of a thousand miles begins with a single step.” And thanks importantly to the determination of Assistant Secretary of Labor Phyllis Borzi, the DOL has given vital support to that fiduciary principle, recently approving a rule that requires both registered investment advisers (RIAs) and stock brokers to place the interests of their clients holding retirement plans before their own.

RIAs have always been subject to the fiduciary duty test, but applying the test to stock brokers who serve retirement plan clients raises, at least theoretically, some challenging questions for a broker:

- 1) Do I serve my clients who have retirement plans differently from my other investor/clients without retirement plans? How? Why?
- 2) When client/investors hold both, do I handle their retirement plans any differently from their regular accounts, and hold myself to a lesser standard. How? Why?

As a practical matter, I can't imagine brokers serving their non-retirement plan clients with a lower standard of duty and care than their retirement plan clients. How could they possibly defend such actions? So, I would expect the brokerage system to move quickly to the all-encompassing application of the fiduciary standard to all of their clients. But the issue would be far better resolved if the SEC took parallel action to the DOL's, and promptly established a fiduciary standard for all intermediaries in serving all of their clients.

But, believe me, the creation of a tough federal standard of fiduciary duty will not end there. It is not only financial advisers and brokers handling client accounts who must subordinate their own financial interests to those of the investors that they serve. *That fiduciary standard must be applied to every person and every entity that touches Other People's Money (OPM)*, applied to every dollar entrusted by investors to our nation's financial system.

A Broader Fiduciary Standard

Ultimately, then, the fiduciary standard *must* also encompass the behavior of all institutional money managers responsible for investing Other People's Money, so far a curious omission from consideration in the debate. (Financial institutions hold some 70% of all U.S. stocks.) It must also include officers, directors, trustees, employees, custodians, and even certain marketing officials of these institutions. Alas, in a curious omission from the Dodd-Frank Act, the SEC is asked to report to the Congress on the subject of fiduciary duty, but it is barred from considering institutional money managers in its study. (One wonders which industry lobbyist snuck that one in, through which member of Congress?) The role of politics and money managers in this debate suggests that the full extension of the fiduciary standard will be a long battle.

If saying that I've been fighting this battle since I wrote that thesis in 1951 is a push (and it is!), it is clear that I've been at it since at least 1971 (note that earlier speech) and surely since 1974, with the formation of Vanguard as the first mutual, shareholder-owned firm, driven ahead largely by our 1975 creation of the first and ultimate fiduciary-oriented, consumer-oriented mutual fund: *the index mutual fund*. Our First Index Investment Trust was designed to track the S&P 500 Index. The beginning of an indexing strategy that was the logical, even obvious, result of our mutual structure. Indeed, it was our first strategic move. That index fund began with an IPO in 1976 that was, to be blunt, a flop, raising only \$11 million—far less than the underwriters' goal of \$150 million. But, now known as Vanguard 500 Index Fund, its assets exceed \$450 billion. With its sister index funds at Vanguard, indexing strategies now account for some \$2.4 trillion of the firm's \$3.2 trillion asset base.

Most of my books touch on (pound on?) the same theme: “Put the investor first.” *Bogle on Mutual Funds* (1993), *Common Sense on Mutual Funds* (1999/2009), and *The Battle for the Soul of Capitalism* (2005) all emphasize this message of fiduciary duty. *The Clash of the Cultures* (2012) even has the temerity to set forth 15 objective standards by which investors can measure the extent to which their mutual funds are being operated by managers who are meeting the fiduciary standards, “The Stewardship Quotient.” The SQ, for example considers management fees and expense ratios, portfolio turnover, sales loads, longevity of portfolio managers, fund share ownership by insiders, board composition, and so on. The SQ sets a high standard, one which too many fund groups fail to meet.

Adam Smith to the Fore

Now think about this: it may not matter *when* and even *if* my expansive goals for the fiduciary standard are achieved. For we live in an Age of Consumerism in which consumers are empowered to demand that businesses serve their needs, and businesses that fail to satisfy those demands face a dim future. This represents the most powerful single economic force in all human history. With today's rapidly expanding availability of information, technology has radically reordered the consumer markets, and continues to do so. In finance, this new age will bring much improved disclosure, more transparency, investor education that separates fact from fiction, and raises “red flags” on key issues such as returns, risks, costs, and management quality. Today's Age of Consumerism shows no sign of abating; more likely, it will accelerate.

We could hardly expect even a man with the wisdom, intelligence, logic and clear vision of Adam Smith to have anticipated in detail the various streams—really rivers—of commerce of today’s business and technological environment. But his overarching vision was surely a harbinger of this Age of the Consumer. As Adam Smith wrote in 1776:

Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident, that it would be absurd to attempt to prove it . . . [T]he interest of the consumer . . . [must be] the ultimate end and object of all industry and commerce.

Applying Smith’s insight to the investment industry, I firmly believe Smith would endorse not only the power of the consumer, but it’s implications for the principle of fiduciary duty. Paraphrasing that final sentence:

The interest of the investor must be the ultimate end and object of the entire financial system.

Whatever fabric the pattern of these threads of history ultimately weaves, many of you in this audience today can take pride in being, dare I say, in the vanguard of this movement. Today begins “The Campaign for Investors” of the Institute for the Fiduciary Standard. It will lead to greater financial freedom for America’s citizen/investors, and will serve, in the words of the Investment Company Act of 1940, “the national public interest” as well. So fight on! It’s worth it! “Stay the Course!” “Press on Regardless!” We are on the right side of history.