Defining Fiduciary

What is an advisor's true fiduciary duty?

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In 1963, the United States Supreme Court held in SEC v. Capital Gains Research Bureau, Inc., that Section 206 of the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisors by operation of law. Section 206 of the Act (generally referred to as the "anti-fraud" provision) makes it unlawful for an investment advisor to engage in fraudulent, deceptive, or manipulative conduct.

The general purpose of an investment advisor's fiduciary duty is to eliminate conflicts of interest, and to prevent an advisor from taking unfair advantage of a client's trust. In order to fulfill this duty, an investment advisor is required to always act in its clients' best interests and to make full and fair disclosure of all material facts, especially when the advisor's interests may conflict with those of his clients.

Specifically, the Supreme Court in Capital Gains indicated that Congress and the SEC intended that "[an investment advisor] should continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect." The SEC has continuously confirmed an advisor's fiduciary duty subsequent to Capital Gains in several Investment Advisers Act Releases. In Release No. 1393 (November 29, 1993), the SEC, referencing Capital Gains, stated: "the Investment Advisers Act imposes on investment advisers an affirmative duty to their clients of utmost good faith, full and fair disclosure of all material facts, and an obligation to employ reasonable care to avoid misleading their clients."

What does this mean? Certainly, an advisor's fiduciary responsibility permeates its entire business operations and client relationships. It requires more than a mere attempt at compliance. Rather, it requires that the advisor undertake reasonable ongoing and continuous efforts to comply with its obligations under the Advisers Act and in its dealings with clients. Here are a few examples of how an advisor's fiduciary duty impacts its advisory operations.

Suitability
Although neither the Act nor SEC rules currently impose an express suitability requirement on investment advisors, the SEC maintains that advisors have a fiduciary duty to reasonably determine that the investment advice and/or services that they provide to their clients are suitable, taking into consideration the client's financial situation, investment experience, and investment objectives. Accordingly, each firm should be prepared to demonstrate that it has a policy to obtain (and maintain) sufficient information regarding the client's circumstances to enable the firm to determine whether particular advice or services are suitable, initially and thereafter. Examples of the type of corresponding documents that advisors may determine to implement include client questionnaires, fact sheets, investment objective(s) confirmation letters, and investment policy statements (IPSs).

Some form of IPS should be obtained and maintained by an investment advisor. However, longer does not mean better! Too many times, especially when defending advisory firms in litigation or arbitration proceedings, we see advisors falling victim to their own sloppy documents (a "canned" questionnaire or ambiguous form that is a minefield for conflicting responses). If the client indicates on page two that her objective is a 10% annual return, but on page five (clearly, in our view, too long a document already) that she can only tolerate a principal loss of 5%, we have a conflict. Therefore, the advisor, as a "fiduciary," should not begin the investment management process until the client's objectives and risk parameters are clarified and consistent, and written confirmation thereof has been obtained.

Our general recommendation is to keep the client "intake" process simple. Have a new client information document that requires the client to indicate, in his own handwriting, his risk parameters and investment objectives, and, most importantly, any reasonable restrictions that the client desires to impose on your investment management services.

Have the client complete and execute the document, including a written indication if she wants to impose any reasonable restrictions. If there are none, have the client, in her own handwriting, indicate "none." Thereafter, before commencing the investment management process, confirm the information obtained in a written investment objectives or policy statement, either to be executed by the client or, in the alternative, advising the client to notify you immediately, in writing, if his understanding is contrary to that stated.

In addition, the confirming document should advise the client to immediately notify you if there has been a change in his financial situation or investment objectives, or if he desires to impose, add, or modify any reasonable restrictions to the management of his account. Thereafter, the advisor annually should send a letter to the client confirming that you continue to manage the accounts in accordance with the client's previously designated investment objectives, and that it remains the client's responsibility to advise you if there has been a change in his financial situation or investment objectives, or if he desires to impose, add, or modify any reasonable restrictions to the management of his accounts.

Best Execution

As fiduciaries, investment advisors are obligated to act in the best interest of their clients. Accordingly, they must seek the best available execution for each client's securities trades. "Best execution" requires advisors to have their customers' orders executed at prices and expenses that are as favorable as possible under the circumstances. An advisory firm will seek to meet its duty of best execution by selecting broker/dealers that can provide the best qualitative execution, taking into consideration various factors. Such factors include, but are not limited to, the value of research provided (if any), the capability of the firm to execute trades efficiently, the competitiveness of its commission rates or transaction fees, and the overall level of "customer service."

Thus, while the firm should give significant weight to the competitiveness of the available commission/transaction rates, it may be justified in not necessarily selecting the broker/dealer that offers the lowest possible prices for the firm's client account transactions. In other words, even where the firm uses its best efforts to seek the lowest possible commission rate, it might not necessarily obtain the lowest rate for client account transactions.

Depending on the scope of the firm's trading activities, the firm can determine the availability of best execution by a variety of methods, including its own experience with transactions effected by various broker/dealers, by conducting its own surveys and obtaining execution data from other B/Ds, and by reviewing trading data from third-party industry research sources. The extent and/or frequency of a firm's review and monitoring procedures shall be dependent upon the firm's business operations and trading practices. To the extent that a firm's trading activities include the purchase and sale of mutual funds that trade at net asset value at the end of the trading day, the corresponding best execution obligation is qualified, such that the advisor must reasonably determine that: (1) the broker/dealer or custodian is effectively processing the transaction; and, (2) if certain mutual funds are assessed transaction fees, the transaction fee fund was superior to similar funds available without transaction fees, and the amount of the transaction fee was comparable (i.e., need not be the lowest) to the fees charged by other similar broker/dealers.

Client-Directed Brokerage
In the event that a firm's clients expressly direct the firm to effect all securities transactions through a particular broker/dealer with which the advisory firm does not have a relationship (not to be confused with clients who agree to utilize the broker/dealer/custodian generally recommended by the advisory firm—a point that too many advisory agreements seem to confuse), the firm should be prepared to demonstrate the following:

(a) the client made the direction (the best way is to confirm the direction in the investment advisory agreement);

(b) it has disclosed to the client (in the advisory agreement and on Schedule F of Part II of Form ADV) that the client will be responsible to negotiate the terms and arrangements for its account with that broker/dealer, and the firm will correspondingly be unable to seek better execution services or prices from other broker/dealers nor will the firm be able to "bunch" the client's transactions for execution through other broker/dealers with orders from other accounts managed by the firm; and

(c) it has disclosed to the client that the client may incur higher commissions or other transaction costs or greater spreads, or receive less favorable net prices, on transactions than would otherwise be the case had the client determined to effect transactions through alternative brokerage relationships generally available through the advisory firm. In the event that transactions for client accounts are effected through a broker/dealer that has referred the client to the firm, the potential for a conflict of interest arises and corresponding written disclosure (in the advisory agreement and on Schedule F) of such relationship must be made to the client before effecting transactions through the referring broker-dealer.

Moreover, if as a result of such an arrangement the client pays more for commissions/transaction fees, the client should acknowledge, in writing (in the advisory agreement) that as result of such direction, the client will incur higher commissions or other transaction costs than would otherwise be the case had the client determined to effect transactions through alternative brokerage relationships generally available through the advisor. Otherwise, regulators may find that the client is unnecessarily "paying-up" for trade execution and the arrangement between the advisor and the referring broker/dealer is a disguised referral fee, thereby subjecting the firm to a potential regulatory enforcement proceeding.

These are just a few examples of how an advisor's fiduciary duty impacts its advisory operations. As an advisor, you will have the burden to demonstrate that you acted in the best interests of your clients, and made full and fair disclosure of all material facts, especially when your interests could conflict with those of the client.