Compliance Corner

— *By: Michael B. Koffler***

Does a Statutory Fiduciary Duty Mean a More Substantive Fiduciary Duty? What the Future May Hold

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and ushered in the greatest reform of the financial services industry since the dawn of the federal securities laws. Tucked away in section 913 of the Dodd-Frank Act is language authorizing the Securities and Exchange Commission (Commission) to promulgate rules providing that the standard of conduct for investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may provide), is to act in the best interest of the customer without regard to the financial or other interest of the adviser. With the President's signature, investment advisers registered with the Commission are now, for the first time, subject to a federal statutory fiduciary duty. This article discusses some of the possible ramifications of this legislative change for investment advisers.

The principles defining and governing fiduciary duty arose out of the law of equity. As a result of the risks to clients in entrusting their property to fiduciaries, the common law evolved over time to impose certain substantive duties on fiduciaries that limit their freedoms. Courts have imposed two primary duties on fiduciaries: the duty of loyalty and the duty of care. From these overarching duties, various obligations have been imposed on fiduciaries under the common law. The duty of loyalty requires fiduciaries to refrain from converting or misappropriating the entrusted powers and assets and from using them for unauthorized purposes or for personal gain. Based on the duty of loyalty, courts and regulators have required fiduciaries to: (i) segregate and earmark entrusted assets; (ii) avoid conflicts of interest with entrustors; (iii) avoid competing with customers; and (iv) provide customers with information and accounting. Some of these requirements are today embedded in the Investment Advisers Act of 1940, as amended, (Advisers Act) and the rules promulgated thereunder, such as the various disclosures on conflicts of interest required under Form ADV, the segregation, account statement and notice provisions in rule 206(4)-2 (on custody) and the requirements in rule 204A-1 that advisers' code of ethics include a standard of conduct required of supervised persons that reflects their fiduciary obligations and include provisions requiring all access persons to report (and advisers to review) their personal securities transactions and holdings periodically.

A Focus on Process?

The common law also imposes a duty of care on fiduciaries when performing their services. Thus, clients have a legal right to receive quality advisory services, commensurate with reasonable expectations. This duty often is measured by the level of care fiduciaries use in managing their own affairs. Typically, this duty is thought to require fiduciaries to, among other things: (i) gather pertinent information; (ii) analyze and deliberate before making a decision; and (iii) apply their expertise and skills in the decision-making process. Inherent in the foregoing is the importance of having a prudent process for making decisions that impact clients' assets. However, Congress and the Commission generally have not adopted normative rules under the Advisers Act concerning the process utilized by advisers to generate, deliver and monitor the advice they provide.

There are several reasons to think that the SEC might be inclined to fill this gap in the future. First, other acts passed in more recent years, such as the Uniform Prudent Investor Act (adopted by states beginning in 1994) and the Employee Retirement Income Security Act of 1974 contain standards governing the process that fiduciaries must follow in providing investment management services. Second, the investment management industry has increasingly made use of investment policy statements and other tools in recent years to guide the process by which they make portfolio management decisions, thus raising the state of the art. Third, various accreditations, such as the Accredited Investment Fiduciary® designation, recognize and emphasize the importance of the process used to manage client assets.

Fourth, broker-dealers likely will also be subject to a fiduciary duty after the Commission completes a report required by section 913(d) of the Dodd-Frank Act. The broker-dealer regulatory regime, as administered by the Commission and the Financial Industry Regulatory Authority, Inc. (FINRA), involves detailed, substantive rules governing almost every aspect of broker-dealer activity. If the Commission or FINRA were to adopt a detailed rule governing broker-dealers' fiduciary duty obligations, then such a rule would likely cover, among other things, the process utilized by broker-dealers to provide investment advice. One would expect such a rule, at least in practice (even if not formally applied to investment advisers), to "migrate" over to investment advisers; after all, section 913 of the Dodd-Frank Act amended section 15(k)(1) of the Securities Exchange Act of 1934, as amended, to provide that the Commission may promulgate rules to provide that, with respect to broker-

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dealers, when providing personalized investment advice about securities to a retail customer (and such other customers as the Commission may provide), the standard of conduct for such broker-dealers with respect to such customer shall be the same as the standard of conduct applicable to investment advisers under section 211 of the Advisers Act. Thus, broker-dealers likely will be subject to the same fiduciary duty as investment advisers, meaning any standards or rules concerning fiduciary duty that are adopted and applied by the Commission or FINRA to broker-dealers may very well become applicable to investment advisers (at least in practice). In this respect, it is worth noting that section 914 of the Dodd-Frank Act requires the SEC to study, among other things, the extent to which having Congress authorize the Commission to designate one or more self-regulatory organizations to augment the Commission's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers.

Accordingly, with a statutory fiduciary duty, it is possible that the SEC will focus more in the future on the process underlying investment advice and the documentation of such process. Such a focus would require firms to:

- consider the purposes of an account and the circumstances of clients;
- exercise reasonable care, skill, and caution in managing client assets;
- evaluate investment and management decisions in the context of clients' overall portfolio;
- ensure clients' investment strategies have risk and return objectives that are suitable;
- consider general economic conditions, the possible effect of inflation or deflation, expected tax consequences of investment decisions or strategies, the role that each investment plays within the overall portfolio, the expected total return from income and the appreciation of capital, other resources of clients, needs for liquidity, regularity of income, and preservation or appreciation of capital;
- make reasonable efforts to verify facts relevant to the investment and management of assets; and
- use special skills or expertise.

To ensure these criteria are satisfied, investment advisers might be expected to consider whether they should: identify an investment objective, risk tolerance, and investment time horizon for each client; utilize an investment policy statement to define a specific investment strategy; ensure they have a process to select asset classes consistent with the identified investment objective, risk tolerance, and investment time horizon; verify that selected asset classes are consistent with implementation and monitoring constraints; and have a process to monitor clients' assets over time to ensure they continue to be consistent with the identified investment objective, risk tolerance, and investment time horizon, as well as any applicable investment restrictions or guidelines. In addition, advisers might wish to verify whether the portfolio management process for each distinct strategy is clearly defined, focused, and documented and whether investment vehicles are appropriate for the portfolio size and the risk/return characteristics.

More Focus on Conflicts?

Section 913 of the Dodd-Frank Act provides that any material conflicts of interest shall be disclosed and may be consented to by the customer. While the Commission and the staff have required advisers to disclose material conflicts ever since the dawn of the Advisers Act, section 913 raises the possibility that the Commission will add the substantive requirement that client consent be obtained for certain material conflicts of interest.

A Focus on Suitability?

An enhanced regulatory focus on the investment management process naturally would cause the SEC (and perhaps FINRA in the future as well) to enhance the scrutiny of the investment advice provided by investment advisers. FINRA Conduct Rule 2310 explicitly requires a broker-dealer, in recommending to a customer the purchase, sale or exchange of any security, to have reasonable grounds for believing that the recommendation is suitable for the customer based upon the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. While the Advisers Act does not expressly impose a suitability requirement on advisers, such a requirement is implicit in the antifraud provisions of Section 206 and has been enforced by the SEC. With the same statutory fiduciary duty for investment advisers and broker-dealers and FINRA enforcing this duty with respect to broker-dealers (and possibly advisers as well in the future), it is logical to believe that the Commission (and/or FINRA in the future) would spend more resources on ensuring that the advice provided by investment advisers is suitable and appropriate for clients. For instance, it would thus not be surprising for the Commission to formalize some of the guidance contained in a rule that was proposed by the Commission, but not adopted in 1994 that would have imposed an express suitability requirement on advisers (see Advisers Act Release No. 1406 (Mar. 16, 1994)).

A Focus on Compensation?

The Advisers Act does not explicitly address or regulate the kinds or amounts of fees an investment adviser may charge clients for advisory services, except with regard to performance-based fees. However, the Commission staff has interpreted the Advisers Act's general antifraud provision as requiring fair and full disclosure to clients of the fees an adviser charges clients, including, where relevant, whether the fees charged are excessive in relation to fees charged by other advisers for comparable services. In addition, an investment adviser might violate Section 206's antifraud provisions by charging a fee that is simply too high. In the view of Commission staff, a fee that is not reasonable in relation to the services provided would violate the adviser's fiduciary duties. In the past, the Commission staff have indicated that fees above 3% for managing retail accounts would receive very close scrutiny.

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Various types of investment adviser compensation arrangements involve conflicts of interest. For instance, advisers can negotiate different fee arrangements with different clients or charge more for managing one type of portfolio than another type of portfolio. Such differences in fee arrangements can create an incentive for an adviser to favor certain clients (e.g., those subject to a higher fee schedule) over other clients. In addition, investment advisers may invest in, or recommend that clients invest in, pooled investment vehicles managed by the adviser. Such practices may be acceptable if the adviser provides distinct services for each fee that is charged and makes full and fair disclosure of the services it provides and the fees it receives. The Commission staff has explained that as part of its fiduciary duty an adviser must disclose to clients any compensation it receives (regardless of source) that may affect its recommendations, so that clients can evaluate the adviser's motivation in recommending the particular transaction. More generally, the Commission has asserted that an adviser's duty to disclose material facts is particularly pertinent whenever the adviser is in a situation involving a conflict, or potential conflict, of interest with a client. A statutory fiduciary duty gives rise to the possibility that the Commission will formalize the interpretations of the staff and/or impose substantive limits or restrictions on adviser compensation practices.

A Focus on Contract Terms?

Section 921(b) of the Dodd-Frank Act provides that the Commission, by rule, may prohibit, or impose conditions or limitations on the use of mandatory pre-dispute arbitration agreements if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors. It is possible that the Commission will ban the use of such agreements on the basis that they are contrary to the statutory fiduciary duty in section 211 of the Advisers Act. Such consideration of mandatory pre-dispute arbitration clauses could cause the Commission to formally add other substantive requirements or restrictions on advisory contracts, such as those concerning termination of the advisory relationship, the amount and sources of compensation and conflicts of interest.

Conclusion.

For the past seventy years, the Advisers Act has largely served as a disclosure-based statute. Given the impending application of a fiduciary duty on broker-dealers, the possibility of a self-regulatory organization for investment advisers and evolving industry practices, it is unlikely that this will be the case over the next seventy years. Advisers should prepare for a regulatory regime in which principle based regulation is increasingly supplemented by detailed, substantive requirements and restrictions. ■

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To learn more about the program or view the complete 2010 schedule, go to: http://www.nrs-education.com/professional-development.html. For more information please contact IAA Special Counsel Paul Glenn, (202) 293-4222, with any questions.

UPCOMING EVENTS:

August 3	Investment Adviser Codes of Ethics—Requirements and Best Practices *Online 1:00 p.m. - 3:00 p.m. (ET)*
August 5	Ethical Decision—Making and Lessons Learned from SEC Enforcement Cases *Online 1:00 p.m. - 3:00 p.m. (ET)*
September 14	Developing a Tailored Compliance Testing Program: Forensic Focus *Online 1:00 p.m. - 3:00 p.m. (ET)*
October 4	Ethics: IA Code of Ethics *In person: Scottsdale*
October 4	Ethics: Ethical Decision-Making *In person: Scottsdale*
October 4	Ethics: Mastering Critical Skills *In person: Scottsdale* and *Online 1:00 p.m. - 3:00 p.m. (ET)*
October 5	Disclosure: Form ADV Part 1 & Reg Reporting *In person: Scottsdale*
October 5	Disclosure: Form ADV Part 2 & Identify/Disclose *In person: Scottsdale*
October 5	Disclosure: IA Performance and Advertising *In person: Scottsdale*
October 7	Professional Ethics *In person: Scottsdale* and *Online 1:00 p.m. - 3:00 p.m. (ET)*
October 26	The Architecture of a Sustainable Compliance Program *Online 1:00 p.m. - 3:00 p.m. (ET)*
November 2	Advisers Act: Framework of the Act—Duty to Supervise; Who Must Register; Exclusions and Exemptions; State and Federal Responsibilities *Online 1:00 p.m. - 3:00 p.m. (ET)*