Chapter 8

An Investment Adviser's Fiduciary Duty

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* This chapter is provided strictly for educational purposes and does not constitute legal advice regarding any particular set of facts.

§ 8:1 Introduction

Fiduciary duty remains a contentious issue as regulators try to decide which financial service providers should be subject to a fiduciary duty and under what circumstances. This chapter discusses an investment adviser's fiduciary duties, focused primarily on those duties emanating from common law and the federal securities laws administered by the U.S. Securities and Exchange Commission (SEC). The discussion begins with the nature of the adviser-client relationship and the sources of an adviser's fiduciary obligations. It then addresses the basic fiduciary duties an adviser owes to its clients and various aspects of how they might apply in practice, listing numerous examples and highlighting emerging issues. The chapter concludes with practical tips on what advisers can do to help ensure that they comply with their fiduciary obligations.

§ 8:2 Fundamental Nature of the Adviser-Client Relationship

An adviser's relationship with its clients is fundamentally one of "trust and confidence."[1] This flows from the fact that clients seek

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1. "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." INV. ADVISER ASS'N, WHAT IS AN INVESTMENT ADVISER?: FIDUCIARY DUTY, https://www.investmentadviser.org/eweb/dynamicpage.aspx?webcode=WhatisIA [hereinafter IAA]. *See also* In the Matter of Arleen W. Hughes doing business as E.W. Hughes & Co., Securities Exchange Act Release No. 4048 (Feb. 18, 1948), *aff'd*, Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) [hereinafter Hughes] ("This reliance and

assistance from advisers on sensitive matters, such as their financial well-being, where clients may have little to no expertise. Some advisers even have discretionary authority to act on behalf of their clients, opening accounts, trading securities, moving assets and the like. As such, advisory clients are vulnerable[2] to the adviser and, in some cases, highly vulnerable. To afford some measure of protection in light of that vulnerability, advisers are held to have fiduciary duties to their clients, which help avoid adviser overreaching or abuse of position, and support the relationship as one of trust and confidence.

§ 8:3 Legal Basis for An Adviser's Fiduciary Duties

There are two main legal bases for an investment adviser's fiduciary duties: common law and federal statutory law. These are discussed below.

§ 8:3.1 Common Law

An investment adviser, as agent, owes fiduciary duties to its client, as principal, under common law principles of agency.[3] Certain other

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repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser."); SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) ("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 Investment Advisers Act was originally enacted)); In the Matter of James C. Dawson, Investment Advisers Act Release No. 3057 (July 23, 2010) [hereinafter Dawson] ("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)).

2. There are various theories for why or when fiduciary duties are imposed under the law. Some theories require that the relationship contain an element of vulnerability, such as the vulnerability of a beneficiary to the fiduciary's abuse of power. Other theories require that the fiduciary have discretion to act on behalf of the beneficiary or that the fiduciary be acting with respect to a critical resource of the beneficiary. For a more complete discussion of the theory grounding fiduciary duty, see D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002) [hereinafter Theory of Fiduciary Duty].

3. Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent will act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents to so act. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). *See, e.g.*, Patricia Burdett v. Robert S. Miller, 957 F.2d 1375 (USCA 7th Cir. 1992) (holding that an investment adviser is a fiduciary under Illinois common law and stating that a fiduciary duty is the duty of an agent to treat his principal with the utmost candor, rectitude, care, loyalty, and good faith).

aspects of an adviser's fiduciary duties are grounded in the law of trusts.[4] Under either of those frameworks, an adviser's duties under 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 any party with standing to sue.

§ 8:3.2 Federal Statutory Law

[A] Investment Advisers Act Section 206

An adviser's fiduciary duty also emanates from certain federal statutes, most notably section 206[5] of the Investment Advisers Act of 1940 (the "Investment Advisers Act"), a prohibited transactions section which generally prohibits an adviser[6] from engaging in any

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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." Andrew J. Donohue, Director, SEC Division of Investment Management, Remarks Before the IAA/ACA Insight's Investment Adviser Compliance Forum 2010 (Feb. 25, 2010).
5. Section 206 applies by its terms to all persons within the scope of the definition of "investment adviser" under the Investment Advisers Act, including SEC-registered, state-registered and unregistered advisers, even though some of the rules adopted by the SEC 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* Amendments to Form ADV, Release No. IA-3060 (July 28, 2010) [hereinafter ADV Release], at n.256.
6. An adviser can be held liable for its own breaches of fiduciary duty, as well as those of associated persons acting on its behalf, under theories of control or supervisory responsibility. *See, e.g.*, In the Matter of Fidelity Management & Research Co. & FMR Co., Inc., Release No. IA-2713 (Mar. 5, 2008) (settled) [hereinafter FMR] (Fidelity found to have breached its fiduciary duty to its advisory clients by, among other things, allowing certain executives' and traders' receipt of travel, entertainment and gifts from brokers and certain traders' family or romantic relationships with brokers to influence its selection of brokers for client transactions, resulting in the substantial possibility of higher execution costs to Fidelity's advisory clients); Staff, Investment Adviser Regulation Office of the SEC's Division of Investment Management, Outline (Mar. 2013), http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf [hereinafter SEC Staff Outline], at n.199 ("The SEC has stated that the 'delicate fiduciary relationship' between an investment adviser and a client imposes an obligation on an adviser to review and to monitor its activities and the activities of its employees.") (citation omitted). Associated persons of an adviser can themselves be held liable for breaches of fiduciary duty, either directly or through allegations of aiding and abetting or "causing" another person's violation. *See, e.g.*, In the Matter of Mohammed Riad & Kevin Timothy Swanson, SEC Admin. Proc. File No. 3-15141. Initial

practice that is fraudulent, deceptive, or manipulative.[7] Although section 206 does not explicitly mention an adviser's "fiduciary duty," in the seminal case of *SEC v. Capital Gains Research Bureau*,[8] the U.S. Supreme Court said that the Investment Advisers Act reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship."[9]

It is not clear whether the Court in *Capital Gains* was merely explaining common law, interpreting section 206, or both. Either way, the case has long been cited for the proposition that advisers owe a fiduciary duty to their clients under the Investment Advisers Act,[10] 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.[11]

Decision Release No. 590 (Apr. 21, 2014) [hereinafter Riad/Swanson] (stating that "[i]nvestment advisers and their associated persons are fiduciaries"). On appeal, based on independent *de novo* review of the record, the Commission found both portfolio managers Riad and Swanson committed fraud, and that they caused and aided and abetted the adviser's and fund's fraud violations. *See* Investment Advisers Act Release No. 4420A (July 7, 2016). *See also* In the Matter of Ambassador Capital Mgmt., LLC & Derek H. Oglesby, Investment Advisers Act Release No. 3725 (Nov. 26, 2013) [hereinafter Ambassador Capital] (adviser and portfolio manager alleged to have caused money market fund's failure to comply).

7. Note that an adviser's fiduciary duties under sections 206(1) and (2) of the Investment Advisers Act extend not only to "clients," but "prospective clients" as well.

8. Capital Gains Research Bureau, 375 U.S. 180 (1963).

9. In *Capital Gains*, 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, a practice sometimes referred to as "scalping." The case held that the adviser's practice operated as a fraud or deceit upon clients within the meaning of section 206 of the Investment Advisers Act.

10. At least under section 206(2) of the Investment Advisers Act, which had been enacted at the time of the events at issue in *Capital Gains* and was the principal focus of the Court's opinion. The fiduciary relationship embedded in the Investment 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. *See also* Hughes, *supra* note 1, where the SEC discussed an adviser's fiduciary duties under common law while finding the registrant in that case in violation of anti-fraud provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "Exchange Act"); In the Matter of SignalPoint Asset Mgmt., et al., Release No. IA-3868 (July 2, 2014) (settled) (adviser's alleged breaches of fiduciary duty were found to constitute violations of section 206(2)).

11. *Capital Gains*, 375 U.S. at 194, text accompanying n.44.

As a result, section 206 is viewed as setting a "federal" fiduciary standard[12] for advisers. Because there is generally no private right of action under the Investment Advisers Act,[13] the contours of that duty are shaped largely by federal courts interpreting the act, as well as by SEC interpretation and enforcement of section 206 and rules promulgated under that section.

Although there is likely substantial overlap between an adviser's common law fiduciary duty and its federal fiduciary duty under the Investment Advisers Act, the two are unlikely to be identical. Some commentators believe the federal fiduciary duty is a subset of the adviser's general fiduciary duty.[14] That could be the case if the federal fiduciary duty under section 206 is interpreted to be, in a nutshell, a duty not to defraud clients and, indeed, many of the SEC's enforcement cases under section 206 focus on failures to disclose. However, that also implies every violation of section 206 would also ground a claim for breach of fiduciary duty under common law. It is unclear whether that would be the case, given the far-reaching scope of section 206 and its related rules.[15] Moreover, common law breaches of fiduciary duty, such as simple breaches of due care, would not seem to ground a claim under Investment Advisers Act section 206 unless

12. This was confirmed in the U.S. Supreme Court case of Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) ("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)).

13. *Id*.

14. *See* Investor as Purchaser Subcommittee, Memorandum to the SEC Investor Advisory Committee (Feb. 15, 2010) (regarding Fiduciary Duty Issue, at 3: "The federal fiduciary duty comprises a subset of the general fiduciary duty that an investment adviser owes to his clients.").

15. Section 206 is, after all, an anti-fraud provision, and the SEC has on occasion defined as "fraudulent" in rules 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 Investment Advisers Act 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 Investment Advisers Act Rule 206(4)-6. Without more, neither of those scenarios seems 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 Investment Advisers Act prohibitions on fraud and deceit are constrained by principles of common law fraud. *Capital Gains*, 375 U.S. at 184 n.6, at 192–95, text accompanying nn.39–47.

the breach was found to have operated as a fraud, deceit, or similar conduct within the scope of that section.[16]

[B] Dodd-Frank Act

[B][1] Advisers

Importantly, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") of 2010 has further shaped an adviser's federal fiduciary duty under the Investment Advisers Act. Section 913 of the Dodd-Frank Act calls for the SEC to study existing legal and regulatory standards of care for advisers[17] when providing personalized investment advice to retail customers.[18] That study was completed in January 2011[19] and, based on that, the SEC is authorized—but not required—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 that is no less stringent than the standard applicable to advisers under Investment Advisers Act section 206.[20] The rules must also require disclosure of any material conflicts of interest.

The Dodd-Frank Act does not actually hold advisers to a "fiduciary duty" using those words, but the "best interest" standard, the reference to section 206, and the disclosure requirements seem to all point in that direction. Although the relevant study was completed quite some time ago, the SEC has still not decided whether to engage in rulemaking in this area as of the publication of this chapter.

[B][2] Municipal Advisors

The Dodd-Frank Act also added to the Securities Exchange Act of 1934 a new class of financial service providers called municipal

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16. For example, a careless trading error might ground a common law claim for breach of fiduciary duty of care brought by harmed clients, but unless the careless conduct was also fraudulent, deceitful, manipulative or misleading in some manner (for example, inconsistent with the adviser's disclosures), it would not seem to violate section 206 as well.
17. The Dodd-Frank Act calls for the SEC to look at others in addition to advisers, such as brokers, dealers, and their associated persons.
18. *See generally* Dodd-Frank Act § 913.
19. *See* SEC Staff, Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011), www.sec.gov/news/studies/2011/913studyfinal.pdf. *See also* Duties of Brokers, Dealers, and Investment Advisers, Release No. IA-3558 (Mar. 1, 2013), http://www.sec.gov/rules/other/2013/34-69013.pdf (SEC's subsequent public request for data).
20. Oddly, the act required the SEC to study the issue but seems to have predetermined the result by giving the SEC a specific standard of conduct to require from advisers if it opts to engage in rulemaking in this area (to act in the best interest of clients, etc.).

advisors.[21] The definition of "municipal advisor" excludes investment advisers registered with the SEC under the Investment Advisers Act to the extent they are providing investment advice in that capacity. Significantly, and in contrast to advisers registered under the Investment Advisers Act, 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 [MSRB (the Municipal Securities Rulemaking Board)]."[22] (emphasis added)

The fiduciary duty imposed by this section is self-executing. The MSRB has also adopted Rule G-42 Duties of Non-Solicitor Municipal Advisors,[23] effective June 23, 2016, which imposes on municipal advisors various standards of conduct, including a "fiduciary duty that includes a duty of loyalty and a duty of care" owed to municipal entity clients. Rule G-42 further spells out specific requirements applicable to the municipal advisor-client relationship, such as those for:

- disclosure of conflicts of interest and disciplinary information;
- written documentation of the advisory relationship, covering key items such as compensation, scope of engagement, and termination of or withdrawal from the relationship; and

21. "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 § 975. Among other things, municipal advisors must register with the SEC unless excluded or exempt. *See* Registration of Municipal Advisors, Release No. 34-70462 (Sept. 20, 2013). The Act also grants the SEC authority to regulate and sanction municipal advisors for fraudulent conduct and other violations of the federal securities laws. More information on municipal advisor regulation can be found in chapter 54 of this treatise.
22. Dodd-Frank Act § 975. The MSRB is a self-regulatory organization whose mission is to protect investors, municipal entities and the public interest by promoting a fair and efficient municipal market, regulating firms that engage in municipal securities and advisory activities, and promoting market transparency.
23. MSRB Rule G-42, http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/~/link.aspx?_id=883FE79BCE8645739286DB9B675A8C6B&_z=z.

- the advisor's recommendations to be based on a reasonable belief that they are suitable for the client (based on information obtained through reasonable diligence).[24]

Rule G-42 also contains express prohibitions relative to the municipal advisor-client relationship, such as prohibitions against:

- excessive compensation;
- making false or misleading representations or omissions in the process of seeking an engagement;
- certain fee-splitting arrangements;
- certain payments made for the purpose of obtaining business; and
- except in limited circumstances, engaging in certain principal transactions with a municipal entity client.[25]

Rule G-42 is accompanied by extensive Supplementary Material providing guidance as to what the specific provisions are intended to mean and how they are intended to apply.

On its surface, Rule G-42 does not appear to impose obligations on municipal advisors that are very far afield of those familiar to all advisers. However, time will tell how the new MSRB fiduciary duty will be interpreted and applied in practice. Except for aspects that may be unique to municipal securities, it can be envisioned that a municipal advisor's fiduciary duty and the fiduciary duty imposed on other advisers will be interpreted similarly.[26]

§ 8:3.3 Other Provisions Impacting an Adviser's Fiduciary Duty

Although the principal focus of this chapter is advisers as they are regulated under the Investment Advisers Act, investment advisers have—or may have—fiduciary duties to their clients emanating from other sources as well, several of which are summarized below:

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24. MSRB Rule G-42(a)–(d).
25. MSRB Rule G-42(e).
26. Notably, the SEC did not wait for Rule G-42 to become effective before enforcing against a municipal advisor for breach of fiduciary duty. Relying on the self-executing Dodd-Frank Act provisions, as well as pre-existing MSRB rules, the SEC brought an administrative proceeding against a municipal advisor and certain associated persons alleging breach of fiduciary duty for failing to disclose certain conflicts. *See* In the Matter of Central States Capital Mkts., LLC, et al., Investment Advisers Act Release No. 4352 (Mar. 15, 2016) (settled).

[A] Investment Company Act Sections 36(a) and 36(b)

Under section 36(a) of the Investment Company Act of 1940, an adviser can be liable for breach of fiduciary 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 fund shareholders from the many subtle abuses that are not separately prohibited in the Investment Company Act.[27] However, despite decades of litigation involving section 36(a),[28] there is still no 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.[29]

In addition to section 36(a), section 36(b) of the Investment Company Act makes advisers to registered investment companies liable for breach of fiduciary duty if they receive excessive compensation. With the intense focus on fund fees, this is one of the most litigated sections under the Investment Company Act. However, the U.S. Supreme Court has now confirmed a decades-old standard applied to these cases, stating that "to face liability under section 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[30] While this makes it more difficult for plaintiffs to successfully challenge fees as excessive under section 36(b), litigation in this area continues.[31]

27. *See* Brown v. Bullock, 194 F. Supp. 207, 238–39 at n.1 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961) (en banc).
28. See the cases cited in Bellikoff, et al. v. Eaton Vance Corp., et al., 481 F.3d 110 (2d Cir. 2007).
29. See authorities cited in ROBERT A. ROBERTSON, FUND GOVERNANCE: LEGAL DUTIES OF INVESTMENT COMPANY DIRECTORS § 9.01[2] (2016).
30. Jones, et al. v. Harris Assocs., L.P., 130 S. Ct. 1418, 1426 (2010).
31. *See, e.g.*, Chill v. Calamos Advisors LLC, et al., USDC, SDNY, Fed. Sec. L. Rep. ¶99,047 (Mar. 28, 2016) (plaintiff's section 36(b) claims allowed to survive defendants' motion to dismiss); Turner v. Davis Selected Advisers, LP, et al., Fed. Sec. L. Rep. ¶98,831, USCA (9th Cir.) (Sept. 29, 2015) (Court of Appeals affirms dismissal of plaintiff's section 36(b) claims against adviser and distributor); SEC Litig. Release No. 22,402 (June 27, 2012) (concerning SEC v. AMMB Consultant Sendirian Berhad, No. 1:12-cv-01 052 (D.C. Cir. June 26, 2012) (adviser settled SEC charges without admitting or denying the allegation that it breached its fiduciary duty under section 36(b) for excessive compensation, among other things).

[B] State 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 Investment Advisers Act.[32] It is possible these state provisions could be interpreted to impose a fiduciary duty on advisers as well, using the rationale spelled out by the Supreme Court in the *Capital Gains* case.[33]

In addition, some states have adopted rules, on the basis of advisers being fiduciaries, that prohibit advisers from engaging in certain "unethical business practices," defined in substance to include giving unsuitable advice, exercising discretionary authority without client approval, trading accounts excessively, engaging in unauthorized trading, charging unreasonable fees, lending money to (or borrowing money from) a client, and failing to disclose material conflicts of interest, among other practices.[34] These rules purport to apply to state-registered advisers, *and* to SEC-registered advisers to the extent the conduct alleged is fraudulent or deceptive, or would otherwise fall within the state's authority to enforce against advisers who commit fraud or deceit.[35]

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32. *See, e.g.*, Uniform Securities Act of 1956 § 102; Uniform Securities Act of 2002 § 502. *See also* Texas Securities Act §§ 33-1.A., 33-1.C.; Colorado Securities Act § 11-51-501(5). More information on state adviser regulation can be found in chapters 35, 36 and 37 of this treatise.

33. There has already been movement in that direction. *See, e.g.*, Brief for North American Securities Administrators Association, Inc. (NASAA) as Amicus Curiae Supporting Richard Lee Van Dyke d/b/a Dick Van Dyke Registered Inv. Advisor, Plaintiff-Appellant v. Jesse White, in his official capacity as Illinois Secretary of State, Illinois Department of Securities, and Tanya Solov, in her official capacity as Director of the Illinois Department of Securities, Defendants-Appellees (Ill. App. Ct. Nov. 20, 2015) (arguing that anti-fraud section 12J of the Illinois Securities Law of 1953, like section 206 of the Investment Advisers Act, provides the foundation of an investment adviser's fiduciary duty to its clients). *See also* Barry J. Belmont, et al. v. MB Inv. Partners, Inc., No. 12-1580 (3d Cir. 2013), discussing how the federal common law under section 206 of the Investment Advisers Act has influenced the development of the state common law as applied to an adviser's fiduciary duty.

34. These rules are generally based on a model Policy Statement developed by NASAA. *See* NASAA Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers, Model Rule 102(a)(4)-1 (adopted 4/27/97, amended 4/18/04, 9/11/05), http://www.nasaa.org/wp-content/uploads/2011/07/6-IAUnethical091105.pdf. *See, e.g.*, WASH. ADMIN. CODE § 460-24A-220; MONT. ADMIN. R. 6.10.402; UTAH ADMIN. CODE R164-6-1g.

35. Although Congress largely divided adviser regulation between the states and the SEC under the National Securities Markets Improvements Act (NSMIA) of 1996, NSMIA does not preempt the states from pursuing even SEC-registered advisers if they commit fraud or deceit. *See* Investment Advisers Act § 203A(b)(2).

[C] ERISA

Under the Employee Retirement Income Security Act of 1974 (ERISA), a person is a "fiduciary" with respect to an ERISA plan to the extent the person engages in certain activities, including:

- exercising certain discretionary authority or control with respect to plan assets, or
- rendering investment advice for a fee or other compensation with respect to plan assets, or having any authority or responsibility to do so.[36]

Among other things, ERISA fiduciaries are held to a "prudent expert" standard of care[37] and the "exclusive benefit rule,"[38] and must avoid "prohibited transactions,"[39] as provided in relevant sections of ERISA and related regulations. In some respects, the limits imposed on an ERISA fiduciary are considered stricter than those imposed on advisers under the Investment Advisers Act.[40]

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36. ERISA § 3(21)(A). The DOL has taken the position that the relevant definition of fiduciary also applies when investment advice is provided to an individual plan participant or beneficiary in a plan that allows participants or beneficiaries to direct the investment of their accounts. *See* DOL Advisory Opinion 2005-23A (Dec. 7, 2005).
37. ERISA section 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 Commission, Uniform Prudent Investor Act, http://www.uniformlaws.org/shared/docs/prudent%20investor/upia_final_94.pdf.
38. ERISA section 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 . . . ."
39. Key prohibited transaction provisions appear in ERISA section 406(a) and (b), and similar provisions in section 4975 of the U.S. Internal Revenue Code.
40. *See, e.g.*, Ron Rhoades, ONE-MAN THINK TANK: INSIDE THE LEGAL ISSUES OF THE GOLDMAN SACHS HEARINGS, RIABiz (May 5, 2010) ("It should be noted that the Investment 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*, 10 J. INV. COMPLIANCE 4 (1999). Indeed, an ERISA fiduciary's duties are sometimes referred to as the "highest known to the law." *See, e.g.*, Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1998) (citation omitted).

In April 2016, the DOL adopted amendments to the long-standing regulatory definition of ERISA "fiduciary" as it relates to non-discretionary investment advisory fiduciaries, as well as certain key prohibited transaction exemptions, for the purported purpose of better protecting plans, participants, beneficiaries, and IRA owners from conflicts of interest, imprudence, and disloyalty.[41] These changes may significantly impact investment advisers who provide advice to ERISA plans, plan participants, or IRAs, to the extent they become subject to ERISA fiduciary rules and prohibited transaction restrictions they were not familiar with before. In the coming months, as the new rules come into effect and compliance is required, the implications of these changes will become more evident.[42]

[D] Broker-Dealer Laws

Dual-registered advisers/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 those imposed by the Financial Industry Regulatory Authority (FINRA). 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."[43]

The SEC has been more focused recently on the duties imposed on brokers, as compared to those imposed on advisers and whether they

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41. *See* Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,945 (Apr. 8, 2016; eff. June 7, 2016) (Final Rule), https://www.federalregister.gov/articles/2016/04/08/2016-07924/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#footnote-9, and related releases.
42. More information on being an ERISA fiduciary can be found in *infra* chapters 49 and 49A; DEP'T OF LABOR, MEETING YOUR FIDUCIARY RESPONSIBILITIES (Feb. 2012), http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.
43. More information on broker-dealer advisory services can be found in *infra* chapter 40. *See also* James Hamilton, *SEC Regulation of Investment Advisers and Brokers in the Brave New World, in* PRACTICAL COMPLIANCE & RISK MGMT. FOR THE SEC. INDUS. (May–June 2008) [hereinafter Brave New World]; In the Matter of Dep't of Enf't v. William B. Fretz, Jr., John P. Freeman & The Keystone Equities Grp., LP, FINRA National Adjudicatory Council, Complaint No. 2010024889501 (Dec. 17, 2015), where respondents were found, among other things, to have breached their fiduciary duties to investors by engaging in business-related misconduct that is inconsistent with just and equitable principles of trade in violation of NASD Rule 2110 and FINRA Rule 2010, conduct that also grounded an SEC enforcement action for breach of section 206 of the Investment Advisers Act in In the Matter of William B. Fretz, Jr., John P. Freeman, Covenant Capital Management Partners, L.P. & Covenant Partners, L.P., Investment Advisers Act Release No. 4206 (Sept. 23, 2015) (settled).

should be harmonized in some areas,[44] particularly since the Dodd-Frank Section 913 study referenced in section 8:3.2[B][1] above recommends a uniform fiduciary standard for all brokers, dealers, *and* investment advisers, at least when they are providing personalized investment advice about securities to retail customers.[45] Notably, as mentioned in section 8:3.2[B][1] above, with regard to advisers, the Dodd-Frank Act does not expressly say brokers will actually have a "fiduciary duty" to their customers, although the "best interest" standard, disclosure and consent requirements and references to section 206 seem to be aiming in that direction.[46]

§ 8:4 Basic Fiduciary Duties an Adviser Owes to Its Clients

A single definitive list of an adviser's fiduciary duties is not found in either the common law or the Investment Advisers Act.[47] However,

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44. For a more complete discussion of a broker's duties as compared to those of advisers, *see* Brave New World, *supra* note 43. In particular, note this regarding brokers' duties even under the law prior to the Dodd-Frank Act: "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* Rand Institute for Social Justice, Investor and Industry Perspectives on Investment Advisers and Broker-Dealers (2008) [hereinafter the Rand Report] (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).
45. *See* the Dodd-Frank Section 913 Study, *supra* note 19. More information on a potential uniform fiduciary duty for broker-dealers and advisers can be found *infra* chapter 8A of this treatise.
46. Significantly, SEC Chair Mary Jo White has expressed her *personal* view that broker-dealers and investment advisers should be subject to a uniform fiduciary standard of conduct when providing personalized securities advice to retail investors. *See Examining the SEC's Agenda, Operations and FY 2016 Budget Request, Before the H. Comm. on Financial Services*, 114th Cong. (2015) (testimony by SEC Chair Mary Jo White).
47. *See* Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, Remarks Before the Eighth Annual Investment Adviser Compliance Summit: Fiduciary Duty: Return to First Principles (Feb. 27, 2006) [hereinafter 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?").

the most fundamental duties advisers are generally held to owe are the duties of care and loyalty.[48] Some authorities also refer to an adviser's duty of obedience.[49] Still others refer to a duty to act in good faith,[50] and a duty of disclosure.[51]

Whether these are viewed individually as separate duties, or grouped together in some way and analyzed as facets of one another, they are certainly among the most frequently cited fiduciary duties an adviser is held to owe. Each of these duties is discussed in more detail in succeeding sections, along with more granular illustrations of what those duties might mean to an adviser when applied in practice.

§ 8:5 How the Basic Fiduciary Duties Apply to a Particular Adviser

How fiduciary duties apply to any particular adviser will vary depending on the circumstances, including the adviser's business model, clientele, services, arrangements, and other factors.[52] For

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48. *See* IAA, *supra* note 1 ("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.").

49. *See, e.g.*, Kathryn B. McGrath, Director of the SEC Division of Investment Management, Keynote Address to the 1987 Mutual Funds and Investment Management Conference: Will the Investment Company and Investment Advisory Industry Win an Academy Award? (1987) [hereinafter McGrath Remarks], at 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.

50. *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194, text accompanying n.44 (1963). *See also* Ron A. Rhoades, *What Are the Specific Fiduciary Duties of Financial Advisors?* (Jan. 1, 2008) (among others, refers to the duties of care, loyalty and good faith as a "triad" of duties). *Cf.* 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).

51. *Capital Gains*, 375 U.S. at 194, text accompanying n.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.

52. IAA, *supra* note 1 ("The parameters of an investment adviser's fiduciary duty depend on the scope of the advisory relationship . . . ."). *See* Michael S. Caccese, *Portfolio Manager Lift-Outs, Investment Performance Portability, and the CFA Institute Member*, 34 SEC. REG. L.J. 31, 33 (2005) ("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.").

example, whether an adviser has satisfied its duty of disclosure to a client might depend on whether the client is sophisticated. Retail clients may warrant more basic, detailed disclosure than institutional clients who have more internal expertise and can better fend for themselves. As a result, just as there is no single definitive list of an adviser's fiduciary duties, there is also no single source defining how an adviser's fiduciary duties will apply in all circumstances. Instead, the scope, contours, and application of an adviser's fiduciary duties in any given situation are contextual and must be determined on a case-by-case basis.[53]

§ 8:6 Altering or Waiving an Adviser's Fiduciary Duties

Generally speaking, an adviser's fiduciary duties can be altered or waived, with the client's consent. This is the case under common law,[54] as well as federal law.[55]

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53. As noted in Theory of Fiduciary Duty, *supra* note 2, theories vary on which elements of vulnerability, discretion and other factors are required before a relationship will be considered "fiduciary." The variability of these elements from theory to theory helps to explain why an adviser's fiduciary obligations can vary from client to client, depending on how many of those elements are present in any given adviser-client relationship and to what degree. For a case illustrating this point, see W. Reserve Life Assurance v. Graben, 233 S.W.3d 360, 373–75 (Tex. Ct. App. 2007) (no pet. h.), where the court analyzed the circumstances that made the financial advisor in that case a "fiduciary" and what evidence supported the plaintiffs' breach of fiduciary duty claim.

54. *See* Theory of Fiduciary Duty, *supra* note 2, at 1492: "[I]n most fiduciary settings, parties may modify default rules of fiduciary duty through contract." (citations omitted). *See also* RESTATEMENT (THIRD) OF AGENCY § 8.06 (2006), specifying generally that conduct by an agent (fiduciary) that would otherwise constitute a breach of duty does not constitute a breach if the principal (beneficiary) consents to the conduct, provided certain parameters are met. The ability to alter or waive fiduciary rules is also recognized in the trust law. *See, e.g.*, Uniform Prudent Investor Act § 1(b) ("The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust.").

55. *See, e.g.*, Hughes, *supra* note 1 ("To prevent any conflict and the possible subordination of this duty to act solely for the benefit of his principal, a fiduciary at common law is forbidden to deal as an adverse party with his principal. *An exception is made, however, where the principal gives his informed consent to such dealings* . . . . [Thus], if registrant chooses to assume a role in which she is motivated by conflicting interests, under the exception we have discussed *she may do so if, but only if, she obtains her client's consent after disclosure*.") (emphasis added); *see also* SEC Staff, Division of Investment Management and OCIE, Information for Newly-Registered Investment Advisers (2010) ("[Y]ou are a 'fiduciary' to your advisory clients. This means . . . you cannot use your clients' assets for your own benefit or the benefit of other clients, *at least without client consent*.") (emphasis added).

Investment advisers usually obtain client consent to a fiduciary alteration or waiver by one or more methods. They might, for example, obtain *express* consent through provisions in the investment advisory agreement or contract signed by the client. More commonly, client consent is *implied* or *inferred* when the adviser discloses its practices to the client in Form ADV or elsewhere, allowing the client to decide whether to proceed with the advisory relationship or not, in light of the matters disclosed. Clients that choose to proceed are generally viewed as having consented to the practices disclosed.[56] However, in order for a client's consent to be effective, it must be *informed*, meaning that it must be based on full and frank disclosure.[57]

Which of an adviser's fiduciary duties may be altered and to what degree—perhaps to the point of being waived altogether—are the subject of some controversy.[58] Certainly in some cases, courts and regulators have invalidated an adviser's attempt to alter or waive fiduciary obligations, most often by finding inadequate disclosure (which would render client consent ineffective)[59] or by determining

56. *See* Knut A. Rostad, *Conflicts of Interest and the Duty of Loyalty, at the Securities and Exchange Commission*, 22 Inv. Law. 1 (Sept. 2015) [hereinafter Rostad] (quoting Robert Plaze, former Associate Director of the SEC's Division of Investment Management: "In the vast amount of cases the Commission or a court will infer consent from disclosure, such as disclosure in the [Form ADV Part 2A firm] brochure—even if the client hasn't read it.").

57. *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195–97 (1963) (an adviser's disclosure must be "full and frank"); Form ADV, Part 2, General Instruction 3: "[Your fiduciary obligation] requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them." *See also* RESTATEMENT (THIRD) OF AGENCY § 8.06(1)(a)(ii) (2006) (specifying generally that a principal's consent to conduct that would otherwise constitute a breach of duty requires the agent to disclose all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment).

58. For a more complete discussion of the decades old "war" between the "contractarian" school of thought, which generally holds that fiduciary duties may be reduced or eliminated by contract, and the "anticontractarian" school of thought, which generally views fiduciary duties as unwaivable, see Paul S. Miller, *Congress, Corporate Boards, and Oversight: A Public/Private Law Comparison*, 44 U. RICH. L. REV. 771, 792–94 (2010) [hereinafter Miller]; Ann E. Conaway, *Why No Respect? The Contractual Duties of Good Faith and Fair Dealing in Delaware*, WIDENER UNIV. DEL. L. SCH. (June 17, 2007).

59. *See Capital Gains*, 375 U.S. 180 (adviser failed to disclose material facts about personal transactions and conduct therefore operated as a fraud or deceit upon clients, in violation of section 206); and other cases cited throughout these notes finding adviser's disclosure inadequate. *See also*

that the alteration or waiver would violate public policy,[60] including those policies determined to underpin other express legal provisions.[61]

Notwithstanding these concerns, alterations and waivers of fiduciary duties are commonplace in the advisory industry. Here are examples:

- Advisers prohibited under strict fiduciary principles from engaging in principal transactions with their clients nonetheless do so, by following Investment Advisers Act section 206(3) and the consent procedures called for under that section.

Rostad, *supra* note 56, at 3 (quoting Robert Plaze, former Associate Director of the SEC's Division of Investment Management: "Can you ever have fraud when there has been full disclosure? [I] think the answer is that you can have fraud if the SEC or court does not infer client consent from the disclosure. Let me give you an example. In the middle of a brochure or other client communication, the adviser explains that he will use your money to pay his mortgage if he is short some month. I think a court would not infer consent.").

60. *See, e.g.*, Massachusetts Securities Division, Policy Statement on Robo-Advisers and State Investment Adviser Registration (updated Apr. 1, 2016) [hereinafter MA Robo-Advisers Policy Statement] (expressing concern about the broad disclaimers and waivers the Division has seen from certain robo-advisers: "Many fully automated robo-advisers appear implicitly to take the position that the fiduciary duty of care (including the requirement to provide personalized and appropriate investment advice) can be significantly disclaimed with the written consent of the client. However, a complete and blanket disclaimer of any fiduciary relationship would be ineffective. For the same reason, while the nature of a client's contractual relationship with an adviser can, to an extent, be narrowed by written agreement, the Division will not permit the core fiduciary relationship to be eliminated." (citations omitted)).

61. For example, one could easily envision a court or regulator, on public policy or similar grounds, not allowing an adviser to contract or disclose away its basic fiduciary obligations as embedded in other affirmative provisions of law, such as: an adviser attempting to use a contractual provision allowing it to engage in an ERISA "prohibited transaction" without adhering to an available exemption; or an adviser attempting to disclose away the conflict of interest that would exist if it directed fund client brokerage commissions to pay for fund distribution in a manner inconsistent with Investment Company Act Rule 12b-1(h). Moreover, Investment Advisers Act section 215(a) voids any provision binding any person to waive compliance with the Investment Advisers Act or related rules. Therefore, any conduct that would be considered a breach of fiduciary duty under section 206 cannot be contracted or disclosed away, such as an adviser attempting to disclaim its basic duty of disclosure as embodied in section 206, or an adviser seeking waiver of the conflict that would exist if the adviser made political contributions and then accepted compensation from a government entity inconsistent with the Investment Advisers Act "pay-to-play" rule (Rule 206(4)-5).

- Advisers that might otherwise be prohibited under fiduciary principles from benefitting themselves through the use of client assets nonetheless do so, at least indirectly, when they invest clients in affiliated mutual funds, after making full disclosure of the conflict of interest this presents.
- Institutional advisers hired as sub-adviser to a client's primary adviser might disclaim the otherwise applicable fiduciary obligation to determine suitability of a particular investment or investment strategy for the client, leaving suitability to be determined by the client's primary adviser, who knows and manages the client's overall financial picture.

These are but a few of the numerous examples of fiduciary alterations and waivers that are routine in the advisory industry.[62] Indeed, most of the examples of adviser fiduciary duties listed in the next section are subject to alteration or waiver, at least to some degree, by obtaining a client's consent, often through the disclosure process. Alterations and waivers are necessary and desirable if advisers and clients are to be afforded the flexibility to shape their relationships as they wish.[63]

§ 8:7 Specific Examples of an Adviser's Fiduciary Duties

Despite the absence of a single source defining an adviser's fiduciary duties, there are authorities that can be consulted for guidance on what an adviser's duties are and how they might apply in particular circumstances. These include statements of the common law,[64] state

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62. For a discussion of the use of "hedge clauses" common in advisory contracts, altering the otherwise applicable fiduciary duty of care, see also *infra* section 8:9.
63. This concept is at the heart of the "contractarian" school of thought in fiduciary law. *See* Miller, *supra* note 58. *See also* Rostad, *supra* note 56, at 4 (quoting Robert Plaze, former Associate Director of the SEC's Division of Investment Management, who indicates that if consent were not inferred from disclosure (thereby allowing an adviser's conflicts to be waived by clients), the advisory business itself would be impossible to conduct, and further indicating that the question of what is in the client's "best interest" is left to the client to decide after full disclosure: "The Investment Advisers Act involves clients who are in most cases fully capable of providing consent. Failure to recognize that would send the SEC down a road of substituting its (or its staff's) judgments about best interest for the client's.").
64. Often as codified in the *Restatements*, such as the RESTATEMENT (THIRD) OF AGENCY (2006).

and federal case law,[65] legislative history,[66] guidance from the SEC[67] and other regulators,[68] and industry commentators[69] and other thought leaders.[70] The list of duties below was compiled from those sources and is sorted under each of the major duties mentioned previously in section 8:4 (the duties of care, loyalty, obedience, good faith, and disclosure), accompanied in each case by illustrative examples.

Importantly, the examples below are intended to be instructive, but should be used only as a starting point for analysis. In other words, an adviser will not necessarily have breached its fiduciary duty if it acts inconsistently with these examples, given the need—discussed in prior sections—for each circumstance to be considered in context and on a case-by-case basis.

§ 8:7.1 Duty of Care

An adviser's fiduciary duty of care generally requires the adviser to—

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65. *See, e.g.*, the cases cited throughout these notes.
66. *See, e.g.*, the legislative history behind the Investment Advisers Act discussed in Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979). With regard to the legislative history of section 913 of the Dodd-Frank Act, see Jim Hamilton, Wolters Kluwer CCH Financial Reform News Center, Senator Johnson Clarifies Compromise on Broker Duty of Care (July 19, 2010), http://financialreform.wolterskluwerlb.com/2010/07/senator-johnson-clarifies-compromise-on-broker-duty-of-care.html#more.
67. This would include guidance from the SEC staff, such as that appearing in the SEC Staff Outline, *supra* note 6, as well as in SEC Staff Remarks, IM Guidance Updates, and OCIE Risk Alerts cited throughout these notes, recognizing that the views of SEC staff are not necessarily the views of other SEC staff members, individual SEC Commissioners, or the Commission as a whole.
68. *See, e.g.*, statements from state Blue Sky regulators, FINRA, DOL and MSRB cited throughout these notes.
69. *See, e.g.*, Scott A. Meyers & 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 & RISK MGMT. FOR THE SEC. INDUS. (Sept. 1, 2009) [hereinafter Duty of Due Diligence article].
70. Thought leaders in this arena include among others the Investment Adviser Association, a trade organization for SEC-registered advisers, referenced *supra* note 1; and the Institute for a Fiduciary Standard (http://www.thefiduciaryinstitute.org), which advocates six key fiduciary duties for advisers: (1) Serve the client's best interest, (2) Act in utmost good faith, (3) Act prudently—with the care, skill and judgment of a professional, (4) Avoid conflicts of interest, (5) Disclose all material facts, and (6) Control investment expenses. Others active in the discussion of an adviser's fiduciary duties include fi360 and its associated Center for Fiduciary Studies (http://www.fi360.com), the Center for Fiduciary Excellence (CEFEX) (https://www.cefex.org/), and 3Ethos (http://3ethos.com/).

- Exercise due care (prudence and reasonableness) when acting on behalf of clients.[71]

  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;[72]
  - acting with due care when assessing a client's risk tolerance, selecting investments consistent with that risk level,[73] and reasonably monitoring for risk; and
  - ensuring that new client assets are invested reasonably promptly.[74]

- Employ reasonable care to avoid misleading clients.[75]

  Examples of this might include—

  - using due care when completing Form ADV and making other disclosures to clients and prospective clients;[76]
  - calculating performance with due care when preparing marketing materials, pitch books, website presentations and other materials provided to clients and prospective clients;[77] and

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71. For a discussion about the standard of care (negligence versus gross negligence) applicable in any given case, see *infra* section 8:9.1.
72. *See* MA Robo-Advisers Policy Statement, *supra* note 60 (expresses doubt that robo-advisers, as least as currently structured, could properly discharge their fiduciary duty to their clients in part because of the brief questionnaires used to gather client information).
73. *See* Riad/Swanson, *supra* note 6 (portfolio managers' actions, which shifted the fund away from its disclosed principal strategy and changed its fundamental risk footprint, showed a "highly unreasonable" and "extreme departure from the standards of ordinary care," in violation of the fiduciary duty owed by an investment adviser).
74. *See* FDIC Trust Examination Manual, at sec. F.1.b. ("Fiduciaries are obligated to keep funds productive . . . . [F]ailure to invest cash when appropriate and practicable should be considered imprudent and a breach of fiduciary duty subject to criticism. In those cases where the fiduciary is responsible for the investment of cash, it is difficult for a fiduciary to justify permitting cash to remain idle when it is possible to make it productive.").
75. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194, text accompanying n.45 (1963).
76. *See* Riad/Swanson, *supra* note 6 (portfolio managers' "extreme departure from the standards of ordinary care" resulted in material misrepresentations and omissions in a fund client's annual and semiannual reports).
77. *See* In the Matter of Virtus Investment Advisers, Inc., Investment Advisers Act Release No. 4266 (Nov. 15, 2015) (settled) [hereinafter Virtus] (adviser

  - comparing adviser account performance to appropriate benchmark indexes selected with due care to ensure a meaningful and balanced presentation.[78]

- Have a reasonable basis for investment advice.[79]

  Examples of this might include—

  - using due diligence to research investments and making selections and recommendations with due care;[80]

  - monitoring investments with reasonable frequency for potential changes, consistent with the adviser's contractual and discretionary obligations;[81] and

  - using only investments and techniques in which the adviser and its personnel are reasonably skilled, experienced, and

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found to have been negligent in not knowing that the performance track record adviser used, which was supplied by its sub-adviser, was false). *See also* In the Matter of Cantella & Co., Investment Advisers Act Release No. 4338 (Feb. 23, 2016) (settled).

78. *See* Factors to be Considered in Connection with Investment Company Advisory Contracts Containing Incentive Fee Arrangements, Investment Advisers Act Release No. 315 (Apr. 6, 1972) (discussing how the selection of an inappropriate index in performance fee arrangements can raise Investment Advisers Act issues, as well as fiduciary issues). *See also* Lori A. Richards, Director of the SEC's OCIE, Remarks Before Investment Counsel Association/IA Week Investment Adviser Compliance Summit: Compliance Issues for Investment Advisers Today (Apr. 28, 2003) [hereinafter Richards Compliance Issues] (where comparing performance to an inappropriate index is listed among recurring problems found during adviser examinations).

79. IAA, *supra* note 1.

80. *See* In the Matter of Larry C. Grossman & Gregory J. Adams, Initial Decision Release No. 727, Admin. Proc. File No. 3-15657 (Dec. 23, 2014) (among other things, adviser found to have breached his fiduciary duty of care by not performing reasonable due diligence on investments recommended to investors). *See also* In the Matter of Total Wealth Management, Inc., Jacob Keith Cooper, Nathan McNamee & Douglas David Shoemaker, Investment Advisers Act Release No. 3818 (Apr. 15, 2014) [hereinafter Total Wealth Management] (respondents alleged to have breached their fiduciary duties by failing to conduct the due diligence they claimed they were doing and making misrepresentations about the due diligence they performed).

81. *See* Inv. Adviser Ass'n, There They Go Again (2011) ("[A] fiduciary obligation to monitor the account is triggered in circumstances in which there is a promise of ongoing account management or advice."). *See also* Leib v. Merrill Lynch, Pierce, Fenner & Smith, 461 F. Supp. 951 (E.D. Mich. 1978) (a broker handling a discretionary account becomes a fiduciary and has a duty to monitor).

competent, and avoiding investments and techniques where they are not.[82]

- Seek best execution[83] of client 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 net result for the client's trade;
  - investing clients in the lowest cost mutual fund share class available for which the client is eligible, and investing consistently with disclosures about costs, trading practices, and best execution;[84]

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82. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (Dec. 11, 2015) (proposing new rules for funds investing in derivatives and proposing that certain funds be required to designate a derivates risk manager, who is sufficiently knowledgeable about the risks and use of derivatives that he or she can effectively fulfill the responsibilities of their position); Investment Adviser Due Diligence Processes for Selecting Alternative Investments and Their Respective Managers, OCIE National Exam Program Risk Alert, vol. IV, issue 1 (Jan. 28, 2014) [hereinafter Alternative Investments Risk Alert] (listing indicators observed firms used to identify risks with the use of alternative investments, including manager personnel that appeared to be insufficiently knowledgeable about a sophisticated strategy they were purportedly implementing).
83. Advisers have long been held to have a duty to seek best execution of client trades and this duty is commonly referred to as "fiduciary" in nature. *See, e.g.*, Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270–71 (3d Cir. 1998) ("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 Exchange Act, Release No. 34-54165 (July 18, 2006) ("Fiduciary principles require money managers to seek the best execution for client trades . . . ."); In the Matter of Everhart Fin. Grp., Inc., Richard Scott Everhart, & Matthew James Romeo, Investment Advisers Act Release No. 4314 (Jan. 14, 2016) (settled) [hereinafter Everhart Financial] ("Section 206 of the Investment Advisers Act imposes on investment advisers a fiduciary duty to act for the benefit of their clients. That duty includes, among other things, an obligation to seek best execution for client transactions—i.e., 'to seek the most favorable terms reasonably available under the circumstances.'" (citations omitted)). Lastly, see Rule 206(3)-2(c) under the Investment 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.
84. *See* OCIE's 2016 Share Class Initiative, OCIE National Exam Program Risk Alert, vol. V, issue 2 (July 13, 2016) (reiterating that an investment adviser has failed to uphold its fiduciary duty when it causes a client to

- periodically and systematically evaluating the quality of the execution being provided by the brokers selected, to ensure that they are continuing to provide best execution;[85] and
- staying apprised of and using reasonably available alternative trading venues—for example, Alternative Trading Systems (ATSs), Electronic Communications Networks (ECNs) and dark pools—to execute trades when they offer best execution.[86]

§ 8:7.2 Duty of Loyalty

An adviser's fiduciary duty of loyalty is generally viewed as requiring the adviser to—

- Act in the best interest of clients.[87]

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purchase a more expensive share class of a fund when a less expensive class of that fund is available). *See also* Manarin Investment Counsel, Ltd., Investment Advisers Act Release No. 3686 (Oct. 2, 2013) (settled); Everhart Financial, *supra* note 83; In the Matter of Pekin Singer Strauss Asset Mgmt. Inc., Investment Advisers Act Release No. 4126 (June 23, 2015) (settled) (all three cases alleging the adviser failed to seek best execution when it invested clients in a more expensive mutual fund share class than other classes available, along with related disclosure failures).

85. The SEC has made it abundantly clear that advisers should be assessing their best execution "periodically and systematically." *See* Lori Richards, Director of the SEC's Office of Compliance, Inspections and Examinations, Remarks Before 2001 Mutual Fund Compliance Conference Investment Company Institute: Valuation, Trading, and Disclosure: Three Compliance Imperatives (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-dealers that are used to execute . . . trades."). *See also* In the Matter of Portfolio Advisory Services, LLC, and Cedd L. Moses, Investment Advisers Act Release No. 2038 (June 20, 2002) [hereinafter PAS], at III.I (citing Interpretive Release Concerning Scope of Section 28(e) of the Exchange Act Release No. 34-23170 (Apr. 23, 1986) (money managers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions)).

86. The SEC has indicated that the prices and other benefits offered by ECNs should be considered when seeking best execution. *See* Order Execution Obligations, Release No. 34-37619A (Sept. 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."). Although that release refers to the obligations of broker-dealers in executing transactions, the proposition is no less relevant to advisers, who have their own duty to seek best execution. Note also that the release refers to a broker-dealer's duty of best execution as "fiduciary."

87. *See* ADV Release, *supra* note 5, at 3 ("Under the Investment Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its

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;[88] and
- 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.[89]

- Place the interest of clients above its own.[90]

  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[91] or other fees from the transaction;

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clients . . . ."). *See also* Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Investment Advisers Act Release No. 2763 (July 30, 2008) [hereinafter 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 . . . .").

88. *See* In the Matter of Gregory L. Merrick, Investment Advisers Act Release No. 4366 (Apr. 13, 2016) (settled) (federal collateral bar imposed against investment adviser representative who breached his fiduciary duty to clients under Ohio law by liquidating their securities so they could buy insurance products, without conducting a reasonable inquiry into the clients' investment objectives and financial situation and without sufficient information to determine if the liquidation was suitable); In the Matter of Neal R. Greenberg, Investment Advisers Act Release No. 3079 (Sept. 7, 2010) (adviser alleged to have committed fraud and breached his fiduciary duty by recommending unsuitable hedge funds for investment by conservative, older investors near or in retirement, who wanted low-risk investments offering significant capital protection).

89. *See* PAS, *supra* note 85 (adviser found liable for failing to seek best execution when broker was interpositioned).

90. The SEC has characterized this as an adviser's obligation "not to subrogate clients' interests to its own." ADV Release, *supra* note 5, at 3. *See also* Press Release, CFP Board, et al., Without Fiduciary Protections, It's 'Buyer Beware' for Investors (June 15, 2010), https://www.cfp.net/news-events/latest-news/2010/06/15/without-fiduciary-protections-it's-buyer-beware-for-investors.

91. 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

- sequencing a client's trade ahead of the adviser's proprietary trade, or aggregating the trades together only with full disclosure and client consent;[92]
- allocating profitable trades to client accounts rather than to proprietary accounts, or allocating trades to proprietary accounts only when using a fully disclosed, fair, consistently applied methodology;[93]
- offering an investment opportunity to clients first, before deciding to take the opportunity for the adviser or its personnel;[94] and
- not improperly inflating client asset values, with the effect of increasing advisory fees.[95]

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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 5, at 18.

92. *See* SMC Capital, Inc., SEC Staff No-Action Letter (pub. avail. Sept. 5, 1995) (SEC staff will not recommend enforcement action for breach of fiduciary duty under section 206 if adviser allocates aggregated trade orders as described in the letter, so long as the practice of aggregating orders will be fully disclosed and no advisory client will be favored over any other client, including those clients in which the adviser or persons associated with the adviser have a direct or indirect beneficial interest).

93. *See* In the Matter of TPG Advisors LLC d/b/a The Phillips Group Advisors & Larry M. Phillips, Investment Advisers Act Release No. 4372 (Apr. 19, 2016) (adviser alleged to have breached its fiduciary duty and violated section 206 by cherry-picking profitable trades and allocating them to favored accounts). Similarly, In the Matter of Bruce A. Hartshorn, Investment Advisers Act Release No. 4371 (Apr. 19, 2016) (settled); In the Matter of Welhouse & Assocs., Inc. & Mark P. Welhouse, Investment Advisers Act Release No. 4231 (Oct. 16, 2015) (settled); In the Matter of J.S. Oliver Capital Mgmt., L.P., Ian O. Mausner & Douglas F. Drennan, Investment Advisers Act Release No. 3658 (Aug. 30, 2013).

94. *See* In the Matter of Ronald V. Speaker and Janus Capital Corp., Release No. IA-1605 (Jan. 13, 1997) (settled), at 4 ("[Portfolio manager] breached his fiduciary duty to the fund by taking the investment opportunity in the debentures without disclosing the opportunity to and obtaining the prior consent of the fund (or a disinterested Janus employee authorized to waive this opportunity on the fund's behalf).").

95. *See* In the Matter of Alphabridge Capital Mgmt., LLC, Thomas T. Kutzen & Michael J. Carino, Investment Advisers Act Release No. 4135 (July 1, 2015) (settled) (adviser found to have breached fiduciary duty by fraudulently inflating valuation of accounts, thereby boosting management and performance fees).

- Avoid conflicts of interest,[96] or if not avoided altogether, obtain clients' informed consent to conflicts after full and frank disclosure.[97]

  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,[98] or doing so only after making full disclosure of the conflict of interest posed;[99]
  - not investing clients in affiliated mutual funds,[100] 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;[101]

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96. *See* In the Matter of Guggenheim Partners Investment Mgmt., LLC, Investment Advisers Act Release No. 4163 (Aug. 10, 2015) (settled) (adviser found to have breached its fiduciary duty by failing to disclose that one of its senior executives approached an advisory client and received a $50 million loan in order for him to participate personally in an acquisition led by the adviser's parent).
97. ADV Release, *supra* note 5, 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 stark significance." *See* McGrath Remarks, *supra* note 49 (citing Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539, 544 (1949). *See also* Julie M. Riewe, Co-Chief, Asset Management Unit of the SEC Division of Enforcement, Remarks Before IA Watch 17th Annual IA Compliance Conference: Conflicts, Conflicts Everywhere (Feb. 26, 2015) [hereinafter Conflicts Remarks], which contains a list of questions advisers should be asking in order to help identify and address conflicts.
98. ADV Release, *supra* note 5, at 33, 35.
99. Soft dollars may inherently raise fiduciary issues unless the adviser is also adhering to section 28(e) under the Exchange Act, the so-called soft dollars "safe harbor." For more on section 28(e), see *infra* note 106.
100. *See* ADV Release, *supra* note 5, at 30 ("Conflicts could arise, for example, when an adviser recommends that clients invest in a pooled investment vehicle that the firm advises . . . ."). *See also* In the Matter of JPMorgan Chase Bank, N.A. & J.P. Morgan Sec. LLC, Investment Advisers Act Release No. 4295 (Dec. 18, 2015) (settled) (among other things, adviser found to have breached its fiduciary duty by failing to disclose that it designed and operated a retail investment account program with a preference for investing in proprietary mutual funds).
101. More information on "double dipping" on fees can be found *infra* section 39:5.2[D]. *See also* Richard Y. Roberts, SEC Commissioner, Remarks Before the Association of Professional Investment Consultants, Third Annual Conference: Various Securities Issue Developments (June 12, 1993)

- not running side-by-side accounts that invest in the same universe of securities but pay the adviser a differential in fees,[102] at least not without client consent after disclosure;
- not investing simultaneously in the same securities with clients or, as noted, at least not without client consent;[103] and
- providing to the Board of a mutual fund client any material information about an adviser's conflicted interest in a proposal.[104]

- Not compromise best execution by placing client trades with a broker that provides benefits for the adviser—or the adviser's

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(noting that there is the possibility of "double dipping" when a portfolio manager places money with in-house mutual funds); MASS. SEC. DIV., POLICY STATEMENT ON STATE-REGISTERED INVESTMENT ADVISERS' USE OF THIRD-PARTY ROBO-ADVISERS (July 2016), https://www.sec.state.ma.us/sct/sctpdf/Policy-Statement-State-Registered-Investment-Advisers-Use-of-Third-Party-Robo-Advisers.pdf [hereinafter MA Third-Party Robo-Advisers Policy Statement] (provides guidelines on how state-registered advisers can meet the fiduciary duties owed to their clients when they utilize a third-party robo-adviser to serve clients, including detailing the ways in which the adviser provides value to its clients for its fees over and above the value provided and fees charged by the robo-adviser).

102. Side-by-side management of performance fee accounts with non-performance fee accounts is now a specific disclosure item in Form ADV, Part 2A, 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, at 19 (Mar. 3, 2008).

103. *See* Conflicts Remarks, *supra* note 97 (listing a number of questions advisers should ask when identifying conflicts, including does the adviser engage in proprietary trading or investing and, if so, has the firm disclosed its potential biases and that its investment advice could be tainted by compensation received from any third parties or from proprietary investing?).

104. *See* IM Guidance Update No. 2016-01 (Jan. 2016) ("[T]he staff believes that [an adviser's] fiduciary duty requires advisers either refrain from recommending the payment of mutual fund assets for distribution or to provide complete information to the mutual fund directors so that they can evaluate the conflict, and determine whether the payment should be made pursuant to a 12b-1 plan.").

other clients[105]—at least not without client consent after full and frank disclosure.[106]

Examples of this might include—

- not steering clients to custody or 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.), at least not without disclosure;[107]
- 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 customary and represent best execution, and full disclosure is made;[108] and

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105. *See* 2008 Proposed Director Guidance on Soft Dollars, *supra* note 87 (noting that there may be incentives for an adviser to compromise its fiduciary obligations to a fund client in its trading activities in order to obtain certain benefits that serve the adviser's own interests or the interests of other clients, including clients that do not generate brokerage commissions (such as fixed-income funds) and others).
106. Protection from the fiduciary breach that might otherwise occur in that scenario is the basis for the protection afforded under the section 28(e) safe harbor in the Exchange Act, 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 Exchange Act and Related Matters, Release No. 34-23170 (Apr. 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.").
107. *See* Form ADV, Part 2A, Item 12.D.3.a. (requiring advisers to disclose if they have an economic relationship that creates a material conflict of interest with any broker-dealer that the adviser routinely recommends, requests or requires that clients direct the adviser to use).
108. *See* In the Matter of Goelzer Inv. Mgmt., Inc. & Gregory W. Goelzer, Investment Advisers Act Release No. 3638 (July 21, 2013) (settled) (although adviser disclosed that transactions for advisory clients would generally be effected through itself as broker, adviser nonetheless found to

- not using client commissions to pay "give-ups," that is, to make concealed payments to a broker-dealer that did not provide any services to benefit the advised accounts.[109]

- Eliminate all conflicts of interest that might incline the adviser—consciously or unconsciously—to render advice that is not disinterested, absent appropriate informed consent.[110]

  Examples of this might include—

  - if both types of fee arrangements are available and otherwise in the client's best interest, charging commission-based fees to buy-and-hold clients (inactively traded accounts), thereby eliminating the prospect of charging the clients unnecessary ongoing 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 a typical asset-based fee account would pay over time;[111]

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have failed to seek best execution because it did not assess itself as broker for its clients, did not compare what it offered clients to the services and costs available at other brokerage firms or generally take steps to ensure that it was seeking best price and execution).

109. *See* SEC Interpretive Release: Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act, SEC Release No. 34-54165 (July 24, 2006) [hereinafter 2006 Soft Dollar Interpretation], at 53–54 ("A principal concern regarding 'give-ups' was that managers used them to direct client commissions to broker-dealers in exchange for providing services that benefited the money manager but had no benefit for his clients—such as to reward broker-dealers for distribution or for steering clients to the manager.").

110. *See* In the Matter of Dawson-Samberg Capital Mgmt., Inc., Now Known as Dawson-Giammalva Capital Mgmt., Inc. & Judith A. Mack, Investment Advisers Act Release No. 1889 (Aug. 3, 2000) [hereinafter Dawson-Samberg] (citing SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191–92 (1963)).

111. *See* Andrew J. Bowden, Director of SEC, OCIE, Remarks Before Investment Adviser Association Compliance Conference: People Handling Other Peoples' Money (Mar. 6, 2014) ("[O]ne of the areas where we are actively looking for undisclosed and unmitigated conflicts is the trend among dually registered firms to move their clients' assets from commission-based brokerage accounts to fee-based wrap accounts that offer advice and no-commission trading for one bundled asset-based fee."). *See also* Examination Priorities for 2016, SEC Office of Compliance and Examinations (OCIE) [hereinafter 2016 Exam Priorities] (noting that OCIE will continue to make fee selection and reverse churning a priority, examining advisers and dually registered adviser/brokers that offer a variety of fee

- not shorting securities that are held long in other client accounts managed by the adviser;[112] and
- not setting higher pay-outs or other incentives for personnel to place client assets into the adviser's proprietary mutual funds or funds that pay extra fees to the adviser, rather than other available fund choices.[113]

- Not use clients' assets for the adviser's own benefit[114] 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 lavish gifts, travel or entertainment, personal benefits or other gratuities;[115]

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arrangements (such as asset-based fees and commissions) to see if recommendations of account types are in the best interest of the investor at the inception of the arrangement and thereafter, including fees charged, services provided and disclosures made about the arrangements).

112. In addition to breaching its fiduciary duty by buying securities for its own account, then selling them after the price increase resulting from its recommendations that clients buy, the adviser in *Capital Gains* also engaged in short selling against its clients. According to the Court's opinion, on at least one occasion, the adviser sold short some shares of a security immediately before stating in a report that the security was overpriced. After the publication of the report, the adviser covered its short sales at a price lower than the sale price. *See Capital Gains*, 375 U.S. at 202 (Appendix to the Opinion of the Court).

113. *See* In the Matter of Banc of America Inv. Servs. Inc. & Columbia Mgmt. Advisors, LLC, Investment Advisers Act Release No. 2733 (May 1, 2008) (settled) (adviser found to have breached its fiduciary duty to wrap fee clients by favoring affiliated funds in investing process, inconsistent with disclosures); Everhart Financial, *supra* note 83 (adviser found to have failed to disclose that 12b-1 fees paid by certain funds to adviser and its personnel created incentive for them to select those funds or classes for client accounts over others with lower expenses). *See also* Morgan Stanley DW Inc., Exchange Act Release No. 48,789 (Nov. 17, 2003) (settled) (respondent did not adequately disclose conflict involved in program payments made to its financial advisors that incentivized them to encourage customers to make and retain investments in funds participating in the program over other available funds).

114. *See* 2008 Proposed Director Guidance on Soft Dollars, *supra* note 87, at 23 ("Second, investment advisers, as fiduciaries, generally are prohibited from receiving any benefit from the use of fund assets . . . .").

115. *See* FMR, *supra* note 6 (Fidelity found to have breached its fiduciary duties to clients by allowing traders to accept excessive travel, entertainment, gifts and gratuities from brokers with whom client trades were placed, resulting in a substantial possibility of higher execution costs).

- not excessively trading a client's account for the purpose of generating soft dollar credits used to benefit the adviser;[116] and
- not using client commissions to reward brokers for referring clients to the adviser.[117]

- Avoid self-dealing (absent appropriate consent).[118]

  Examples of this might include—

  - not engaging in principal trades with client accounts[119] or doing so only in accordance with section 206(3) of the Investment Advisers Act;[120]
  - 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 customary, and represent best execution;[121] and

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116. *See* SEC v. Gordon J. Rollert (USDC D. Mass.), No. 01-Civ.-10237-JLT, SEC Litigation Release No. 18,687 (Apr. 29, 2004).
117. ADV Release, *supra* note 5, at 36.
118. Brave New World, *supra* note 43, at 4.
119. *See* In the Matter of Citigroup Glob. Mkts., Inc., Investment Advisers Act Release No. 4178 (Aug. 19, 2015) (settled) (adviser found to have failed to detect and prevent improper principal transactions); In the Matter of Strategic Capital Grp., LLC & N. Gary Price, Investment Advisers Act Release No. 3924 (Sept. 18, 2014) (settled) (found that principal transactions executed through adviser's affiliated broker violated section 206(3)).
120. *See* In the Matter of Shadron L. Stastney, Investment Advisers Act Release No. 3671 (Sept. 18, 2013) [hereinafter Stastney] (settled) (adviser found to have breached his fiduciary duty to fund advisory client by failing to disclose a material conflict of interest to the Trustee of the fund and engaging in an undisclosed principal transaction with the fund).
121. *See* In the Matter of Alan Gavornik, Nicholas Mariniello & Lee Argush, Investment Advisers Act Release No. 3972 (Nov. 24, 2014) (settled) (adviser and principals found to have breached their fiduciary duty to clients by arranging for unaffiliated broker to execute client trades for a $0.04–$0.06 per share, then paying all commissions in excess of $0.01 per share over to adviser's affiliated broker as an undisclosed "referral fee"); In the Matter of Goelzer Inv. Mgmt., Inc. and Gregory W. Goelzer, Investment Advisers Act Release No. 3638 (July 21, 2013) (settled) (although adviser disclosed that transactions for advisory clients would generally be effected through itself as broker, disclosure was nonetheless found to be misleading because it said execution would be consistent with adviser's duty of 'best execution' even though adviser did not did not assess itself as broker for its clients, did not compare what it offered clients to the services and costs available at other brokerage firms or generally take steps to ensure that it was seeking best price and 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 type, scope and quality of service.[122]

§ 8:7.3 Duty of Obedience

As noted previously in section 8:4, there are sources that refer to an adviser's duty of obedience separately from its duty of care and loyalty. Under this duty, an adviser generally must—

- Adhere to the terms of any governing trust or organic legal documentation.[123]

  Examples of this might include—

  - investing client assets only in securities and other investments in accordance with legal requirements,[124] the client's trust instrument, charter, investment policy statement or disclosure documents;[125] and

  - providing all data, notices, reports and other information called for from the adviser in governing documents.

- Follow any instructions or guidelines provided by the client.[126]

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122. In the Matter of Smith Barney Fund Mgmt. LLC and Citigroup Glob. Mkts., Inc., Investment Advisers Act Release No. 2390 (May 31, 2005) (settled) (adviser found to have put its interests ahead of its client's when, without full disclosure to fund Board, adviser recommended fund hire adviser's affiliate as transfer agent, in an arrangement that allowed affiliate to keep significant profits even though it was merely sub-contracting with an unaffiliated transfer agent to do the bulk of the work at a deeply discounted rate).

123. McGrath Remarks, *supra* note 49, at 7.

124. *See* In the Matter of Gray Fin. Grp., Inc., Laurence O. Gray & Robert C. Hubbard, IV, Investment Advisers Act Release No. 4094 (May 21, 2015) (pension consultant adviser alleged to have breached its fiduciary duty to Georgia-based public pension fund client by recommending and selling to it propriety fund-of-fund investments that were in violation of Georgia law); Ambassador Capital, *supra* note 6 (adviser and portfolio manager alleged to have caused money market fund's failure to comply with risk limits imposed by Investment Company Act Rule 2a-7).

125. *See* Riad/Swanson, *supra* note 6 (by failing to invest fund assets consistently with fund's disclosed principal investment strategy, portfolio managers caused fund and adviser to violate various securities statutes and rules); *accord* In the Matter of Chariot Advisors, LLC & Elliott L. Shifman, Investment Advisers Act Release No. 3653 (Aug. 21, 2013).

126. *See* Richards Fiduciary Speech, *supra* note 47 (discussing an adviser's fiduciary duties and measures some advisers take in order to ensure that portfolio transactions are consistent with disclosures to and instructions from 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)[127] and handling transactions in their accounts (such as account transfers, liquidations, aggregated assets, tax lot considerations, and the like).

§ 8:7.4 *Duty to Act in Good Faith*

Sources that address an adviser's duty to act in good faith indicate that an adviser must[128]—

- Act honestly toward clients with candor and utmost good faith.[129]

  Examples of this might include—

  - being materially truthful and accurate in all communications and disclosures;[130]
  - being forthright about issues, mistakes, and conflicts of interest;[131] and

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127. Advisers adhering to client instructions regarding directed brokerage should also make appropriate disclosures regarding the effect of directing brokerage on other fiduciary matters such as the adviser's ability to achieve the most favorable execution. *See* Form ADV, Part 2A, Item 12.D.; In the Matter of Mark Bailey & Co. and Mark Bailey, Investment Advisers Act Release No. 1105 (Feb. 24, 1988).

128. 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, 369, at text accompanying n.26 (Del. 2006) (footnote omitted). This same court concluded that the duty of good faith is essentially a subset of the duty of loyalty.

129. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194, at text accompanying n.44 (1963).

130. *See* In the Matter of Blackstone Mgmt. Partners L.L.C., et al., Investment Advisers Act Release No. 4219 (Oct. 7, 2015) (settled) (advisers agreed to pay nearly $39 million to settle allegations that they breached their fiduciary duty to investors in violation of Investment Advisers Act section 206 by failing to properly disclose fees).

131. *See* SEC v. Anand Sekaran & Wasson Capital Advisors Ltd., No. 12-civ-8199 (S.D.N.Y. Nov. 9, 2012) (settled) (referenced in SEC Press Release

    - providing fund directors with all information in the adviser's possession that reasonably bears on a fund Board decision, particularly where the adviser has a personal interest in the outcome or other conflict of interest.[132]

- Treat clients fairly.[133]

  Examples of this might include—

    - adopting investment opportunity, aggregation, allocation, and other trading procedures and applying them consistently over time so that no client or group of clients is systematically disadvantaged;[134]
    - allocating shared costs fairly across accounts using a rational methodology applied consistently over time;[135] and
    - seeking a fair and prompt resolution of all legitimate client complaints.

No. 2012-224 (Nov. 9, 2012): "An investment adviser's fiduciary duty applies equally in good times and bad . . . . Sekaran breached that duty when he concealed trading losses and misled clients rather than simply admitting that his investment strategy was unsuccessful.").

132. *See* In the Matter of BlackRock Advisors, LLC, & Bartholomew A. Battista, Investment Advisers Act Release No. 4065 (Apr. 20, 2015) (settled) (adviser found to have breached its fiduciary duty to fund and advisory clients by not disclosing a material conflict); Stastney, *supra* note 120 (adviser alleged to have breached his fiduciary duty to fund advisory client by failing to disclose a material conflict of interest to the Trustee of the fund and engaging in an undisclosed principal transaction with the fund).

133. ADV Release, *supra* note 5, at 3. *See also* Bruce Karpati, Chief, SEC Enforcement Division's Asset Management Unit, Remarks Before the Private Equity International Conference: Private Equity Enforcement Concerns (Jan. 23, 2013) (expressing concern that private equity fund managers who offer co-investment opportunities only to certain favored clients may be violating their fiduciary duty to other clients who may also be interested in such opportunities).

134. *See* In the Matter of Western Asset Mgmt. Co., Investment Advisers Act Release No. 3762 (Jan. 27, 2014) (settled) (by cross-trading securities among client accounts at the bid, rather than at an average between the bid and the ask, adviser found to have favored the buyers in the transactions over the sellers, even though both were advisory clients and owed the same fiduciary duty).

135. *See* In the Matter of Lincolnshire Mgmt., Inc., Investment Advisers Act Release No. 3927 (Sept. 22, 2014) (settled) (expense allocation policy among advised private equity funds was not followed, resulting in one portfolio company, and indirectly the fund that owned it, paying more than its share of certain expenses, in turn resulting in a breach of the adviser's fiduciary duty to the funds and violation of section 206(2) of the Investment Advisers Act); In the Matter of Clean Energy Capital, LLC & Scott A. Brittenham, Investment Advisers Act Release No. 3955 (Oct. 17, 2015) (settled) (adviser found to have misallocated expenses among funds).

§ 8:7.5 *Duty of Disclosure*

Today, an adviser's duty to disclose goes beyond its fiduciary duty and has been expanded by numerous specific regulatory requirements, such as Form ADV. However, viewed even from the fundamental fiduciary perspective, an adviser must—

- Provide full and fair disclosure of all material facts to clients and prospective clients.[136]

  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, including disclosure of all material conflicts of interest;[137]
  - ensuring that communications and disclosures are materially complete so as to provide a fair and balanced picture;[138] and
  - disclosing all pertinent information about an adviser's compensation.[139]

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136. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194, at text accompanying n.44 (1963). *See also* Item 3 in the General Instructions for Part 2 of Form ADV, noting an adviser's disclosure obligations as a fiduciary. Most regulators now require that disclosures also be tailored to reflect the particular adviser's business and be written in "plain English." *See* Item 2 in the General Instructions for Part 2 of Form ADV; MA Third-Party Robo-Advisers Policy Statement, *supra* note 101 ("[T]he Division will not accept 'cookie cutter' disclosure language that does not adequately provide information pertaining specifically to that state-registered investment adviser, nor will it accept language that is not clear to the reader.").

137. *See* Dawson-Samberg, *supra* note 110 (adviser and officer found liable for failing to adequately disclose soft dollar arrangements, violating section 206(2) among other provisions); In the Matter of Royal Alliance Associates, Inc., SagePoint Fin., Inc. and FSC Sec. Corp., Investment Advisers Act Release No. 4351 (Mar. 14, 2016) (settled) (adviser firms failed to disclose that they had a conflict of interest due to a financial incentive to place certain advisory clients in higher-fee mutual fund share classes and, as a result, breached their fiduciary duties by investing them in higher-fee classes).

138. *See* In the Matter of The Dreyfus Corp. & Michael L. Schonberg, Investment 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).

139. *See* Total Wealth Management, *supra* note 80 (respondents alleged to have breached their fiduciary duty to clients by failing to adequately disclose material information about revenue sharing fee arrangements and

- Take all reasonable steps to avoid misleading clients.[140]

  Examples of this might include—

  - avoiding advertisements, communications, and other disclosures[141] that contain only a partial truth, leaving an exaggerated, unwarranted, or other potentially misleading impression.[142]

Certainly, the list of fiduciary duties in this section is not exhaustive, but it does include many of the common duties that an adviser might face, along with examples illustrating how they might apply in practice.

§ 8:8 Emerging Fiduciary Issues

Recent regulatory developments and high-profile industry scandals have raised questions about whether an adviser's fiduciary duty applies—or can be adequately discharged—in various emerging areas of concern. A number of these are addressed below.

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the conflicts of interest posed by these arrangements; adviser's Form ADV merely stated adviser "may" receive revenue sharing fees, but failed to state adviser was already receiving those fees and inform investors about the sources, recipients, amounts and duration of the fees).

140. *Capital Gains*, 375 U.S. at 194, text accompanying n.45. *See also* In the Matter of Oxford Investment Partners, LLC & Walter J. Clarke, Investment Advisers Act Release No. 3412 (May 30, 2012) (adviser alleged to have repeatedly breached its fiduciary duty by recommending investments without telling clients about his personal stake and exploiting a client who was buying an ownership share in the firm).

141. *See* In the Matter of Raymond L. Lucia Cos., Inc. & Raymond J. Lucia, Sr., Investment Advisers Act Release No. 4190 (Sept. 3, 2015) (adviser found to have violated his fiduciary duties to prospective clients and betrayed their trust and confidence by misleading use of "backtested" performance information in slideshow presentations).

142. *See* SEC, FINRA & NASAA, Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars (Sept. 2007) (finding numerous securities firms using advertisements with exaggerated and unwarranted claims). *See also* In the Matter of Alpha Fiduciary, Inc. & Arthur T. Doglione, Investment Advisers Act Release No. 4283 (Nov. 30, 2015) (settled) (adviser found in violation of section 206 by using misleading advertisements); In the Matter of Richard W. Suter & Richard W. Suter d/b/a National Investment Publishing Company, Admin. Proc. File No. 3-6038 (Aug. 27, 1982) (adviser did not meet applicable standards as fiduciary when using advertisements that contained exaggerated statements about how investors would profit).

§ 8:8.1 Duty to Oversee Sub-Advisers and Other Service Providers

The largest Ponzi scheme in U.S. history—the Bernard Madoff affair—sharpened 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[143] have led to the basic question of whether an adviser's fiduciary duties include—or should include—the duty to conduct adequate due diligence on and oversight of sub-advisers with whom an adviser invests a client's assets.[144]

Even before Madoff, there seemed to be little doubt that an adviser could be held liable if it did not conduct adequate due diligence on sub-advisers, in particular if it represented to clients that it would vet the firms and would conduct periodic oversight as well.[145] Depending on the case, however, the adviser's violation might be characterized as

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143. *See, e.g.*, Anwar, et al. v. Fairfield Greenwich Ltd., et al., No. 10-CV-9196, 2015 U.S. Dist. LEXIS 100773 (S.D.N.Y. July 29, 2015) (the court stated: "In numerous rulings in this litigation, the Court has repeatedly held that allegations that the Standard Chartered Defendants conducted no due diligence . . . or that the Defendants failed to monitor investments after aggressively recommending continued investment in the Funds, satisfactorily plead breach of fiduciary duty."). *See also* In the Matter of Hennessee Grp. LLC & Charles J. Gradante, Investment Advisers Act Release No. 2871 (Apr. 22, 2009) (settled) (adviser/hedge fund consultant found to have violated section 206(2) for failing to perform due diligence on the Bayou Fund, which subsequently collapsed; SEC order stated that respondents, in their capacity as investment advisers, "owed fiduciary duties to their clients to perform the services that they represented they would provide and to disclose all material departures from the representations that they made to their client"); In the Matter of Fairfield Greenwich Advisors LLC & Fairfield Greenwich (Bermuda) Ltd., Consent Order of the Commonwealth of Massachusetts Office of Attorney General, No. 2009-0028 (Commw. Mass. Sec. Div. Sept. 8, 2009) (settled) (state action against feeder fund manager that funneled investor funds to Madoff without conducting represented due diligence); People of the State of N.Y. v. J. Ezra Merkin, et al., 26 Misc. 3d 1237(A) (N.Y. Sup. Ct., N.Y. Cty.) (slip op. Feb. 8, 2010) (state action charged 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); SEC v. Stanley Chais, SEC Litigation Release No. 21,096, Civ. 09 CV 5681 (S.D.N.Y. June 22, 2009) (securities fraud charged against manager of feeder funds for intentionally or recklessly ignoring signs of Madoff's fraud).

144. *See* Duty of Due Diligence article, *supra* note 69.

145. In a case that long preceded Madoff, Patrick V. Morris, et al. v. Wachovia Sec., 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 Investment Advisers Act, on the theory

breach of a fiduciary duty, or as a violation of statutory law,[146] fraud provisions (misleading disclosures), contract provisions, SEC rules or orders, or other violations.[147] Today, however, the risk of an adviser being found liable for sub-adviser failures—under one theory or another—is greater than ever.[148] Notably, an adviser's duty to select and oversee other advisers has been characterized as "fiduciary" and has been extended to selecting other types of service providers—custodians, administrators, auditors and the like—to which the client's assets are exposed.[149]

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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.

146. *See, e.g.*, In the Matter of Morgan Stanley & Co., Inc., Admin. Proc. File No. 3-13588 (SEC July 20, 2009) (firm sanctioned for violating Investment 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 ongoing monitoring process when they had not).

147. 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 (Apr. 2009). For a case where a broker representative'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 (2d 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).

148. *See* Virtus, *supra* note 77 (adviser found in violation of various provisions in section 206 for misleading performance information provided by sub-adviser and for not having adequate due diligence procedures in place for hiring and retaining sub-advisers and ensuring the accuracy of third-party produced performance information and marketing materials).

149. *See* Alternative Investments Risk Alert, *supra* note 82 (noting that advisers are fiduciaries and must act in their clients' best interest, including in the due diligence process of selecting alternative investments and their managers); MA Third-Party Robo-Advisers Policy Statement, *supra* note 101 (indicating that an adviser's fiduciary duty includes operating in a fashion that minimizes fees and that advisers must therefore not only avoid excessive fees but should also consider their fees in light of the services provided by third parties, such as sub-advisers). *See also* Richards Compliance Issues, *supra* note 78 (noting that advisers are fiduciaries and discussing an adviser's supervision of service providers—including sub-advisers—and indicating that on a continuing basis, the adviser must concern itself with whether sub-advisers are providing the level of fiduciary

§ 8:8.2 Duty to 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.[150]

However, more recently 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.[151] 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.[152]

These criticisms came to a head, leading to the SEC's adoption of Rule 206(4)-6 under the Investment Advisers Act,[153] 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.

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care that the adviser itself provides to its clients); In the Matter of Western Asset Mgmt. Co. & Legg Mason Fund Adviser, Inc., Investment Advisers Act Release No. 1980 (Sept. 28, 2001) (settled) (adviser found to have failed to supervise employee of sub-adviser under section 203(e)(6)).

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

151. *See, e.g.*, discussion in Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1 J. BUS. & TECH. L. 157 (2006).

152. This was one theme behind the allegations against an adviser and its COO in the administrative proceeding In the Matter of INTECH Inv. Mgmt. LLC & David E. Hurley, Investment Advisers Act Release No. 2872 (May 7, 2009) (settled) (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.). *See also* Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management, to Egan-Jones Proxy Services (May 27, 2004) (addressing an adviser's fiduciary duty in voting proxies).

153. Similar companion rules were also adopted for funds under the Investment Company Act. *See* Release No. 33-8188 (Jan. 13, 2003).

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."[154]

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."[155]

These developments have been a catalyst for advisers to rethink their approach to voting proxies.[156] Meanwhile, similar issues have been raised with regard to an adviser's duty to act on behalf of client accounts in class action lawsuits (filing proofs of claim), tender offers, mergers, bankruptcies, and similar shareholder actions.[157]

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154. Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003) [hereinafter Proxy Adopting Release] (footnotes omitted). An adviser's fiduciary duties with respect to proxy voting were reiterated in Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, SEC Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014) [hereinafter SLB20].

155. Proxy Adopting Release, *supra* note 154 (footnotes omitted). *See also* SLB20, *supra* note 154, at Question 2.

156. *See* Rebecca C. Grapsas, *New Proxy Advisory Firm Developments: What They Mean for Corporate Issuers*, INSIGHTS: THE CORP. & SEC. L. ADVISOR (Aug. 31, 2014) (discusses the Q&As in SLB20, *supra* note 154, relating to compliance by investment advisers with proxy voting fiduciary duties).

157. *See* Steven W. Stone & Ryan F. Helmrich, Morgan, Lewis & Bockius LLP, The Role of Investment Advisers in Client Class Action Claims (2005) (arguing that advisers should not be lawfully responsible for these sorts of matters absent a contractual understanding to the contrary).

§ 8:8.3 Duty to Assess a Client's Mental Competence

Regulators have been very vocal recently about "seniors issues," with the aim of protecting older investors who may be more vulnerable to fraud or abuse.[158] As part of this effort, the SEC, North American Securities Administrators Association, Inc. (NASAA), and FINRA identified and published in a 2008 report approaches that some financial firms use to address seniors issues, including elder financial abuse and the sensitive and sometimes subtle issue of diminished mental capacity.[159]

It is not very surprising that advisers could be held liable if they defraud or otherwise "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.[160]

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 or others have taken advantage of them or otherwise treated them improperly in light of their diminished mental capacity. Incompetence is already covered in the law generally,[161] although many states are now supplementing

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158. The SEC has held a number of Senior Summits in conjunction with FINRA, NASAA, and AARP as part of an overarching effort to protect the nation's seniors. *See* SEC. & EXCH. COMM'N, SENIOR EVENTS AND ENFORCEMENT ACTIONS (last updated Apr. 9, 2008), http://www.sec.gov/investor/seniors/seniorsevents.htm. *See also* SEC. & EXCH. COMM'N, FOR SENIORS (last updated Mar. 20, 2012), http://www.sec.gov/investor/seniors.shtml.

159. SEC, NASAA & FINRA, Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors (Sept. 22, 2008), http://www.sec.gov/spotlight/seniors/seniorspracticesreport092208.pdf. Some of these and similar measures are outlined in FPA/AARP, A FINANCIAL PROFESSIONAL'S GUIDE TO WORKING WITH OLDER CLIENTS, http://assets.aarp.org/www.aarp.org_/articles/money/financial_planning/financial_professional.pdf.

160. Even the cases cited by a regulators' Investor Alert for seniors seem to be based on fraud or suitability issues, and not on the more difficult issue of whether the adviser failed to detect that the investor lacked the mental capacity to consent. *See* SEC. & EXCH. COMM'N, INVESTOR ALERT—INVESTMENT PRODUCTS AND SALES PRACTICES COMMONLY USED TO DEFRAUD SENIORS: STORIES FROM THE FRONT LINE, http://www.sec.gov/spotlight/seniors/elderfraud.pdf.

161. For example, 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* Lisa A. Catalano & Christine Lazaro, *Financial Abuse of the Elderly: Protecting the Vulnerable*, PISABA BAR J. at 11–15, sec. II.B. and n.85 (Fall 2008).

existing laws by enacting Elder Abuse statutes[162] 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 where the adviser has committed fraud or deception, or, perhaps in a more subtle case, where the adviser "knows, or should know" that the vulnerable adult lacks the capacity to consent.[163]

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,[164] 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>.
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> * * *
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> 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>. <u>A stockbroker's fiduciary obligation to a client does not include the duty to ascertain the client's mental competence</u>.[165]

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162. For a discussion of various statutes passed or under consideration by various states, see *id*. at 11–15.
163. *Id*. Aside from issues of their own potential liability for taking, or not taking, actions on behalf of clients lacking mental capacity, advisers must also be aware of their potential obligation to report financial abuse of their clients by others. An increasing number of states are passing laws making it permissible, or mandatory, for advisers and others who suspect financial abuse of elders and other vulnerable adults to alert authorities, and providing immunity from administrative or civil liability for having done so. Many of these laws are based on the NASAA Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation (adopted Jan. 22, 2016).
164. Edward D. Jones & Co. v. Fletcher, 975 S.W.2d 539 (Tex. 1998).
165. *Id*. at 544 (emphasis added).

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 view is that it would not, given that the court spoke broadly about stockbrokers and other "service providers," and that the court's rationale (service providers have no expertise to assess mental capacity) would apply to both advisers and brokers.[166] Moreover, the most logical basis for holding advisers to any standard different than brokers would be the adviser's fiduciary duty, and the court in this case specifically stated that *stockbrokers* owe fiduciary obligations to their clients, even though that does not include a duty to assess mental competence.[167] 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 client's mental competence.

Importantly, some advisers are not waiting for the law to develop in this area, but rather are being proactive to head off problems with their aging clients by adopting specific compliance policies and procedures. For example, some focus on the client on-boarding process, making sure that individual clients provide the adviser with a copy of any power of attorney or similar instrument the client has already signed designating an attorney, trustee, or other fiduciary to act on the client's behalf in the event of incapacity. If no such instrument already exists, advisers may get the client's written consent to having the adviser contact a trusted friend or family member in the event the adviser suspects capacity issues.[168]

Other advisers are training employees to spot "red flags" that may evidence financial abuse and diminished capacity,[169] along the lines outlined in the regulators' 2008 report referred to above. Note, however, that actions taken in response to "red flags" can themselves raise

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166. 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 Mar. 20, 2008), at http://www.nasaa.org/wp-content/uploads/2011/07/3-Senior_Model_Rule_Adopted.pdf.

167. *Edward Jones*, 975 S.W.2d at 544.

168. *See* FINRA Notice 15-37, Financial Exploitation of Seniors and Other Vulnerable Adults (Oct. 2015) (with proposals along these lines for broker-dealers when dealing with financial exploitation issues). *See also* NASAA Guide for Developing Practices and Procedures for Protecting Senior Investors and Vulnerable Adults from Financial Exploitation (released Sept. 12, 2016) (discussing similar measures for both investment advisers and broker-dealers).

169. *See, e.g.*, Morgan Stanley, Working with Senior Investors, http://www.sec.gov/investor/seniors/workingwseniors.pdf (includes steps to take when signs of diminished mental capacity or elder financial abuse are detected).

difficult issues, such as potential claims for breach of the duty of obedience by not adhering to the client's instructions and/or breach of privacy rights if suspicions of diminished capacity are brought to the attention of other family members or outsiders without the client's consent. As such, advisers may be better served by developing internal policies and procedures to guide employees on the appropriate response to capacity issues, which may well include escalating the matter to the firm's legal or compliance personnel.[170]

§ 8:8.4 Duty to Protect Client Assets from Business Disruptions

Advisers have long been urged to consider business continuity planning (BCP) in the process of formulating their compliance policies and procedures under the Investment Advisers Act Rule 206(4)-7, the adviser compliance rule.[171] BCP has been described to include protecting client assets from disruptions that could occur, for example, in the aftermath of a natural disaster or in the event of the unavailability of critical firm personnel.[172] Importantly, the obligation to have a reasonably designed business continuity plan is viewed as "fiduciary."[173]

Since adoption of the compliance rule in 2003, advisers have gained considerable BCP experience in handling disruptions due to natural disasters.[174] However, concerns linger in the following two areas regarding BCP:

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170. *See* AARP Policy Institute Research Report, Protecting Older Investors: The Challenge of Diminished Capacity, at 18 (Nov. 2011) (stating firms surveyed differ in their responses to diminished client capacity, but most included escalation to a supervisor or compliance department).

171. In brief, the compliance rule requires advisers to implement compliance policies and procedures reasonably designed to prevent, detect and correct violations of the Investment Advisers Act. *See* Investment Advisers Act Rule 206(4)-7; Adopting Release for the rule: Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204 (Dec. 17, 2003) [hereinafter Compliance Programs Adopting Release] (where BCP was listed as one of ten key areas advisers should address when designing their compliance programs).

172. *See* Compliance Programs Adopting Release, *id*. at n.22 ("We believe that an adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel. The clients of an adviser that is engaged in the active management of their assets would ordinarily be placed at risk if the adviser ceased operations.").

173. *Id*.

174. *See, e.g.*, SEC ComplianceAlert (June 2007) (discussing lessons learned from Hurricane Katrina, as observed by the SEC staff); SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational

First, concerns linger over the protection of computers and other technology that serve as the backbone for systems relied on by advisers, as well as others in the financial services industry, particularly due to threats stemming from a man-made cause. As such, the SEC has turned laser-like attention to cybersecurity in recent years, urging advisers to address cybersecurity in connection with their BCP.[175] Cybersecurity is expected to remain a high priority for SEC examinations of advisers,[176] as well as for other regulators.[177]

Second, concerns also linger in the area of "transition planning," that is, planning for business disruptions that are so significant that the adviser can no longer provide advisory services and client assets would need to be transitioned away from the adviser.[178] In contrast to a traditional business continuity plan that focused on natural disasters or computer outages, a transition plan would focus more on risks unique to a particular adviser's business, such as the death or departure of key personnel, or disruptions resulting from an adviser's bankruptcy, liquidation, dissolution, sale, or merger of the adviser. While advisers routinely exit the market without significant impact, operational and other challenges can occur when advisers or their investment vehicles go out of business or wind up their affairs, particularly if there are restrictions on a client's ability to access or move assets, or if the transition is occurring under conditions of market stress.

In light of these lingering concerns and concerns about the wide variability in robustness of advisers' existing BCPs, in June 2016, the

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Disruptions Caused by Weather-Related Events Last Year, OCIE National Exam Program Risk Alert, vol. II, issue 3 (Aug. 27, 2013) (discussing the examination of forty advisers' business continuity plans in the wake of Superstorm Sandy).

175. *See* Cybersecurity Guidance, IM Guidance Update No. 2015-02 (Apr. 2015) ("[T]he compliance program of a fund or an adviser could address cybersecurity risk as it relates to identity theft and data protection, fraud, and business continuity, as well as other disruptions in service that could affect, for instance, a fund's ability to process shareholder transactions . . . .") (citations omitted).

176. *See* 2016 Exam Priorities, *supra* note 111, at III.

177. *See* FINRA Report on Cybersecurity Practices (Feb. 2015); NASAA, Compilation of Results of a Pilot Survey of Cybersecurity Practices of Small and Mid-Sized Investment Adviser Firms (Sept. 2014); CFTC Press Release PR7293-15, CFTC Unanimously Approves Proposed Enhanced Rules on Cybersecurity (Dec. 16, 2015).

178. *See* Mary Jo White, SEC Chair, Keynote Address Before the Managed Fund Association: Five Years On: Regulation of Private Fund Advisers After Dodd-Frank (Oct. 16, 2015); Mary Jo White, SEC Chair, Remarks Before the New York Times DealBook Opportunities for Tomorrow Conference: Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014).

SEC proposed a new rule that would specifically require SEC-registered investment advisers to adopt written business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in the investment adviser's operations.[179] Reminding advisers that it is their fiduciary obligation to protect client interests from being placed at risk as a result of the adviser's inability (temporary or permanent) to provide advisory services, the new rule would require these plans to cover not only the areas traditionally covered by BCPs, but additional emerging areas such as cybersecurity, and would require them to cover "business transitions" as well. As of the date this chapter went to press, the comment period on the proposed rule was still open.

§ 8:8.5 Robo-Advisers and Fiduciary Duty

The recent explosion of so-called robo-advisers[180] has raised concerns about whether and how the adviser can properly discharge its fiduciary obligations to clients while interacting in an online-only or digital environment.[181] Some have expressed skepticism that a fully automated platform can actually be a fiduciary,[182] in light of the

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179. *See* Adviser Business Continuity and Transition Plans, Investment Advisers Act Release No. 4439 (June 28, 2016) (proposing new Investment Advisers Act Rule 206(4)-4). On the same day, the SEC Division of Investment Management issued IM Guidance Update No. 2016-04 (June 2016) (addressing business continuity planning for registered investment companies).

180. "Robo-adviser" as used here means any automated investment platform or service that offers wealth management or other types of investment advisory services to clients. Robo-advisers are often viewed as low-cost, easy-access alternatives to traditional investment advisers and brokers, employing computer-driven asset-allocation models and algorithms to invest client portfolios with little or no human interaction. For more on robo-advisers and related compliance issues, see Raef Lee, *The Next Wave of Financial Planning: The Effect of Robo-Advisors*, PRACTICAL COMPLIANCE & RISK MGMT. SEC. INDUS. (May–June 2015).

181. *See* Kara M. Stein, SEC Commissioner, Remarks Before Harvard Law School's Fidelity Guest Lecture Series: Surfing the Wave: Technology, Innovation, and Competition (Nov. 9, 2015). "What does a fiduciary duty even look like or mean for a robo advisor? The idea of a robotic entity that automatically generates investment advice certainly bumps up against what we would traditionally think of as a fiduciary. As this innovation gains more market share (as it seems poised to do), we should be asking whether these new robo advisors can be neatly placed within our existing laws. Or, do we need certain tweaks and revisions? Do investors using robo advisors appreciate that, for all their benefits, robo advisors will not be on the phone providing counsel if there is a market crash?"

182. Skeptics include William Galvin, Secretary of the Commonwealth of Massachusetts, whose Securities Division has issued a Policy Statement saying that fully automated robo-advisers, as currently structured, "may be

personal, more intimate relationship that has historically been understood to entail. Questions are raised in particular about whether robo-advisers do, or can, conduct adequate due diligence in order to render clients appropriately individualized investment advice, especially if they are using only brief on-boarding questionnaires to gather information from clients. Concerns are heightened if the adviser then disclaims responsibility for more extensive or personalized services, such as consideration of assets outside the robo-account, or the need for updated advice in the wake of significant changes affecting the client's financial circumstances.[183]

Other commentators take a more analytical approach toward the question of whether robo-advisers can be fiduciaries, saying that robo-advisers are in many respects no different than traditional advisers and noting that interactions with a "live" adviser about a client's financial goals, risk tolerance, and sophistication can be more or less robust, just as the client information gathered electronically by robo-advisers can be.[184] Still others point out that the impersonal nature of robo-advisers may actually help to avoid conflicts of interest that other advisers face when giving advice.[185]

The SEC is examining robo-advisers in order to deepen their knowledge of the range of services provided, as well as the challenges associated with different automated models.[186] Time will tell how an adviser's fiduciary obligations come to be applied (or not) in this rapidly evolving area of the financial services industry. Regardless, given the public's ever-increasing preference for all things digital, it

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inherently unable to act as fiduciaries" and further indicating that robo-advisers seeking registration in Massachusetts will be evaluated on a case-by-case basis under the guidelines set out in the Statement. *See* MA Robo-Advisers Policy Statement, *supra* note 60.

183. *See id.* at 3.

184. Notably, this includes SEC Chair Mary Jo White. *See* Mary Jo White, SEC Chair, Keynote Address Before the SEC-Rock Center for Corporate Governance: Protecting Investors in an Innovative Financial Marketplace (Mar. 31, 2016) [hereinafter White Robo-Adviser Remarks].

185. *See, e.g.,* Mark Schoeff Jr., *DOL Secretary Perez Touts Wealthfront as Paragon of Low-Cost, Fiduciary Advice, Holds Up Online-Advice Provider as Exemplar of Low-Cost, Fiduciary Advice*, INV. NEWS (June 19, 2015). *Cf.* Melanie L. Fein, paper prepared for Federated Investors, Inc., Robo-Advisors: A Closer Look (June 30, 2015).

186. White Robo-Adviser Remarks, *supra* note 184. *See also* the SEC, Investor Alert: Automated Investment Tools (May 8, 2015), https://www.sec.gov/oiea/investor-alerts-bulletins/autolistingtoolshtm.html (aiming to alert the investing public to some of the risks and limitations of robo-advisers).

seems unlikely that demand for robo-advisory services is going to diminish any time soon.[187]

§ 8:9 Standard of Conduct Applicable to an Adviser's Fiduciary Duty

§ 8:9.1 Negligence Versus Gross Negligence

As discussed previously in section 8:7.1, 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.

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.[188]

As a consequence, when an adviser is acting in a professional capacity, it will generally be held to the standard of care normally exercised by other similarly situated investment professionals. Nonetheless, 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.[189]

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187. One study predicts that the dramatic increase in robo-advised assets in recent years is going to continue, estimating that over $2 trillion dollars will be managed under robo-advisers by 2020, which would comprise about 5.6% of all investment assets in the United States. *See* A.T. Kearney Robo-Advisory Services Study, Hype vs. Reality: The Coming Waves of "Robo" Adoption (June 2015), https://www.atkearney.com/financial-institutions/robo-advisory-services-study (summarizing results of the study).
188. RESTATEMENT (THIRD) OF AGENCY § 8.08.
189. *See* In the Matter of Mark David Anderson, Initial Decision Release No. 203, Admin. Proc. File No. 3-9499 (Apr. 30, 2002) (where, in determining whether a broker's markups/markdowns were unreasonable or excessive, the ALJ took into account industry practice, but said: "[D]eviation from industry practice constitutes only one factor that must be considered.").

Although not without controversy,[190] an adviser's duty of care may be altered by agreement in most cases, as indicated by the boldfaced phrase in the quotation above. Indeed, it is not uncommon 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."[191]

Despite SEC[192] and state[193] 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,

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See also RESTATEMENT (SECOND) OF TORTS § 295A, cmt. 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.").

190. For a more complete discussion of alterations and waivers, see *supra* section 8:6. *See also* the discussion on both sides of this issue in HARVEY E. BINES & STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION (2d ed. 2004) [hereinafter Bines & Thel], § 5.01.

191. 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.

192. *See* SEC Staff Outline, *supra* note 6, at 53–54 (explaining the SEC's historical view of "hedge clauses" and its current view as embodied in 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 facts and circumstances)). Note, however, that the clause referenced in the Heitman letter was an "indemnification" and "hold harmless" clause, and the SEC 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.

193. *See, e.g.*, CONN. DEP'T OF BANKING, INVESTMENT ADVISERS CAUTIONED ON USE OF HEDGE CLAUSES (May 1991), http://www.ct.gov/dob/cwp/view.asp?a=2252&q=299222.

the sample clause above appears to exculpate the adviser from liability at least for simple negligence.[194] Historically, liability limitations 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 or might not be effective against a claim for breach of the common law duty of care based on negligence.[195]

The distinction between negligence and gross negligence could be critically important in a dispute where the level of care taken by an adviser becomes an issue.[196] 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.[197]

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

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194. At least for a registered 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 by statute 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.

195. *But see* Bines & Thel, *supra* note 190, at 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.

196. In contrast, negligence versus gross negligence is less likely to be an issue when advisers are determining prospectively how to discharge their fiduciary obligations, to the extent that they would be aiming to exercise at least ordinary care in their daily activities, regardless of how the advisory agreement reads.

197. What constitutes gross negligence in any given case would be determined under the substantive law applicable in that case. However, proving gross negligence can be 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

breach of duty emanating from Investment Advisers Act 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).[198] This carve-out would arguably preserve any rights a client has against the adviser under, for example, the Investment 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 in the form of indemnifications—that purport to shift away anti-fraud liabilities, on the theory that they violate public policy.[199] If such indemnities were enforced, the reasoning goes, the anti-fraud provisions would lose their prophylactic effect.[200] If that is the rationale with respect to liability shifting provisions like

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TORTS, ch. 5, § 34 (5th ed. 1984); J. D LEE & BARRY A. LINDAHL, 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." Robert Young, et al. v. Nationwide Life Ins. Co., et al., 2 F. Supp. 2d 914, 929 (S.D. Tex. 1998) (quoting Bennett v. Howard, 170 S.W.2d 709, 713 (Tex. 1943)).

198. These carve-outs are often inserted with two aims: (i) to avoid misleading clients into believing that the exculpatory clause cuts off claims they might have against the adviser that are not 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 Investment 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 Investment Advisers Act and therefore void under section 215.

199. *See* Globus, Inc. v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969). 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 Exchange Act. *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.

200. *Globus*, 418 F.2d at 1283–87, sec. 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

indemnities, it could easily be the rationale with respect to exculpatory clauses as well.

(3) If section 206 is deemed to cover negligent conduct,[201] 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 Investment Advisers Act, which voids any provision binding any person to waive compliance with the Investment Advisers Act or related rules.

(4) There is generally no private right of action under the Investment Advisers Act.[202] 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, exculpatory clause, or disclaimer is less likely to protect an adviser from claims of breach of other fiduciary duties,[203] especially the duty of loyalty in a case of involving undisclosed conflict of interest, self-dealing, or bad faith.[204]

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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.").

201. The U.S. Supreme Court has already held in SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), 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 (D.C. Cir. 1992).

202. Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979) ("[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.").

203. *See* MA Robo-Advisers Policy Statement, *supra* note 60, at 7–8 ("[A] complete and blanket disclaimer of any fiduciary relationship would be ineffective . . . . [T]he Division will not permit the core fiduciary relationship to be eliminated.").

204. *See* SEC Staff Outline, *supra* note 6 ("The [adviser's fiduciary] duty is not specifically set forth in the Act, established by SEC rules, or a result of a

§ 8:9.2 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 section 8:9.1. In contrast, claims based on breaches of other fiduciary duties, such loyalty or good faith,[205] more often focus on the fiduciary's state of mind, intent, or motivations.

Cases decided under common law[206] do not agree on whether the duty of loyalty can be violated unintentionally[207] or, if some culpable state of mind is required, exactly what must be shown.[208] 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.[209] 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 Investment 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.[210] It is often a required element when proving violations under

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contract between the adviser and the client (and thus it cannot be negotiated away)."). See also the "contractarian" and "anticontractarian" schools of thought in fiduciary law, discussed generally in Miller, *supra* note 58.

205. 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*, 41 TULSA L. REV. 477 (2006) [hereinafter 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.").

206. 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.

207. *See* Blasius Indus., 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.").

208. For a discussion of duty of loyalty generally, see Bishop, *supra* note 205, at II.B.

209. Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 633 (2010).

210. Case law has established that conduct more culpable than mere negligence is required to prove scienter, Ernst & Ernst v. Hochfelder, 425 U.S. 185

anti-fraud provisions of the federal securities laws.[211] However, in the case of the anti-fraud provisions in section 206 of the Investment Advisers Act, courts have held that scienter is a required element for a claim under section 206(1),[212] but is not for a claim under section 206(2).[213]

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[214] and more severe[215] penalties can be 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."[216]

(1976), although recklessness may be enough. *See* VIII LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION, at 3665–67 n.521 (3d ed. 1991) (noting decisions of eleven circuits that hold recklessness can constitute sufficient scienter).

211. *See, e.g.*, 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 Exchange Act); Aaron v. Sec. & Exch. Comm'n, 446 U.S. 680 (1980) (holding that scienter is required to enforce the anti-fraud provisions of Rule 10b-5 and section 10(b) of the Exchange Act, but that scienter is not required for the government to establish a violation of section 17(a) of the Securities Act concerning untrue or omitted statements of material facts).

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

213. 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., Investment Advisers Act Release No. 2129 (May 15, 2003) (citations omitted). Moreover, there are also authorities supporting the view that "scienter" is not a required element for liability under section 206(4) either. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act Release No. 2628 (Aug. 3, 2007), and cases cited therein, including *Steadman*.

214. *See* Investment Advisers Act § 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.

215. *See, e.g.*, Investment Advisers Act § 217 ("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 five years to six years.

216. 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).

There is no requirement that the person "also be aware that he is violating one of the Rules or Acts."[217]

§ 8:10 Ensuring Discharge of an Adviser's Fiduciary Duty

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

§ 8:10.1 Policies and Procedures Addressing Fiduciary Duties

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.[218] 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 of conduct 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.[219] In addition to general standards of conduct, the Compliance Manual or Code of Ethics might contain specific controls aimed at helping to ensure fiduciary duties are being discharged properly. Advisers often adopt the following controls, among others:

- Restrictions on personal trading by firm personnel, which may include outright bans, pre-clearance requirements, or other

217. *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 Investment Advisers Act as well. *See, e.g.*, In the Matter of Royal Alliance Assocs., Inc., SagePoint Fin., Inc. and FSC Sec. Corp., Investment Advisers Act Release No. 4351, at 7 (Mar. 14, 2016) (settled).
218. As was noted in the Richards Fiduciary Speech, *supra* note 47.
219. Investment Advisers Act Rule 204A-1(a)(1).

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.
- Restrictions on the ability of personnel to become a board member of other entities, including pre-clearance and periodic reporting.

Advisers often also address fiduciary duties in specific procedures throughout their Compliance Manual where fiduciary duties are likely to arise and be particularly acute, such as those governing best execution, soft dollars, trade allocations, and dealing with senior investors, to name a few.[220] Controls adopted in these procedures vary from firm to firm, depending on their business model and risks.

§ 8:10.2 Training of Personnel on Fiduciary Duty

In addition to merely adopting standards and procedures, wise advisers 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 arise and be handled in practice.[221] Discussing hypothetical scenarios that personnel might face can facilitate an understanding of otherwise theoretical points. Sample hypothetical scenarios appear below in Appendix 8A.

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220. Certain policies and procedures relating to client diminished mental capacity are mentioned *supra* section 8:8.3.

221. For examples of training that some advisers institute to help employees spot a client's diminished capacity, see *supra* section 8:8.3.