AN INVESTMENT ADVISER'S FIDUCIARY DUTY

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Events like the Madoff Ponzi scheme, Wall Street reform and other recent developments have focused attention once again on the fiduciary duties advisers owe to their clients.

This paper explains an adviser's fiduciary duties along with the impact recent transformative events have had.[1]

What is the Fundamental Nature of the Relationship Between an Adviser and its Clients?

An adviser's relationship with its clients is fundamentally one of "trust and confidence."[2] This flows from the fact that clients consent to having the adviser act on their behalf, making the clients vulnerable to the adviser. The law provides some measure of protection for clients in light of that vulnerability by imposing on advisers fiduciary duties owed to their clients.

What Is the Legal Basis for an Adviser's Fiduciary Duties?

There are two main legal bases for an investment adviser's fiduciary duties --

✓ Common law:

Under common law principles of agency, an investment adviser, as agent, owes fiduciary duties to its client, as principal.[3] Certain other aspects of an adviser's fiduciary duties are grounded in the law of trusts.[4] In any event, an adviser's duties at common law will depend on judge-made case law emanating from the state level, including application of conflicts of law principles to determine which state's law applies, and will be enforceable by anyone with standing to sue.

✓ Federal statutory law:

Section 206. An adviser's fiduciary duty also emanates from certain federal statutes, most notably Section 206 of the Investment Advisers Act of 1940 ("Advisers Act"), an anti-fraud section which generally prohibits an adviser from engaging in any practice that is fraudulent, deceptive or manipulative. In the seminal case of SEC v. Capital Gains Research Bureau,[5] the U.S. Supreme

[1] This paper is not intended to be an exhaustive academic discussion of an adviser's fiduciary duties, but rather a useful resource to explain the core principles, accompanied by citations that can be pursued for more detail.

[2] See Investor Information>What Is An Investment Adviser?> Fiduciary Duty, on the website of the Investment Adviser Association at https://www.investmentadviser.org/eweb/ (IAA): "Investment advisers owe a fiduciary duty to their clients. As such, an investment adviser stands in a special relationship of trust and confidence with its clients." (emphasis added) See also Capital Gains, *infra* note 5: "In describing their profession, leading investment advisers emphasized their relationship of 'trust and confidence' with their clients…." (citing Senate hearings held at the time the Advisers Act was originally enacted); and In the Matter of James C. Dawson, Advisers Act Release No. 3057 (July 23, 2010) (Dawson) (adviser barred from associating with any other adviser after law judge found that he had engaged in "cherry-picking," allocating a disproportionate percentage of profitable trades to his own account, rather than those of his clients): "Dawson's misconduct undercuts the trust that is the foundation of the investment advisory relationship, and demonstrates a lack of fitness to serve as a fiduciary…." (footnotes omitted; emphasis added).

[3] Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act. Restatement (Third) of Agency § 1.01 (2006).

[4] "We then saw [the fiduciary] concept develop over hundreds of years in the common law. As it did, we saw two streams of analysis emerge: one couched in the law of trusts, the other in the laws of agency." Remarks of Andrew J. Donohue, Director of the SEC Division of Investment Management at IAA/ACA Insight's Investment Adviser Compliance Forum 2010 (February 25, 2010).

[5] 375 U.S. 180 (1963) (Capital Gains).

Court said (in dicta) that the Advisers Act reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship."[6]

It is not clear whether the Court in Capital Gains was merely explaining common law, interpreting Section 206 or both. However, the case has long been cited for the proposition that advisers owe a fiduciary duty to their clients under the Advisers Act,[7] including an affirmative duty to act with utmost good faith, to make full and fair disclosure of all material facts, and to employ all reasonable care to avoid misleading clients.[8]

As a result, the Advisers Act is viewed as setting a "federal" fiduciary standard[9] for advisers.[10] Because there is generally no private right of action under the Advisers Act,[11] the contours of that duty will be shaped largely by federal courts interpreting the Act, as well as by SEC interpretations of Section 206 and rules promulgated under that section.

Although they are likely not identical, there is little guidance that distinguishes an adviser's common law fiduciary duty from its federal fiduciary duty under the Advisers Act. Some believe the federal fiduciary duty is a subset of the adviser's general fiduciary duty.[12] That could be the case if the federal fiduciary duty under Section 206 is interpreted to be, in short, a duty not to defraud clients. However, it also implies that every violation of Section 206 would also ground a breach of fiduciary duty claim under common law. It is unclear whether that would be the case, given how far-reaching the scope of Section 206 might be interpreted to be.[13]

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[6] As described in the case, the adviser had a practice of purchasing shares for its own account shortly before recommending them for long-term investment to its clients, and then immediately selling its own shares at a profit upon the rise in the market price following the recommendation, sometimes referred to as "scalping," and held that the practice operates as a fraud or deceit upon a client within the meaning of Section 206 of the Advisers Act.

[7] At least under Section 206(2) of the Advisers Act, which had been enacted at the time of the events at issue in the Capital Gains case and seemed to be the principal focus of the Court's opinion. The fiduciary relationship embedded in the Advisers Act is also referenced in Lowe v SEC, 472 U.S. 181 (1985), CCH Fed. Sec. L. Rep. ¶92,062, where the Court recognized the adviser-client relationship as a kind of fiduciary, person-to-person relationship intended to be covered by the Act.

[8] Capital Gains, *supra* note 5, in the text surrounding footnote 44.

[9] This was confirmed in the U.S. Supreme Court case of Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (Transamerica): "As we have previously recognized, [Section] 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers…," citing Capital Gains and other cases. "Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations." Id. (citations omitted).

[10] Section 206 applies by its terms to all persons within the scope of the definition of "investment adviser" under the Advisers Act, including SEC-registered, state-registered and unregistered advisers, even though some of the rules adopted by the Commission under Section 206 are limited only to SEC-registered advisers. The SEC has also noted that an adviser's fiduciary duties do not turn on whether the advice given is discretionary or non-discretionary See ADV Release, *infra* note 46, at footnote 256. Compare that to the fiduciary duties thought to be owed by brokers, which may indeed turn on whether the advice is discretionary. See Brave New World, *infra* note 26.

[11] Transamerica, *supra* note 9.

[12] See Memorandum to the SEC Investor Advisory Committee from the Investor as Purchaser Subcommittee, dated February 15, 2010, regarding Fiduciary Duty Issue, at p.3: "The federal fiduciary duty comprises a subset of the general fiduciary duty that an investment adviser owes to his clients."

[13] Section 206 is, after all, an anti-fraud provision and the SEC has on occasion defined as "fraudulent" under Section 206 conduct that would not seem to be recognized as "fraud" at common law. For example, advisers who are deemed to have custody under Rule 206(4)-2 must maintain client assets with a "qualified custodian" or risk committing fraud under that rule. Similarly, advisers who exercise proxy voting discretion without adopting proxy voting procedures risk committing fraud under Rule 206(4)-6. Without more, neither of those scenarios seem likely to constitute "fraud" – or breach of fiduciary duty for that matter – at common law. Moreover, in Capital Gains, the Supreme Court quite explicitly rejected the idea that the Advisers Act prohibitions on fraud and deceit are constrained by principles of common law fraud. Capital Gains, *supra* note 5, in footnote 6 and the text surrounding footnotes 39-47.

Dodd-Frank Reform Act -- Advisers. Importantly, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") signed into law in July 2010 has the potential to further shape an adviser's federal fiduciary duty under the Advisers Act. The Dodd-Frank Act calls for the SEC to study existing legal and regulatory standards of care for advisers[14] when providing personalized investment advice to retail customers. Based on that study, the SEC is authorized to promulgate rules requiring advisers to "act in the best interest of the customer without regard to the financial or other interest of the adviser providing the advice," under a standard of conduct which is no less stringent than the standard applicable to advisers under Section 206.[15] The rules must also require disclosure of any material conflicts of interest.

Although the Dodd-Frank Act does not actually hold advisers to a "fiduciary duty" using those words, the "best interest" standard, the reference to Section 206 and the disclosure requirements seem to be pointing in that direction.

Dodd-Frank Reform Act – Municipal Advisors. The Dodd-Frank Act also adds (to the Securities Exchange Act of 1934) a new class of financial service providers called municipal advisors.[16] The definition of "municipal advisor" specifically excludes investment advisers registered with the SEC under the Advisers Act, although on its face would include unregistered and state-registered advisers who otherwise meet the definition (and are not excluded under some other provision).

Significantly, the Dodd-Frank Act imposes on municipal advisors an express fiduciary duty:

> ''A municipal advisor and any person associated with such municipal advisor shall be deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act, practice, or course of business which is not consistent with a municipal advisor's fiduciary duty or that is in contravention of any rule of the [Municipal Securities Rulemaking] Board."[17] (emphasis added)

Time will tell exactly how this new federal fiduciary duty will be interpreted and applied. Except for aspects that may be unique to municipal securities, it can be envisioned, however, that the fiduciary duty imposed on all advisers under Section 206 of the Advisers Act and that imposed on municipal advisors under this new provision will be interpreted similarly.

✓ Other sources of fiduciary duty:

Advisers may have a fiduciary duty to their clients emanating from other sources as well. Several of these potential sources are mentioned below although a full discussion of them is beyond the scope of this paper.

- Section 36(a) of the Investment Company Act of 1940: Under Section 36(a) of the Investment Company Act of 1940, an adviser can be held liable for breach of fiduciary

[14] And others, such as brokers, dealers and their associated persons.

[15] See Dodd-Frank Act Section 913 generally. It does seem rather odd, however, that the Act requires the SEC to study the issue but seems to pre-determine the result by giving the SEC a specific standard of conduct to require from advisers in any ensuing rulemaking (to act in the best interest of clients, etc.).

[16] "Municipal advisor" is generally defined as anyone who provides advice to or on behalf of a municipal entity with respect to municipal financial products or who solicits a municipal entity on behalf of another person (like an investment adviser seeking an advisory engagement). See Dodd-Frank Act Section 975. Among other things, municipal advisors must register with the SEC. The Act also grants the SEC authority to regulate and sanction municipal advisors for fraudulent conduct and other violations of the federal securities laws.

[17] See Dodd-Frank Act Section 975.

duty “involving personal misconduct” in respect of any registered investment company for which it serves as adviser. Section 36(a) has been described as a “reservoir of fiduciary obligations” that is designed to protect shareholders from the many subtle abuses that are not separately prohibited in the Investment Company Act.[18] However, despite decades of litigation involving Section 36(a),[19] we still do not have a definitive understanding of what it means for a breach of fiduciary duty to “involve personal misconduct.” While actual intent to violate the law may not be required, there is authority suggesting that nonfeasance of duty or abdication of responsibility may be enough.[20]

- Blue Sky Laws: In many cases, securities statutes and regulations adopted by various states (so-called Blue Sky laws) prohibit conduct similar to that prohibited by Section 206 of the Advisers Act.[21] Using the rationale spelled out by the Supreme Court in Capital Gains, these state provisions could be interpreted to impose a fiduciary duty on advisers as well.

- ERISA: Persons who operate pension, retirement, welfare and other types of plans covered by the Employee Retirement Income Security Act of 1974 (“ERISA”) may be considered fiduciaries under ERISA, including investment advisers who are hired to manage plan assets. Among other things, advisers who are ERISA fiduciaries are required to adhere to the ERISA “prudent man” standard of care[22] and the ERISA “exclusive benefit rule,” as interpreted, applied and enforced by the Department of Labor (“DOL”).[23] In some respects, the ERISA fiduciary duty is considered stricter than the duties imposed on advisers under the Advisers Act.[24]

- Broker-Dealer Laws: Dual-registered adviser/brokers may have other duties to their clients that emanate from their status as a broker-dealer, under the broker-dealer laws or SRO rules, such as the FINRA Conduct Rules. The nature of those duties will depend on the nature of the relationship between the adviser/broker and its client but may include duties characterized as “fiduciary.”[25] While a complete discussion of a broker’s duties as

[18] See Brown v. Bullock, 194 F. Supp. 207, n.1 at 238-239 (S.D.N.Y.), aff’d, 294 F.2d 415 (2d Cir. 1961) (en banc).

[19] See the cases cited in Bellikoff et al. v. Eaton Vance Corp. et al., 481 F.3d 110 (2d Cir. 2007).

[20] See the authorities referenced in Robert A. Robertson, Fund governance: legal duties of investment company directors, § 9.01[2].

[21] See, for example, Section 33-1.C. of the Texas Securities Act and Section 11-51-501(5) of the Colorado Securities Act.

[22] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a), provides that “a fiduciary shall discharge his duties with respect to a plan . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims . . . .” Some states have enacted their own version of the “prudent man” rule or the more modern “prudent investor rule” applicable generally to “trustees.” See Uniform Law Commissioners, Uniform Prudent Investor Act at: http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp.

[23] ERISA § 404(a)(1)(B) also provides that “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries….” More information on being an ERISA fiduciary can be found on the DOL’s website at: http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.

[24] See Ron Rhoades, Columnist, “One-Man Think Tank: Inside the legal issues of the Goldman Sachs hearings,” RIABiz, Wednesday 5.5.10 : “It should be noted that the Advisers Act has always adopted the ‘best interests’ standard found in the Investment Advisers Act of 1940, which is a codification of state common law. In contrast, ERISA largely adopted a ‘sole interests’ standard – which is a stricter form of fiduciary obligation. Hence, financial advisors providing clients advice on accounts subject to ERISA may possess additional duties under their status as an ERISA fiduciary.” See also, Richard K. Matta, “ERISA for securities professionals: 2008 update,” Journal of Investment Compliance (Vol. 10, No. 1, 1999, pp. 4-34).

[25] See Brave New World, *infra* note 26.

compared to those imposed on advisers is beyond the scope of this paper,[26] suffice it to say that changes are likely to be in the offing, given that the Dodd-Frank Act discussed above:

- calls for further study of the legal and regulatory framework governing the standard of care applicable to brokers versus investment advisers when providing retail customers personalized investment advice;
- allows the SEC to promulgate rules providing that the standard of conduct applicable to all brokers and dealers when providing retail customers personalized investment advice shall be to act in the "best interest of the customer without regard to the financial or other interest of the broker [or] dealer…providing the advice," under a standard of conduct which is no less stringent than the standard applicable to advisers under Section 206 of the Advisers Act;[27] and
- provides that the standard of conduct applicable to brokers and dealers shall be "the same" as that applicable to advisers in that context.[28]

Interestingly, as noted above with regard to advisers, the Dodd-Frank Act does not actually say brokers will actually have a "fiduciary duty" to customers, although the "best interest" standard, disclosure and consent requirements and references to Section 206 seem to be aiming in that direction.

What are the Basic Fiduciary Duties an Adviser Owes to its Clients?

A comprehensive list of an adviser's fiduciary duties is not found in either the common law or the Advisers Act.[29] However, duties of care and loyalty[30] are among the basic fiduciary duties advisers are generally held to owe their clients, at a minimum. Some authorities also list a duty of obedience.[31] Still others refer to a duty to act in good faith,[32] and a duty of disclosure.[33]

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[26] For a more complete discussion of a broker's duties as compared to those of advisers, see James Hamilton, J.D., LL.M, "SEC Regulation of Investment Advisers and Brokers in the Brave New World," *Practical Compliance & Risk Management for the Securities Industry* (May-June 2008) (Brave New World). In particular, note this regarding brokers' duties even under pre-Dodd-Frank Act law: "Accordingly, brokers who handle discretionary accounts are generally thought to owe fiduciary obligations to their clients. Not only do such duties transcend the basic regulatory constraints placed on the broker, but they also give rise to individual enforcement rights by the client. In contrast, brokers handling nondiscretionary accounts are generally thought to owe much more limited duties to the customer, principally concerning many of the rules that apply to all registrants, including prompt order execution, knowing one's security, knowing one's customer, disclosing conflicts of interest, and refraining from engaging in securities fraud." (footnotes omitted) See also Investor and Industry Perspectives on Investment Advisers and Broker-Dealers, Rand Institute for Social Justice (the so-called "Rand Report") (2008) discussing investor beliefs about whether advisers and other financial professionals were required to act in their best interest or were required to act as fiduciaries.

[27] See Dodd-Frank Act Section 913(g)(2).

[28] See Dodd-Frank Act Section 913(g)(1).

[29] See "Fiduciary Duty: Return to First Principles," Remarks of Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, at the Eighth Annual Investment Adviser Compliance Summit in Washington, D.C. (February 27, 2006) (Richards Fiduciary Speech): "How do the responsibilities of a fiduciary translate into an adviser's obligations to clients each and every day? This is a key question. Probably no statute or set of rules could contemplate the variety of factual situations and decisions that an advisory firm faces. Can you imagine the number of rules and releases and regulations that this would require?"

[30] See IAA, *supra* note 2: "As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients."

[31] See, for example, McGrath Remarks, *infra* note 51, at p.7: "The words 'fiduciary duty' refer to the duties, of first, obedience to the terms of one's trust, second, diligence and care in the carrying out of one's fiduciary functions, and third, undivided loyalty to the beneficiaries of one's trust." Other authorities do not list the duty of obedience separately, but rather consider it within the framework of the other basic duties of care and loyalty.

[32] See Capital Gains, *supra* note 5, at text surrounding footnote 44. See also Ron A. Rhoades, JD, CFP®, Editor, FiduciaryNow.com, "What Are The Specific Fiduciary Duties of Financial Advisors?" (January 1, 2008) at

Each of these duties is discussed in more detail below.

How do these Basic Duties Apply to a Particular Adviser?

How fiduciary duties apply to any particular adviser will vary, depending on the adviser's business model, clientele, services, relationships and other factors.[34] For example, whether an adviser has satisfied its duty of disclosure might depend on how sophisticated its clients are.

However, we can learn something about how an adviser's duties might apply in practice from various authoritative sources, including the common law,[35] state and federal case law,[36] legislative history,[37] SEC guidance,[38] industry commentators[39] and others.[40] The list below was compiled from those sources and is sorted under each of the major duties discussed previously, accompanied in each case by illustrative examples.

✓ Duty of Care: An adviser must –

- Exercise due care (prudence and reasonableness) when acting on behalf of clients.[41]

  Examples of this might include –
  - eliciting from clients a sufficient amount of information at the inception of the relationship (and updated thereafter periodically) to make a reasonable assessment of their sophistication in investment matters and risk tolerance

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http://www.fiduciarynow.com/WhatAreTheSpecificFiduciaryDutiesofFinancialAdvisors.pdf who, among others, refers to the duties of care, loyalty and good faith as a "triad" of duties. Compare Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006), explaining that the duty of good faith is essentially a subset of the duty of loyalty.

[33] Capital Gains, *supra* note 5, at the text surrounding footnote 44: "Courts have imposed on a fiduciary an affirmative duty of… full and fair disclosure of all material facts." Others consider the duty of disclosure part and parcel of the duty of loyalty, since disclosure is usually required where non-disclosure would otherwise mislead a client or leave the client uninformed about (and therefore not consenting to) a conflict of interest.

[34] IAA, *supra* note 2: "The parameters of an investment adviser's fiduciary duty depend on the scope of the advisory relationship…." Also, Michael S. Caccese, "Portfolio Manager Lift-Outs, Investment Performance Portability, and the CFA Institute Member," Securities Regulation Law Journal [Vol. 34:31 2005] at 33: "The specific contours of the fiduciary duties owed by investment advisers to their clients will vary depending on the particular circumstances present in the relationship between the fiduciary and its client."

[35] Often as codified in the Restatements, such as the Restatement (Third) of Agency (2006), referenced *supra* note 3.

[36] See, for example, the cases cited throughout these footnotes.

[37] See, for example, the legislative history behind the Advisers Act discussed in Transamerica, *supra* note 9. A full discussion of the legislative history of amendments to the Advisers Act made by the Dodd-Frank Act is still being written. See, for example, Jim Hamilton, "Senator Johnson Clarifies Compromise on Broker Duty of Care," Wolters Kluwer CCH Financial Reform News Center at: http://financialreform.wolterskluwerlb.com/2010/07/senator-johnson-clarifies-compromise-on-broker-duty-of-care.html#more.

[38] In addition to the Commission releases cited throughout these footnotes, see Richards Fiduciary Speech, *supra* note 29: "I would suggest that an adviser, as that trustworthy fiduciary, has five major responsibilities when it comes to clients. They are: to put clients' interests first; to act with utmost good faith; to provide full and fair disclosure of all material facts; not to mislead clients; and to expose all conflicts of interest to clients."

[39] See, for example, the Duty of Due Diligence article, *infra* note 73.

[40] Such as the trade organization for SEC-registered advisers known as the Investment Adviser Association, referenced *supra* in note 2, among others.

[41] See the discussion below at pp. 16-19 about the standard of care (negligence versus gross negligence) applicable in any given case.

- acting with due care when assessing a client's risk tolerance, selecting investments consistent with that risk level and reasonably monitoring for risk
  - making sure new client assets are invested reasonably promptly

- Employ reasonable care to avoid misleading clients.[42]

  Examples of this might include –
  - using due care when completing Form ADV and making other disclosures to clients and prospective clients
  - calculating performance with due care when preparing marketing materials, pitch books, website presentations and other materials provided to clients and prospective clients
  - comparing adviser account performance to benchmark indexes selected with due care to ensure a meaningful and balanced presentation

- Have a reasonable basis for investment advice.[43]

  Examples of this might include –
  - using due diligence to research investments and making selections and recommendations with due care
  - monitoring investments with reasonable frequency for potential changes, consistent with the adviser's contractual and discretionary obligations
  - using only investments and techniques in which the adviser and its personnel are reasonably competent and avoiding investments and techniques where they are not

- Seek best execution[44] of clients' trades (seek the best net price and terms reasonably available under the circumstances).

  Examples of this might include –
  - using due care when selecting brokers and other trading venues with a view to maximizing the client's net result
  - periodically evaluating the quality of the execution being provided by the brokers selected, to ensure that they are continuing to provide best execution
  - staying apprised of and using reasonably available alternative trading venues (for example, ATSs, ECNs and dark pools) to execute trades when they offer best execution[45]

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[42] Capital Gains, *supra* note 5, at text surrounding footnote 45.

[43] IAA, *supra* note 2.

[44] Advisers have long been held to have a duty to seek best execution of client trades and this duty is most commonly referred to as "fiduciary" in nature. See, for example, Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270-271 (3d Cir. 1998), which says: "The duty of best execution, which predates the federal securities laws, has its roots in the common law agency obligations of undivided loyalty and reasonable care that an agent owes to his principal." See also Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Release No. 34-54165 (July 18, 2006): "Fiduciary principles require money managers to seek the best execution for client trades….''; and In the Matter of Fleet Investment Advisors: "In addition, an investment adviser's fiduciary duty includes the requirement to seek the best execution of client securities transactions where the adviser is in a position to direct brokerage transactions," Release No. IA-821 (Sept. 9, 1999), citing Kidder Peabody & Co., Inc., Edward B. Goodnow, Advisers Act Release No. 232, 1968 SEC LEXIS 251 (October 16, 1968) and other cases. Lastly, see Rule 206(3)-2(c) under the Advisers Act, which refers to the adviser's duty to act in the best interests of its clients, including the duty "with respect to best price and execution" for client transactions

[45] The SEC has made it abundantly clear that advisers should be assessing their best execution "periodically and systematically." This should include at least considering venues such as ATSs (alternative trading systems). See Remarks of Lori Richards, Director of the SEC's Office of Compliance, Inspections and Examinations, at the ICI Conference 2001 Mutual Fund Compliance Conference (June 14, 2001): "To ensure that advisers are fulfilling their duty of best execution, they are required to 'periodically and systematically' evaluate the quality of execution services received from the broker-

✓ <u>Duty of Loyalty</u>: An adviser must –

- Act in the best interest of clients.[46]

  Examples of this might include –
  - recommending only suitable investments for clients, based on an appropriate understanding of each client's circumstances, goals and risk tolerance
  - not interpositioning a broker into client trades for the purpose of compensating the broker for referring the client to the adviser, when the broker does not have a role in executing, clearing or settling the trade[47]
  - recommending to clients fund share classes that are the lowest cost available consistent with the client's eligibility, expected term of ownership, servicing expectations and other relevant factors, even if the pay-out to the adviser or adviser rep may be higher in a different fund or class

- Place the interest of clients above its own.[48]

  Examples of this might include –
  - making decisions to buy or sell securities for a client's account on the basis of the client's best interest and not on the basis of the adviser's opportunity to earn a commission[49] or other fees from the transaction
  - sequencing a client's trade ahead of the adviser's proprietary trade (or aggregating the trades together only with full disclosure and client consent)
  - allocating profitable trades to client accounts rather than to proprietary accounts[50] (or allocating trades to proprietary accounts only when using a fully disclosed, fair, consistently applied methodology)

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dealers that are used to execute …trades." See also, In the Matter of Portfolio Advisory Services, LLC, and Cedd L. Moses, Advisers Act Release No. 2038 (June 20, 2002) at III.I; Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934,Release No. 34-23170 (April 23, 1986) (money managers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions); and Order Execution Obligations, Release No. 34-37619A (September 6, 1996) at 176 ("[T]he Commission believes that because technology is rapidly making [electronic] systems more accessible, broker-dealers must regularly evaluate whether prices or other benefits offered by these systems are reasonably available for purposes of seeking best execution of these customer orders."). Even though some of these sources refer to the best execution duty of broker-dealers, the proposition cited is no less relevant to advisers.

[46] See Amendments to Form ADV, Release No. IA-3060 (July 28, 2010) (ADV Release) at 3: "Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients…." See also Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Release Nos. 34-58264; IC-28345 (July 30, 2008) (2008 Proposed Director Guidance on Soft Dollars), at n. 64: "Under sections 206(1) and (2), in particular, an adviser must discharge its duties in the best interest of its clients…."

[47] See In the Matter of Portfolio Advisory Services, LLC, and Cedd L. Moses, Advisers Act Release No. 2038 (June 20, 2002) (adviser found liable for failing to seek best execution when broker was interpositioned).

[48] The Commission recently characterized this as an adviser's obligation "not to subrogate clients' interests to its own." ADV Release, *supra* note 46, at 3. See also "Without Fiduciary Protections, It's 'Buyer Beware' for Investors," Press Release issued by the Investment Adviser Association, et al., June 15, 2010, available at: http://www.financialplanningcoalition.com/docs/assets/3C7AB96C-1D09-67A1-7A3E526346D7A128/JointFOFPressRelease-ConferenceCommitteeFINAL6-15-10.pdf.

[49] In addressing the conflict created by commission-based arrangements, the SEC stated: "The [Form ADV disclosure] item simply recognizes that an adviser that accepts compensation from the sale to a client of securities has an incentive to base investment recommendations on the amount of compensation it will receive, rather than on the client's best interests, and thus involves a significant conflict of interest." ADV Release, *supra* note 46, at 18.

[50] See Dawson, *supra* note 2.

- offering an investment opportunity to clients first, before deciding to take the opportunity for the adviser or its personnel

- Avoid conflicts of interest, or if not avoided altogether, obtain clients' informed consent to conflicts after full and frank disclosure.[51]

  Examples of this might include –
  - not using "soft dollars" (client commissions) to obtain research from brokers that is used by the adviser for managing other accounts and that the adviser would otherwise have to pay for using "hard dollars" out of its own pocket,[52] or doing so only after making full disclosure of the conflict of interest posed by this practice[53]
  - not investing clients in mutual funds managed by the adviser,[54] at least not without waiving fees so as to avoid "double dipping" or, at a minimum, making full disclosure of the conflicts of interest posed
  - not running side-by-side accounts that invest in the same universe of securities but pay the adviser a differential in fees[55]
  - not investing simultaneously in the same securities with clients

- Not compromise best execution by placing client trades with a broker that provides benefits for the adviser – or the adviser's other clients -- at least not without clients' consent after full and frank disclosure.[56]

  Examples of this might include –
  - not steering clients to custody and then trade their advised accounts with certain brokers that provide the adviser benefits, in the form of research or other advantages (software, back office support, training, promotional assistance, etc.)

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[51] ADV Release, *supra* note 46, at 3. While in some contexts, disclosure (and consent) has been recognized to "cure" conflicts, the disclosure must be full and frank: "If dual interests are to be served, the disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all its start significance." See "Will the Investment Company and Investment Advisory Industry Win an Academy Award?" remarks of Kathryn B. McGrath, Director of the SEC Division of Investment Management, at the 1987 Mutual Funds and Investment Management Conference ("McGrath Remarks"), citing Scott, The Fiduciary Principle, 37 Calif. L. Rev. 539, 544 (1949).

[52] ADV Release, *supra* note 46, at 33 and 35.

[53] And perhaps also adhering to the 28(e) safe harbor.

[54] See ADV Release, *supra* note 46, at 30: "Conflicts could arise, for example, when an adviser recommends that clients invest in a pooled investment vehicle that the firm advises…."

[55] Side-by-side management of performance fee accounts with non-performance fee accounts is now a specific disclosure item in Form ADV, Part 2 (Item 6). In proposing this requirement, the Commission stated: "An adviser charging performance fees to some accounts faces a variety of conflicts because the adviser can potentially receive greater fees from its accounts having a performance-based compensation structure than from those accounts it charges a fee unrelated to performance (e.g., an asset-based fee). As a result, the adviser may have an incentive to direct the best investment ideas to, or to allocate or sequence trades in favor of, the account that pays a performance fee." Amendments to Form ADV, Release No. IA-2711 (March 3, 2008) at 19.

[56] Protection from the fiduciary breach that might otherwise occur is the basis for the protection afforded under the Section 28(e) safe harbor in the Securities Exchange Act of 1934, when advisers cause clients to "pay up" in order to obtain research or brokerage benefits. See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Release No. 34- 23170 (April 23, 1986) (footnotes omitted): "In connection with the abolition of fixed commission rates on May 1, 1975, money managers and broker-dealers expressed concern that, if money managers were to pay more than the lowest commission rate available to a broker-dealer in return for services other than execution, such as research, they would be exposed to charges that they had breached a fiduciary duty. This concern was based on the traditional fiduciary principle that a fiduciary cannot use trust assets to benefit himself. The purchase of research with the commission dollars of a beneficiary or a client, even if used for the benefit of the beneficiary or the client, could be viewed as also benefiting the money manager in that he was being relieved of the obligation to produce the research himself or to purchase it with his own money."

- not suggesting, recommending or requiring that clients custody and trade their advised accounts with the adviser (if a dual-registered adviser/broker) or the adviser's affiliated broker, unless commissions are waived or unless commissions are usual and customarily and represent best execution
- not using a client's commissions to pay for research that does not or cannot benefit the client (such as research on investments outside the investment restrictions on the client's account)

- Eliminate all conflicts of interest that might incline the adviser – consciously or unconsciously – to render advice that is not disinterested, absent appropriate informed consent.[57]

  Examples of this might include –
  - if both types of fee arrangements are available and otherwise suitable, charging commission-based fees to buy-and-hold clients (inactively traded accounts), thereby eliminating the prospect of charging the clients unnecessary on-going fees for very little time, attention and work associated with their accounts; and charging asset-based fees to clients whose accounts are actively traded, thereby eliminating the prospect of over-trading the accounts and generating commissions in excess of what an a typical asset-based fee account would pay over time
  - not shorting securities that are held long in other client accounts managed by the adviser
  - not setting higher pay-out for adviser reps who place clients into the adviser's proprietary mutual funds than other available fund choices

- Not use clients' assets for the adviser's own benefit[58] or the benefit of other clients, at least without client consent.

  Examples of this might include –
  - not using client commissions to obtain perks or benefits from brokers, such as gifts, travel or entertainment, personal benefits or other gratuities[59]
  - not churning a client's account for the purpose of generating soft dollar credits used to benefit the adviser[60]
  - not using client commissions to reward brokers for referring clients to the adviser[61]

- Avoid self-dealing (absent appropriate consent).[62]

  Examples of this might include –

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[57] In the Matter of Dawson-Samberg Capital Management, Inc., Now Known as Dawson-Giammalva Capital Management, Inc. and Judith A. Mack, Advisers Act Release No. 1889 (August 3, 2000) (Dawson-Samberg), citing Capital Gains, 375 U.S. at 191-92.

[58] See 2008 Proposed Director Guidance on Soft Dollars, *supra* note 46, at 23: "Second, investment advisers, as fiduciaries, generally are prohibited from receiving any benefit from the use of fund assets…."

[59] See In the Matter of Fidelity Management & Research Company and FMR Co., Inc., Release No. IA-2713 (March 5, 2008) (Fidelity firm and traders breached their fiduciary duties to fund clients by accepting excessive travel, entertainment, gifts and gratuities from brokers with whom fund trades were placed, resulting in a substantial possibility of higher execution costs).

[60] See Securities and Exchange Commission v. Gordon J. Rollert (USDC D. Mass., No. 01-Civ.-10237-JLT, SEC Lit. Release No. 18687 (April 29, 2004).

[61] ADV Release, *supra* note 46, at 36.

[62] Brave New World, *supra* note 26, at 4.

- not engaging in principal trades in client accounts (or doing so only in accordance with Section 206(3) of the Advisers Act)
- not executing trades for the adviser's own clients (if the adviser is a dual-registered adviser/broker) or using the adviser's affiliated broker for executing client trades, unless commissions are waived or unless commissions are usual and customarily and represent best execution
- not hiring affiliates of the adviser to service client accounts at the client's expense, unless they are the lowest cost provider for the appropriate quality of service

✓ Duty of Obedience: An adviser must –

- Adhere to the terms of any governing trust or organic legal documentation.[63]

  Examples of this might include –
    - investing client assets only in securities and other investments in accordance with the client's trust instrument, corporate charter or investment mandate
    - providing all data, notices, reports and other information called for in governing documents

- Follow any instructions or guidelines provided by the client.

  Examples of this might include –
    - adhering to instructions from clients concerning impermissible investments (such as socially-screened investments), managing their accounts (such as approved brokers or directed brokerage) and handling transactions in their accounts (such as account transfers, liquidations, added assets, tax lot considerations, etc.)

✓ Duty to Act in Good Faith: An adviser must[64] –

- Act honestly toward clients with candor and utmost good faith.[65]

  Examples of this might include –
    - being truthful and accurate in all communications and disclosures
    - being forthright about issues, mistakes and conflicts of interest
    - providing fund directors with all information in the adviser's possession that reasonably bears on a board decision, particularly where the adviser has a personal interest in the outcome or similar conflict of interest

- Treat clients fairly.[66]

  Examples of this might include –

[63] McGrath Remarks, *supra* note 51, at p.7.

[64] In the corporate context, one court explained: "A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient." Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006) at text surrounding footnote 26 (footnote omitted). This same court concluded that the duty of good faith is essentially a subset of the duty of loyalty.

[65] Capital Gains, *supra* note 5, at text surrounding footnote 44.

[66] ADV Release, *supra* note 46, at 3.

- avoiding favoritism of one client or group of clients over another in handling investment opportunities and trade allocations
- adopting investment opportunity and trade allocation procedures and applying them consistently over time so that no client or group of clients is systematically disadvantaged
- allocating shared costs across accounts using a rational methodology applied consistently over time
- seeking a fair and prompt resolution of all legitimate client complaints

✓ Duty of Disclosure: An adviser must --

- Provide full and fair disclosure of all material facts to clients and prospective clients.[67]

  Examples of this might include –
  - ensuring that disclosures contain all facts that a reasonable investor ought to know in order to make an informed decision about investing[68]
  - ensuring that communications and disclosures are materially complete so as to provide a fair and balanced picture[69]

- Not mislead clients.[70]

  Examples of this might include –
  - avoiding advertisements, communications and disclosures that contain only a partial truth, leaving an exaggerated, unwarranted or other potentially misleading impression[71]

Of course, this list of duties is not exhaustive, but includes many of the common duties that an adviser might face, along with examples to illustrate how they might apply in practice.

What Other Fiduciary Duties Might an Adviser Owe to its Clients?

Recent developments and industry scandals have raised questions about whether an adviser's fiduciary duties cover – or should cover -- additional emerging areas of concern. Three of these are discussed below.

In today's environment, an adviser will (or might) be deemed to have a fiduciary duty to --

[67] Capital Gains, *supra* note 5, at text surrounding footnote 44.

[68] See Dawson-Samberg, *supra* note 57 (adviser and officer liable for failing to adequately disclose soft dollar arrangements, violating Section 206(2) (under which adviser has a fiduciary duty) and 207 (prohibiting false and misleading SEC filings) of the Advisers Act).

[69] See In the Matter of The Dreyfus Corporation and Michael L. Schonberg, Advisers Act Release No. 1870 (May 10, 2000) (adviser and portfolio manager found liable under Section 206(2) for not disclosing IPO practices that had a material effect on fund's performance).

[70] Capital Gains, *supra* note 5, at text surrounding footnote 45.

[71] See the report entitled "Protecting Senior Investors: Report of Examinations of Securities Firms Providing 'Free Lunch' Sales Seminars," issued by the SEC in conjunction with FINRA and NASAA (September 2007), finding numerous securities firms using advertisements with exaggerated and unwarranted claims. See also In the Matter of Richard W. Suter and Richard W. Suter d/b/a National Investment Publishing Company, Administrative Proceeding File No. 3-6038 (August 27, 1982) (adviser liable for violating Section 206, among others, as a result of advertisements containing exaggerated statements about how investors would profit).

- Conduct due diligence on sub-advisers:

The largest Ponzi scheme in history – the Bernard Madoff affair – raises questions about whether the advisers and fund managers that placed their clients' assets with Madoff could be held liable for failing to properly vet and oversee his operations. Cases raising these issues[72] have led some to ask whether an adviser's fiduciary duties include – or should include -- the duty to conduct adequate due diligence on sub-advisers (or other service providers) to whom an adviser exposes a client's assets.[73]

Even before Madoff, there seemed to be little doubt that an adviser could potentially be held liable if it did not conduct adequate due diligence on sub-advisers, particularly if it represented to clients that it would vet the firms and would conduct periodic oversight as well.[74] Depending on the case, however, the adviser's violation would not necessarily have been couched as breach of a "fiduciary" duty. Rather, it might have been couched as a violation of statutory law,[75] fraud provisions (misleading disclosures), contract provisions, SEC orders or other violations.[76] Suffice it to say, however, that in today's post-Madoff environment, the risk of liability for due diligence failures – under one theory or another – is substantially heightened.

- Vote proxies:

For years, advisers often did not vote proxies on behalf of client accounts, believing that the task was too costly and time consuming and that their clients' small holdings were unlikely to make a difference in the outcome anyway. Instead, they reportedly followed the "Wall Street Rule" that if they became dissatisfied with management, they simply sold the stock.[77]

[72] See, for example, In re Hennessee Group, LLC, SEC Rel. No. 2781, Admin. Proceeding File No. 3-13454 (April 22, 2009) (adviser/hedge fund consultant fined for failing to perform due diligence of the Bayou Fund, which subsequently collapsed); In the Matter of Fairfield Greenwich Advisors LLC, Admin. Complaint, Docket No. 2009-0028 (April 1, 2009) (state action against feeder fund manager that funneled investor funds to Madoff without conducting advertised due diligence); People of the State of New York v. J. Ezra Merkin, Index No. (N.Y.Sup.Ct. April 6, 2009) (state action charging fund manager with, among other things, breach of fiduciary duty for failing to conduct due diligence, supervise, or monitor and manage investments in Madoff funds). Also SEC v. Chais, SEC Litigation Release No. 21096 (S.D.N.Y. Civ. 09 CV 5681) (Jun. 22, 2009) (securities fraud charged against manager of feeder funds for intentionally or recklessly ignoring signs of Madoff's fraud).

[73] See Scott A. Meyers and James G. Martignon, "The Post-Madoff Emergence of a Fiduciary Duty of Due Diligence - Recent Regulatory Enforcement Actions and Their Impact on Best Practices for Investment Managers," *Practical Compliance and Risk Management for the Securities Industry* (Sep. 1, 2009) (Duty of Due Diligence article).

[74] In a case that long preceded Madoff, Patrick V. Morris, et al. v. Wachovia Securities, Inc., 277 F. Supp. 2d 622 (E.D. Va. 2003), private plaintiffs sued an adviser alleging, among other things, failure to adequately monitor the portfolio managers that were handling the plaintiff's account as part of a program offered by the adviser. The court permitted the plaintiff's claim for rescission of the advisory agreement to go forward on the basis of a violation of Section 206(2) of the Advisers Act, on the theory that the adviser fraudulently induced the plaintiff to enter its program with untrue promises to monitor the portfolio managers for performance and for adherence to their advertised strategies. The plaintiffs' claims under Rule 10b-5 were not permitted to go forward on pleadings grounds. (In a subsequent ruling, summary judgment was granted in favor of the defendant on all remaining claims.)

[75] See, for example, In the Matter of Morgan Stanley & Co., Inc., Admin. Proc. File No. 3-13588 (SEC July 20, 2009) (firm sanctioned for violating Advisers Act Section 206(2), among other provisions, by breaching its fiduciary duty to certain clients and prospective clients by telling them that recommended investment managers had been approved through the firm's due diligence and on-going monitoring process when they had not).

[76] For a more complete discussion of an adviser's potential liability for failure to oversee sub-advisers, see Lorna A. Schnase, "Can an Adviser be Liable for the Wrongdoing of Another Adviser?" IAA Newsletter Compliance Corner (April 2009). For a case where a broker rep's lack of due diligence was found to have aided and abetted violations by an adviser, see Rolf v. Blyth, Eastman Dillon & Co., Inc., and Michael Scott, 570 F.2d 38 (2nd Cir.), cert. denied, 439 U.S. 1039 (1978) (rep constantly reassured client about adviser "without investigation and with utter disregard for whether there was a basis for the assertions," and rendered substantial assistance to adviser in the fraudulent mismanagement of client's portfolio by engaging in a "hand-holding operation" to prevent client from discovering the fraud).

[77] See the "Wall Street Rule" referenced in Release No. 33-8188 (Jan. 13, 2003).

However, in the last decade or so, advisers and other institutional shareholders have been criticized for not voting proxies given their enormous collective voting power, along with their ability in some cases to affect the outcome of shareholder votes and influence corporate governance.[78] In other cases, advisers were criticized for voting proxies in a manner that may inure to the adviser's own benefit, but not necessarily to the client's benefit.[79]

These criticisms came to a head in 2003 when the SEC adopted Rule 206(4)-6 under the Advisers Act,[80] which in substance makes it fraudulent for an adviser to exercise proxy voting authority without having procedures reasonably designed to ensure that the adviser votes in the best interest of clients, including procedures to address material conflicts that may arise between the adviser's interests and those of its clients.

In this process, the SEC confirmed that advisers with discretion to vote proxies have a fiduciary duty with respect to their proxy voting authority. In the Adopting Release, the SEC said:

> "The federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for its clients. Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own."[81]

This does not mean that advisers would necessarily breach their fiduciary duty if they did not vote a particular proxy. The SEC acknowledged this when adopting Rule 206(4)-6 by stating:

> "We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies."[82]

Rule 206(4)-6 has been a catalyst for advisers to rethink their approach to voting proxies. Meanwhile, similar issues have been raised with regard to an adviser's duty to act on behalf of

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[78] For example, see the discussion in Burton Rothberg and Steven Lilien, "Mutual Funds and Proxy Voting: New Evidence on Corporate Governance," Journal of Business & Technology Law (Vol. 1, No. 1 2006).

[79] This was one theme behind the allegations against an adviser and its COO in a recent settled administrative proceeding, In the Matter of INTECH Investment Management LLC and David E. Hurley, Advisers Act Release No. 2872 (May 7, 2009), where the adviser had directed a proxy voting firm to use AFL-CIO-based proxy voting guidelines for voting proxies in all its client accounts, not just union-related accounts, at the same time that the adviser was participating in an AFL-CIO adviser ranking survey that ranked advisers based on their adherence to AFL-CIO recommendations on certain votes. An improved score on the survey could ostensibly help the adviser to retain and attract more business from union-related clients. This conflict of interest, according to the SEC order, was not addressed adequately in the adviser's proxy voting procedures.

[80] They also adopted similar companion rule s for funds under the Investment Company Act. See Release No. 33-8188 (Jan. 13, 2003).

[81] Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003) (footnotes omitted).

[82] Id. (footnotes omitted).

client accounts in class action lawsuits (filing proofs of claim), tender offers, mergers, bankruptcies and similar shareholder actions.[83]

- Assess a client's mental competence:

The SEC has been very vocal recently about "seniors issues," with the aim of protecting older investors who may be more vulnerable to fraud or abuse.[84] As part of this effort, the SEC, NASAA and FINRA identified and published in a 2008 report practices that some financial firms use to address seniors issues, including elder financial abuse and the sensitive and sometimes subtle issue of diminished mental capacity.[85]

It is not very surprising that advisers could be held liable if they defraud or "abuse" an elderly client (financially speaking). However, holding advisers responsible – under fiduciary principles or any other legal theory -- for assessing a client's mental competence would seem to be a radical departure from anything advisers have been held responsible for in the past and outside the professional competence of most advisers.[86]

Nevertheless, more issues in this area are likely to arise in the coming years as an increasing number of investors reach senior status and questions are raised about whether advisers have taken advantage of them due to their diminished mental capacity. Incompetence is already covered in the law generally[87] although many states are now supplementing existing laws by enacting Elder Abuse statutes[88] addressing abuse, capacity and similar issues specifically with respect to "vulnerable adults." In most cases, however, liability to an adviser under those statutes would result only in the case of fraud, deception or, perhaps in a more subtle case, where the adviser "knows, or should know" that the vulnerable adult lacks the capacity to consent.[89]

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[83] See Fiduciary Duty and Securities Class Action Lawsuits (August 15, 2007) at http://www.ncsonline.com/NCSOnline/News/tabid/195/newsID/15/Default.aspx: "The scope of an investment adviser's fiduciary duty continues to expand. There are indications that an investment adviser with discretion over a client's account may be responsible for protecting the client's right to participate in class action lawsuits involving securities owned by him or her." See also Steven W. Stone and Ryan F. Helmrich, The Role of Investment Advisers in Client Class Action Claims at http://www.morganlewis.com/pubs/The%20role%20of%20investment%20advisers%202.pdf, (arguing that advisers should not be lawfully responsible for these sorts of matters absent a contractual understanding to the contrary).

[84] In 2006, 2007 and 2008, the SEC held Senior Summits, in conjunction with FINRA, NASAA and AARP as part of an overarching effort to protect the nation's seniors. See Senior Events and Enforcement Actions at: http://www.sec.gov/investor/seniors/seniorsevents.htm. See also "For Seniors" on the SEC's website at: http://www.sec.gov/investor/seniors.shtml.

[85] The full report can be found here: http://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf. Some of these and similar measures are outlined in the AARP's publication "A Financial Professional's Guide to Working With Older Clients," at: http://assets.aarp.org/www.aarp.org_/articles/money/financial_planning/financial_professional.pdf. See also Lisa A. Catalano and Christine Lazaro, "Financial Abuse of the Elderly: Protecting the Vulnerable," PIABA Bar Journal (Fall 2008).

[86] Even the cases cited by the Commission in its Investor Alert for seniors seem to be based on fraud or suitability issues, and not on the more subtle issue of whether the adviser failed to detect that the investor lacked the mental capacity to consent. See "Investor Alert -- Investment Products and Sales Practices Commonly Used to Defraud Seniors: Stories from the Front Line," at http://www.sec.gov/spotlight/seniors/elderfraud.pdf.

[87] The legal effect of dealing with parties lacking capacity may be addressed in the law of contracts, or under consumer protection or deceptive trade practice statutes. See the discussion in Section II.B. and n. 85 of Elder Abuse article, *infra* note 88.

[88] For a discussion of various statutes passed or under consideration by various states, see Lisa A. Catalano and Christine Lazaro, "Financial Abuse of the Elderly: Protecting the Vulnerable," PISABA Bar Journal (Fall 2008), pp. 11-15 (Eder Abuse article).

[89] Id.

To avoid potential problems in this arena, some advisers are training employees to spot "red flags" that may evidence financial abuse and diminished capacity.[90] Unfortunately, actions taken in response to "red flags" can themselves raise sticky issues, such as potential claims for breach of the duty of obedience (by not adhering to the client's instructions) and breach of privacy rights (if suspicions of diminished capacity are brought to the attention of other family members or outsiders).

One case discussing these issues faces head-on the question of whether a financial advisor has the duty to assess a client's mental capacity. There, the court held that at least stockbrokers do not,[91] stating:

> [W]e acknowledge that the risk that an elderly person may not appreciate the significance of a stock transaction is neither improbable nor unforeseeable, but this risk must be balanced against the utility of affording an elderly person the same services available without question to younger people…. <u>There simply is no responsibility on the part of service providers in general or stockbrokers in particular to determine the competence of their clients</u>.
>
> …
>
> Another factor in the duty equation is burden of the duty. <u>Stockbrokers and other service providers cannot be expected to have any expertise in assessing mental capacity</u>. The burden of making this assessment is thus especially great. <u>A service provider should not be put to choosing between refusing to assist an elderly person with legitimate transactions and incurring liability for providing such assistance when the provider lacks any qualification for determining competence</u>.[92]

It is not clear whether this case would have come out differently if the financial advisor was an investment adviser rather than a stockbroker. One might guess not, given that the court spoke broadly about stockbrokers and other "service providers" and that the court's rationale (no expertise to assess capacity) would apply to both advisers and brokers.[93] However, until the law is more fully developed nationwide, it remains to be seen whether advisers under any circumstance will be held to have a legal duty – fiduciary or other -- to ascertain a clients' mental competence.

What Standard of Conduct Applies to an Adviser's Fiduciary Duty?

<u>Negligence vs. Gross Negligence</u>. As discussed previously, an adviser owes a fiduciary duty of care to its clients and must act with "due care" in discharging its advisory functions. This begs the question, however, of exactly what care is "due," meaning what standard of care is owed or would be considered sufficient to discharge the duty owed.

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[90] See, for example, the Morgan Stanley slide presentation on Working with Senior Investors, at: http://www.sec.gov/investor/seniors/workingwseniors.pdf, including steps to take when signs of diminished mental capacity or elder financial abuse are detected.

[91] <u>Edward D. Jones & Company, and Delmar "Bo" McKinney, Petitioners, v. Pat Letcher, Independent Executrix of the Estate of Beatrice Clark Cairns, Deceased, Respondent,</u> 975 S.W.2d 539 (Tex. Sup. Ct. 1998).

[92] <u>Id</u>. at 544 (emphasis added).

[93] This raises the further issue of what would have happened if the stockbroker had held himself out as a "senior certified" expert or credentialed in some other way on retirement, elderly or senior matters, which has been the subject of recent regulatory concern as well. See NASAA Model Rule on the Use of Senior-Specific Certifications and Professional Designations (Adopted March 20, 2008) at http://www.nasaa.org/content/Files/Senior_Model_Rule_Adopted.pdf.

At common law, an agent is generally held to a standard of care commensurate with that exercised by persons in similar circumstances:

> **Subject to any agreement with the principal**, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances. Special skills or knowledge possessed by an agent are circumstances to be taken into account in determining whether the agent acted with due care and diligence. If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.[94]

Thus, when an adviser is acting in a professional capacity, it will be held to the standard of care normally exercised by other similarly situated investment professionals. That said, it is not necessarily enough to prove merely that an adviser adhered to industry custom or practice to avoid liability for breach of its duty of care. Rather, it is just one factor to be considered.[95]

Although not without controversy,[96] an adviser's duty of care may be altered by agreement in most cases, as noted by the boldfaced phrase in the quotation above. Indeed, it is common for investment advisory agreements to contain provisions that limit the liability of the adviser for certain conduct. For example, a broad version of this clause might read:

> "[Adviser] shall not be liable for any error of judgment or mistake of law or for any loss arising out of any investment, or for any act or omission taken with respect to the Account, except for willful misfeasance, bad faith or gross negligence in the performance of its duties, or by reason of reckless disregard of its obligations and duties hereunder and except to the extent otherwise provided by law."[97]

Despite SEC[98] and state[99] regulatory concerns about the use of "hedge clauses" – clauses that "hedge" or limit the adviser's liability to the client, whether in the form of exculpatory clauses like the liability limitation above, or indemnities, waivers or other limiting provisions -- these clauses are still in widespread use. On its surface, this type of clause appears to exculpate the adviser from liability at least for simple negligence, meaning a lack of due care.[100] Historically, liability limitations

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[94] Restatement 3d Agency § 8.08.

[95] See In the Matter of Mark David Anderson, Initial Decision Release No. 203, Administrative Proceeding File No. 3-9499, where, in determining whether a broker's markups/markdowns were unreasonable or excessive, the ALJ took into account industry practice, but said: "[I]ndustry practice constitutes only one factor that must be considered." See also Restatement 2d Torts § 295A comment b.: "Any such custom of the community in general, or of other persons in like circumstances, is always a factor to be taken into account in determining whether the actor has been negligent."

[96] See the discussion on both sides of this issue in Harvey E. Bines and Steve Thel, Investment management law and regulation (Bines and Thel) § 5.01 Unforceable Provisions Generally.

[97] Narrower versions of this clause exculpate the adviser from liability for losses arising from the adviser's "mistake of investment judgment" and still others for losses suffered as a result of "any error of judgment or mistake of law in connection with [the Adviser's] performance" under the advisory agreement.

[98] See Heitman Capital Management, LLC, SEC No-Action Letter (pub. available Feb. 12, 2007) (hedge clause is not "per se" fraudulent but can be fraudulent depending on the fact and circumstances). Note, however, that the Staff's concern in that letter seems to be whether this type of clause might mislead the client into believing that any rights they may have to pursue the adviser under the securities laws would be cut off, rather than whether it is permissible to use this type of clause to alter the otherwise applicable standard of care in general.

[99] See, for example, Investment Advisers Cautioned on Use of Hedge Clauses, Connecticut Department of Banking, at http://www.ct.gov/dob/cwp/view.asp?a=2252&q=299222.

[100] At least for a fund client, an adviser ostensibly would not be held to a standard more lax than that provided in Section 17(i) of the Investment Company Act of 1940, which in substance prohibits an adviser being protected from liability for willful misfeasance, bad faith or gross negligence in the performance of its duties, or by reason of reckless disregard of its obligations and duties under the advisory agreement.

of this type were intended to shield advisers from claims of negligence in the selection of particular portfolio securities, which involves the exercise of professional judgment and could be subjected to endless second-guessing after the fact with the benefit of 20/20 hindsight. As a result, customary exculpatory clauses evolved holding advisers only to the more lax, gross negligence standard, at least for actions involving professional judgment.

Nonetheless, it is unclear whether and how these clauses would be applied to shield the adviser from a breach of fiduciary duty. All things being equal, such a limitation might be effective against a claim for breach of the common law duty of care based on negligence.[101]

The distinction between negligence and gross negligence may be important in a dispute where the level of care taken by an adviser in seeking best execution becomes an issue.[102] Case law often defines gross negligence as conduct so extreme that it may be difficult to hold an adviser liable for failing to take the requisite care unless the adviser has completely abdicated its responsibility or has established a pattern of repeated failures tending to show conscious indifference.[103]

Regardless of how an exculpatory clause might apply to common law claims, it is less likely to be given effect to limit liability for a breach of duty emanating from Section 206 or other statute. There are a number of reasons why, among them:

1) Exculpatory clauses – like the sample clause quoted above and many others like it – by their terms often limit liability for claims "except to the extent otherwise provided by law" (or similar carve-out).[104] This carve-out would arguably preserve any rights a client has

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[101] However, see Bines and Thel, *supra* note 96, at p. 228: "Investment managers should not be confident that exculpatory clauses will permit them to avoid the consequences of ordinary negligence." As those authors point out, exculpation for negligence may be particularly difficult, if not impossible, for advisers acting as trustees, as fiduciaries of ERISA plan assets or as advisers to private foundations. Moreover, some courts may find that exculpating any professional fiduciary from their own negligence is simply against public policy.

In a separate but related issue, state contract law applicable to the advisory agreement may invalidate exculpatory clauses (and similar waiver, release, indemnification and other clauses) unless the clauses are drafted meeting strict form and notice/consent requirements. For example, Texas law imposes "fair notice" requirements on any provision that exculpates a party from the consequences of its own negligence. Under the first "fair notice" requirement (known as the express negligence doctrine), parties seeking to exculpate themselves for such consequences must express that intent in specific terms and within the four corners of the contract. Under the second "fair notice" requirement (known as the conspicuousness requirement), something -- such as all capital letters or bolded or underlined text -- must appear on the face of a contract to attract the attention of a reasonable person to the relevant language when the contract is read. Exculpatory clauses not meeting these requirements risk being held unenforceable if governed by Texas law. See Statement on Legal Opinions Regarding Indemnification and Exculpation Provisions Under Texas Law, Legal Opinions Committee of the Business Law Section of the State Bar of Texas (March 14, 2006), appearing in the Texas Journal of Business Law, Vol. 41:3 (2006).

[102] This is less likely to be an issue when counseling an adviser client prospectively about fiduciary obligations, since attorneys would not normally be comfortable counseling a client that it is alright to be negligent, regardless of how the advisory agreement reads.

[103] Of course, what constitutes gross negligence in any given case would be determined under the substantive law applicable in that case. However, proving gross negligence is generally considered fairly difficult. Cases often define gross negligence as "the failure to show even the slightest amount of care" or a "gross deviation from what an ordinary person would do under the same circumstances" or some similar formulation that often includes an element of intentionality, willfulness or recklessness. See Prosser and Keaton on the Law of Torts, Ch. 5 §34 (5th ed. 1984); and Modern Tort Law §10.19 (rev. ed.). For example, in Texas, gross negligence has been defined as the "entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the right or welfare of the person or persons to be affected by it." <u>Robert Young, et al. v. Nationwide Life Insurance Company, et al</u>., 2 F.Supp.2d 914, 929 (S.D. Tex. 1998), quoting <u>Bennett v. Howard</u>, 170 S.W.2d 709, 713 (Tex. 1943).

[104] These carve-outs are often inserted with 2 aims: (i) to avoid misleading clients into believing that the exculpatory clause cuts off claims they might have against the adviser that are <u>not</u> based on willful misfeasance, bad faith, gross negligence or reckless disregard, but that may be essentially strict liability claims for violating federal or state law; and (ii) so that the clause itself is not potentially construed as entering into a contract in violation of the Advisers Act (for example, exculpating the adviser for negligent or other violations of the securities laws) or the continuation of a relationship or practice in violation of the Advisers Act and therefore void under Section 215.

against the adviser under, for example, the Advisers Act or other federal securities laws, notwithstanding the limitation.

2) Section 206 is, at its core, an anti-fraud provision and courts have long voided clauses – often indemnification clauses -- that purport to shift away anti-fraud liabilities, on the theory that they violate public policy.[105] If such indemnities were enforced, the reasoning goes, the anti-fraud provisions would lose their prophylactic effect.[106] If that is the position with respect to liability shifting provisions like indemnities, it could readily be the position with respect to exculpatory clauses as well.

3) If Section 206 is deemed to cover negligent conduct,[107] and the exculpatory clause were interpreted to be a waiver of compliance with Section 206 to that extent, then the exculpatory clause could be void under Section 215(a) of the Advisers Act, which voids any provision binding any person to waive compliance with the Advisers Act or related rules.

4) There is generally no private right of action under the Advisers Act.[108] This makes the SEC the most likely party to claim breach of Section 206. Any exculpatory clause in the advisory agreement would, of course, not be binding on the SEC.

No matter what their effect in a case involving the fiduciary duty of care, a limitation of liability or exculpatory clause is less likely to protect an adviser from claims for breach of the fiduciary duty of loyalty, for example, in a case of involving undisclosed conflict of interest, self-dealing or bad faith.[109]

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[105] Globus, Inc. v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969) (Globus). Although the court specifically noted that the case involved behavior that went beyond mere negligence, the court's opinion indicated that the provisions at issue there were designed to deter negligence. Moreover, the court's reasoning has been extended to prophylactic provisions under other federal securities statutes, such as Section 16(b) under the Securities Exchange Act of 1934. See First Golden Bancorporation v. Ronald F. Weiszmann v. Morgan Stanley & Co., Incorporated, et al., 942 F.2d 726 (10th Cir. 1991) and cases cited there.

[106] Globus, *supra* note 105, at Section III: "Civil liability under section 11 and similar provisions was designed not so much to compensate the defrauded purchaser as to promote enforcement of the Act and to deter negligence by providing a penalty for those who fail in their duties…. Thus, what Professor Loss terms the 'in terrorem effect' of civil liability… might well be thwarted if underwriters were free to pass their liability on to the issuer. Underwriters who knew they could be indemnified simply by showing that the issuer was 'more liable' than they (a process not too difficult when the issuer is inevitably closer to the facts) would have a tendency to be lax in their independent investigations.…Cases upholding indemnity for negligence in other fields are not necessarily apposite. The goal in such cases is to compensate the injured party. But the Securities Act is more concerned with prevention than cure."

[107] The U.S. Supreme Court has already held in Capital Gains, *supra* note 5, that scienter is not required under Section 206(2). Therefore, mere negligence may be enough to prove liability, at least under that section. Lower courts have also held that scienter is not required under Section 206(4). See SEC v. Steadman, 967 F.2d 636 (US App DC 1992).

[108] Transamerica, *supra* note 9, at 24: "[W]e hold that there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract [under section 215], but that the Act confers no other private causes of action, legal or equitable."

[109] The reasoning here would be the same as it is in the corporate context. Corporations are often permitted to exculpate directors from personal liability for monetary damages if they breach their duty of care, but not if they breach their duty of loyalty. See, for example, Section 102(b)(7) of the Delaware General Corporation Law, which only permits directors to be exculpated from personal liability for certain breaches of duty (essentially the duty of care), but not for breach of the director's duty of loyalty, bad faith, intentional misconduct, knowing violations of law or improper personal benefit. This is likely due to the immoral, unethical or repugnant nature of breaches of loyalty, etc., as compared to breaches of the duty of care, and to the desire to avoid having fiduciaries profit unfairly from their misconduct at the expense of the corporation and its shareholders. Compare, however, the Uniform Limited Liability Company Act, which does not allow an LLC operating agreement to eliminate the duty of loyalty entirely, but permits it to identify specific types or categories of activities that do not violate the duty, if not manifestly unreasonable. Uniform Limited Liability Company Act (1996), Section 103(b)(2)(i).

State of Mind; Scienter; Willfulness. Whether an adviser has breached its duty of care will generally depend on whether the adviser has met the requisite standard of care as discussed above. In contrast, claims based on breaches of other fiduciary duties, such loyalty or good faith,[110] more often focus on the fiduciary's state of mind, intent or motivations.

In cases decided under common law,[111] authorities do not uniformly agree on whether the duty of loyalty can be violated unintentionally,[112] or if some culpable state of mind is required, exactly what it is.[113] Some authorities argue that "good faith" is a separate fiduciary duty, others that is not a separate duty at all, but really just the key element in defining the state of mind that must motivate a loyal fiduciary.[114] As a result, cases pressing breach of loyalty or good faith claims under common law can vary widely in approach from jurisdiction to jurisdiction.

In contrast, in cases involving breach under the Advisers Act, the issue about state of mind most commonly boils down to whether proof of "scienter" is required to make a claim. Scienter refers to a certain culpable state of mind that implies intent.[115] It is often a required element when proving violations under anti-fraud provisions of the federal securities laws.[116] However, in the case of the anti-fraud provisions in Section 206 of the Advisers Act, courts have held that scienter is a required element for a claim under Section 206(1),[117] but is not for a claim under Section 206(2).[118]

Another "state of mind" factor in SEC proceedings under Section 206 is whether the adviser's violation was "willful." When a violation is "willful," different[119] and more severe[120] penalties can be

[110] Without doubt, breaches of care are not always readily distinguishable from breaches of loyalty or other fiduciary breaches. See Carter G. Bishop, "A Good Faith Revival of Duty of Care Liability in Business Organization Law," Tulsa Law Review (Vol. 41:nnn 2006) (Bishop) at 490: "However, there remains reasonable disagreement over whether there are adequate measures to properly distinguish breach of loyalty from breach of care claims. These are often contextual but nonetheless illustrate the difficulty in easily categorizing a claim as purely care or purely loyalty."

[111] Many of the salient cases in this arena are decided under corporate law as applied to directors and officers, which may have elements of both common law and state corporate statutory law.

[112] See Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) (citations omitted): "I therefore conclude, even finding that the action taken was taken in good faith, it constituted an unintended violation of the duty of loyalty….I parenthetically note that the concept of an unintended breach of the duty of loyalty is unusual but not novel."

[113] See the discussion of duty of loyalty generally in Bishop, *supra* note 110, at II.B.

[114] Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti, And Jeffrey M. Gorris, "Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law," The Georgetown Law Journal (Vol. 98:629 2010) at 633.

[115] Case law has established that conduct more culpable than mere negligence is required to prove scienter, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), although recklessness may be enough. See Louis Loss & Joel Seligman, Securities Regulation, Vol. VIII, ch.9, § B(6), at 3665-67 n. 521 (3d ed.1991) (noting holdings of eleven circuits that recklessness can constitute sufficient scienter).

[116] See, for example, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding that scienter is required for any private cause of action for damages under Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934); and Aaron v. Securities Exchange Commission, 446 U.S. 680 (1980) (holding that scienter is required to enforce the antifraud provisions of Rule 10b-5 and Section 10(b) of the 1934 Act, but that scienter is not required for the government to establish a violation of Section 17(a) of the 1933 Act concerning untrue or omitted statements of material facts).

[117] Steadman v. SEC, 603 F.2d 1126, 1134 (5th Cir. 1979) (Steadman).

[118] SEC v. Moran, 922 F. Supp. 867, 896-898 (S.D.N.Y. 1996), citing Steadman, Capital Gains and others. As the SEC put it: "If the misstatement or omission of a material fact is negligent, then Section 206(2) is violated; if the misstatement or omission is made with scienter, then Section 206(1) is violated." In the Matter of Jamison, Eaton & Wood, Inc., Advisers Act Release No. 2129 (May 15, 2003) (citations omitted). According to the SEC at least, "scienter" is not a required element for liability under Section 206(4) either. See Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. IA-2628 (August 3, 2007) and cases cited there.

[119] See Advisers Act Section 203(e) (censure, denial or suspension of registration), (f) (bar or suspension of association with an investment adviser) and (i) (civil monetary penalties) for penalties available for "willful" violations.

imposed. Significantly, the SEC has long applied a very weak definition of "willful" under the securities laws, stating that it means merely "that the person charged with the duty knows what he is doing."[121] There is no requirement that the person "also be aware that he is violating one of the Rules or Acts."[122]

What Might Advisers Do to Help Ensure They Discharge their Fiduciary Duties?

In short, advisers can adopt effective policies and procedures and can train their personnel on what it means to have a fiduciary duty in practice.

Policies and procedures. Rarely do advisers adopt a procedure entitled "Fiduciary Duties" attempting to list all the fiduciary duties owed to clients, given that there are so many and so many ways that they might arise.[123] Instead, fiduciary duties are more typically addressed in the general portions of an adviser's policies and procedures, where the "tone at the top" is established along with the firm's general standards of conduct applicable to all personnel. General standards with a fiduciary flavor might include requiring personnel to:

- Put clients' interests first,
- Avoid taking unfair advantage of clients, and
- Avoid abusing the adviser's position of trust and confidence.

These general standards may appear in the general or introductory section of the firm's Compliance Manual. Or, they may appear in the adviser's Code of Ethics, which is required to contain standards of business conduct that the adviser requires of its supervised persons and that reflect the adviser's fiduciary obligations.[124]

In addition to setting general standards, an adviser might adopt controls aimed at helping to ensure fiduciary duties are being discharged properly. Common controls include:

- Restrictions on personal trading by firm personnel, which may include outright bans, pre-clearance requirements or other restrictive measures, along with reporting requirements to facilitate monitoring
- Prohibitions on insider trading (improper use of material, non-public information), with appropriate monitoring
- Restrictions on the giving and receiving of gifts, entertainment, gratuities and business courtesies, along with reporting requirements to facilitate monitoring
- Restrictions on the ability of personnel to conduct outside business activities and other securities-related activities, including pre-clearance and periodic reporting, and
- Restrictions on the ability of personnel to become a board member of other entities, including pre-clearance and periodic reporting.

Aside from addressing general fiduciary standards, advisers often also address fiduciary duties in specific procedures where fiduciary duties are likely to arise and be particularly acute, such as

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[120] See, for example, Section 217 of the Advisers Act, which says: "Any person who willfully violates any provision of this title, or any rule, regulation, or order promulgated by the Commission under authority thereof, shall, upon conviction, be fined not more than $ 10,000, imprisoned for not more than five years, or both." The Dodd-Frank Act also extends the statute of limitations for violations of Section 217 from 5 years to 6 years.

[121] Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000), citing Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949).

[122] Id., citing Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965). Although many of these prior cases involved violations under other securities statutes, this is the position the SEC takes with regard to willful violations under the Advisers Act as well. See In the Matter of William Keith Phillips, Advisers Act Release No. 61278 (January 4, 2010).

[123] As was noted in the Richards Fiduciary Speech, *supra* note 29.

[124] Advisers Act Rule 204A-1(a)(1).

those governing best execution, soft dollars, trade allocations and the like. Controls adopted in these procedures vary from firm to firm, depending on their business model and risks.

Training. In addition to merely adopting standards and procedures, advisers would be wise to train their personnel on what it means to have a fiduciary duty, including not only what an adviser's fiduciary duties are, but how those duties might apply in practice. Discussing hypothetical scenarios that personnel might face can facilitate an understanding of otherwise theoretical points. Sample hypotheticals appear below in Appendix A.

* * *

The Madoff Ponzi scheme, Wall Street reform and other recent developments have focused attention once again on the fiduciary duties advisers owe to their clients and, some might argue, have even expanded those duties to cover emerging areas of concern. However, basic duties of care, loyalty, obedience, good faith and disclosure still provide an effective framework for an adviser's fiduciary obligations to clients and offer the flexibility to ground additional duties as new circumstances arise.

APPENDIX A

AN INVESTMENT ADVISER'S FIDUCIARY DUTY

HYPOTHETICAL Q & A SCENARIOS
August 2010

(Caveat: The comments provided offer only one interpretation of these scenarios. Other interpretations may be valid as well.)

1. In exchange for substantial long-term investments in other accounts managed by the ADVISER, the ADVISER allows certain investors to make profitable market-timing trades (quick in-and-out trading) in one of the mutual funds managed by the ADVISER, in contravention of the fund's policies on market timing.
   -- Is that a breach of fiduciary duty and, if so, what duty?

   Comments: This is intended to be a classic market timing case, raising breach of fiduciary duty of LOYALTY issues (among others). The adviser has caused a client fund to violate its own policies on market timing, potentially to the detriment of fund shareholders. Given that this was done ostensibly to benefit the adviser (who would earn additional fees managing the assets that the timer has agreed to bring to the adviser in other accounts), the adviser's duty of GOOD FAITH is also called into question.

2. One of the investments an ADVISER is considering for an ADVISER client account is a Singapore bank CD paying interest 2% higher than that paid by any U.S. bank for a similar CD.
   -- Can the ADVISER buy that CD for its client accounts consistent with its fiduciary duty?

   Comments: If it looks too good to be true, it probably is….so the old saying goes. If nothing else, the outsized interest rate being offered on this CD heightens an adviser's duty of DUE DILIGENCE on this investment before the adviser should recommend it to its clients. Buying the CD without adequate assurances that the bank is solvent, is able to pay that interest rate for the foreseeable term, and is sufficiently regulated to not be overly risky for the client's account, could constitute a breach of the duty of CARE (lacking a reasonable basis for the investment/inadequate due diligence on an investment). (Note that this similar to the allegations made in the case brought against the Stanford firm and its affiliated bank in Antigua….)

3. An ADVISER is considering whether to hire Manager X as a sub-adviser for one of the ADVISER Funds. The only information the ADVISER has about Manager X is the following:
   - Manager X has sent marketing materials showing startlingly smooth and high returns that Manager X has generated for other clients over decades.
   - Manager X is widely-known in the industry.
   - Manager X was previously employed by the SEC.
   - Manager X belongs to the same country club as the ADVISER.
   - Manager X is known as a "great guy."

   -- Would hiring Manager X on that basis be a fiduciary breach? If so, of what duty?

   Comments: This is intended to be a variation on the Bernard Madoff situation, raising issues about an adviser's duty of DUE DILIGENCE to investigate sub-advisers and other service providers hired to manage client assets. If this is the only information the adviser has about Manager X, then the adviser might not be taking adequate CARE in selecting that sub-adviser. Indeed, the startlingly smooth and high returns shown by Manager X waves a red flag that the adviser should investigate further before hiring Manager X, on the "if it looks too good to be true, it probably is" theory.

4. A broker that executes trades for the ADVISER Funds calls the ADVISER with the opportunity to invest in a new offering of bonds. The ADVISER thinks it sounds like a good opportunity, so the ADVISER buys some of the bonds in its personal or proprietary account.
   -- Is that trade permissible?
   -- If not, what if none of the ADVISER's client accounts are permitted to invest in that type of bonds? Is it then permissible?

Comments: This raises a question of the fiduciary duty of LOYALTY. Fiduciary principles would dictate that this investment opportunity be offered FIRST to the adviser's clients. If the investment is not permissible for them, or otherwise not in their best interest, the adviser could then consider taking the opportunity for itself. An adviser that takes for itself investment opportunities for which its clients are potentially eligible has a conflict of interest. An adviser's duty of DISCLOSURE would dictate that the conflict be fully disclosed.

5. ADVISER is deciding whether to recommend to the ADVISER Funds Board that it continue using the current Third-Party Administrator for the Funds. If rehired, the Third-Party Administrator says it is willing to pay over to the ADVISER half of the administrative services fee it is paid by the Funds in order to help the ADVISER expand its investment management business.
   -- Can the ADVISER pursue that arrangement consistent with its fiduciary duty?

   Comment: This raises questions about an adviser's fiduciary duty of LOYALTY and GOOD FAITH. The adviser has a fiduciary obligation to act with candor and utmost good faith with the Board, making full disclosure of all material facts. If the adviser's recommendation to the Board to retain the current Third Party Administrator is biased because the Third Party Administrator has offered to share revenues with the adviser so the adviser can fund its own business expansion, then the adviser's loyalty has been compromised and it would not be acting in good faith. At a minimum, the adviser should make FULL DISCLOSURE to the Board of the conflict of interest posed by the revenue sharing arrangement, so the Board can take that into account when assessing the adviser's recommendation. (Note that this is similar to the allegations made in the BISYS Fund Services proceeding in 2006.)

6. An ADVISER genuinely likes the future prospects of X Co. and therefore buys some shares of X Co. for its proprietary account. Shortly thereafter, the ADVISER recommends that the shares of X Co. be purchased into every ADVISER Fund and client account where the stock is suitable. The ADVISER also recommends the stock to all its newsletter subscribers and everyone who follows ADVISER on Facebook and Twitter. The stock almost immediately increases in price, whereupon the ADVISER sells its shares of X Co. in its proprietary account to lock in its gains.
   -- Is that trade permissible?
   -- If not, what could be done to make it permissible?

   Comments: This is very similar to the "scalping" scenario that led to the Capital Gains Research case decided by the U.S. Supreme Court in 1963. In that case, the adviser was found to have breached its fiduciary duty UNDER SECTION 206 of the Advisers Act by defrauding its clients, that is, failing to disclose to them beforehand that the adviser engaged in this type of practice so they could take that into consideration when assessing the adviser's recommendations. The case implies that full disclosure would have avoided this violation. However, it is hard to imagine disclosure that would both be deemed adequate and would allow an adviser to take advantage of fully informed clients using this type of practice.

7. Broker X and Broker Y can both provide equally favorable execution of a client trade, except that Broker X charges more in commissions. ADVISER nonetheless selects Broker X to execute the client's trade because ADVISER thinks the higher commission is worth it, given that Broker X provides ADVISER with valuable research to use in making investment decisions for that client's account and all ADVISER's other clients' accounts.
   -- Is that a breach of fiduciary duty?
   -- If so, what duty?
   -- If so, how could a breach be avoided?

   Comment: This is intended to be a classic soft dollar scenario. Without more, this practice could constitute a breach of the duty of LOYALTY, in that the adviser is using a client's asset (its brokerage commissions) for the adviser's own benefit, by paying for research that the adviser would otherwise have to pay for out of its own pocket. This situation is complicated by the fact that the research also benefits the adviser's other clients, so that one client's asset (its brokerage commissions) is now being used to subsidize benefits to a different client. These issues could potentially be avoided if the adviser engaged in this practice only in accordance with Section 28(e) under the Securities Exchange Act of 1934, which creates a safe harbor from fiduciary breaches that might otherwise arise with soft dollars. Both Section 28(e) and fiduciary principles would dictate that the conflict of interest inherent in this practice be fully disclosed to clients.

8. ADVISER reads in famous investor Walter Buford's annual letter to his company's shareholders (publicly available) that he thinks U.S. airlines have become overly risky long-term investments and that he has just sold his major ownership stake in a major U.S. airline that he owned. ADVISER decides to sell out of its proprietary account all shares of that U.S. airline that ADVISER owns too.
   -- Is that trade permissible?
   -- What if ADVISER knows there are shares of that U.S. airline in ADVISER Funds or other ADVISER client accounts, but nonetheless sells the airline shares out of its proprietary account before selling them out of its clients' accounts?

   Comment: If the adviser decides, based on Buford's announcement, that the airline's shares should be sold, selling the adviser's own proprietary stake before selling the shares owned in client accounts could constitute a breach of the fiduciary duty of LOYALTY, by essentially "front running" the clients' trades (i.e., trading ahead of clients which could mean that the adviser would get a better price for its shares than the clients would for theirs). There may also be a question of CARE raised if an adviser acts solely on the basis of what another investor does, even a famous investor, without doing its own due diligence to confirm that conclusion.

9. ADVISER is recommending mutual funds to purchase in order to satisfy a client's asset allocation into equities. ADVISER recommends a proprietary ADVISER Fund even though there are similar unaffiliated funds that would be equally suitable for this purpose that the client could buy in their account.
   -- Would that recommendation be a fiduciary breach?
   -- If so, how could the breach be avoided?

   Comment: This raises issues about the adviser's duty of LOYALTY and duty of DISCLOSURE. One question is whether the adviser is unduly biased toward recommending its own funds because of the added management fees it would earn from having additional assets in the funds. The adviser should fully disclose to its clients this inherent conflict of interest and consider whether fees at the advised account level or the fund level should be waived in order to avoid an unfair "double dipping" on fees where the client essentially pays twice, at both levels, for the same service. Compliance monitoring should also test to make sure recommendations of proprietary funds are being made appropriately.

10. ADVISER is explaining investment alternatives to a senior client, who is acting a bit erratically on this day. The client does not seem to be absorbing the information provided, but is adamant about which alternative they want to pursue.
   -- Would it be a fiduciary breach to pursue the alternative selected by the client if the client turned out to be mentally incompetent?
   -- Would it be a fiduciary breach if the ADVISER chose not to act on client's selection but to wait until another time when the client was more focused to try explaining the alternatives again?
   -- Would it be a breach for ADVISER to contact the client's adult children to explain that client is acting this way and ask them what to do about the financial alternatives facing the client?

   Comment: This raises difficult issues about the duty to ASSESS A CLIENT'S MENTAL COMPETENCE. Whether or not courts impose on advisers a fiduciary duty to assess mental competence, the client is exhibiting "red flags" indicating that competence might be an issue. Therefore, the adviser would be wise to act cautiously in this situation. Failing to act as directed by the client could raise duty of OBEDIENCE issues. Contacting the client's adult children could be a breach of the client's privacy rights. Moreover, substituting the children's decision for that of the client could raise LOYALTY and OBEDIENCE issues (among many others). Instead, it might be in the client's best interest to revisit the alternatives with the client at another time when the client is more focused.