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Fiduciary Duties of Investment Advisors, Broker-Dealers and Fund Managers

Navigating Regulatory and Litigation Developments to Minimize Fiduciary Liability Claims

THURSDAY, FEBRUARY 24, 2011

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Today's faculty features:

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Fiduciary Duties for Investment Advisors, Broker-Dealers and Fund Managers

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Overview of Fiduciary Duty Regulation

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Investment Advisers Standard of Conduct

- Sections 206(1) and (2) of the Advisers Act prohibit an investment adviser from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client" and from "[e]ngaging in any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client"
  - The U.S. Supreme Court has construed these sections as establishing a fiduciary standard of conduct for investment advisers
- This fiduciary standard of conduct encompasses two duties:
  - Duty of Loyalty
    - must act in the best interests of clients
  - Duty of Care
    - must make a reasonable investigation to determine that the investment adviser is not basing its recommendations on materially inaccurate or incomplete information

Investment Advisers Standard of Conduct

- Guidance and precedent from the SEC, its staff and the courts on an investment adviser's duty of loyalty and the duty of care have addressed, among other things:
  - Disclosure of conflicts of interest
  - Reasonable basis for investment advice
  - Principal trading restrictions
  - Agency cross trading restrictions
  - Best execution
  - Advertising
- Also, under Section 36(b), an investment adviser to a fund is deemed to have a fiduciary duty "with respect to the receipt of compensation for services" from the fund
  - *Jones v. Harris Associates*, 130 S.Ct. 1418 (2010)
    - "[T]o face liability under § 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"
    - "In recognition of the disinterested directors' role, the Act instructs courts to give board approval of an adviser's compensation 'such consideration . . . as is deemed appropriate under all the circumstances'"

Hedge Fund Advisers Standard of Conduct

- In *U.S. v Lay*, 612 F.3d 440 (6^{th} Cir. 2010), the Sixth Circuit held that there was sufficient evidence to support a finding that a hedge fund adviser owed a fiduciary duty to a hedge fund investor
  - Defendant argued that he only had a fiduciary relationship with the hedge fund, but not with the hedge fund's investor
  - The district court opined that "there is evidence in the record that the characteristics of an adviser-client relationship were present between the defendant and the [investor] regarding the [hedge fund]"
    - Defendant had adviser-relationship with investor as to another fund
    - Investor's investment in two funds was part of a single investment strategy
    - Investor was only investor in hedge fund and had active role in hedge fund
- Also, in November 2010, the SEC proposed new rules and rule amendments under the Advisers Act to implement provisions of the Dodd-Frank Act to require most hedge fund advisers to register with the SEC
  - Today, hedge fund advisers, even those that are exempt from registering with the SEC, are subject to Section 206 under the Advisers Act

Broker-Dealer Exclusion

- The Advisers Act excludes from the definition of "investment adviser", among other persons, any broker or dealer:
  - Whose performance of investment advisory services is "solely incidental" to the conduct of its business as a broker or dealer; and
  - Who receives no "special compensation" for its advisory services
- In 2005, the SEC adopted Advisers Act Rule 202(a)(11)-1, the principal purpose of which was to deem broker-dealers offering "fee-based brokerage accounts" as not being subject to the Advisers Act
  - On March 30, 2007, the U.S. Court of Appeals for the District of Columbia Circuit, in *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007), vacated the original Advisers Act Rule 202(a)(11)-1 holding that the SEC did not have the authority to exempt broker-dealers offering fee-based brokerage accounts from the definition of "investment adviser"
- Under current regulations, broker-dealers who receive fees, other than transaction-based fees like commissions, markups or markdowns, for services that include investment advice, for example managing a discretionary account, will typically be subject to the Advisers Act (and its fiduciary duty)

Broker-Dealers Standard of Conduct

- The antifraud provisions of the federal securities laws and SRO rules establish standards of conduct for broker-dealers
  - must deal fairly with customers
  - must observe high standards of commercial honor and just and equitable principles of trade
    - *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (failure to reveal excessive mark-up was an omission to state a material fact and a fraudulent device)
- Broker-dealers are not generally subject to a fiduciary duty, although courts have held that in the limited situations in which broker-dealers exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, they may owe customers a fiduciary duty
  - *U.S. v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006) (fiduciary duty found "most commonly" where "a broker has discretionary authority over the customer's account")

Comparison of Standards of Conduct

- As a fiduciary, in all cases, an investment adviser must fully disclose all material information that is intended "to eliminate, or at least expose, all conflicts of interest"
  - *In the Matter of Fidelity Management Research Company*, Investment Advisers Act Release No. 2713 (Mar. 5, 2008) (settled order) (SEC alleged that Adviser failed to disclose to its advisory clients certain conflicts of interest (arising from travel, entertainment and gifts from brokers))
- On the other hand, the extent of a broker-dealer's duty to disclose material information to its customer depends on the nature of the relationship with the customer
  - *De Kwiatkowski v. Bear, Stearns & Co., Inc.,* 306 F.3d 1293, 1302 (2d Cir. 2002), (broker-dealer "is obliged to give honest and complete information when recommending a purchase or sale")

Comparison of Standards of Conduct

- Both investment advisers and broker-dealers have a duty to seek best execution of a client's securities transactions
  - *In the Matter of Fidelity Management Research Company*, Investment Advisers Act Release No. 2713 (Mar. 5, 2008) (settled order) (SEC asserted the substantial possibility of higher execution costs)
- When engaging in transactions directly with customers on a principal basis, a broker-dealer violates Exchange Act Rule 10b-5 when it knowingly or recklessly sells a security to a customer at a price not reasonably related to the prevailing market price and charges excessive markups, without disclosing the fact to the customer
  - *See, e.g., Grandon v. Merrill Lynch & Co.,* 147 F.3d 184, 189-90 (2d Cir. 1998)
  - *See also* NASD IM-2440-1 – "Mark-Up Policy" limiting amount of markups dealers may charge

Comparison of Standards of Conduct

- Both investment advisers and broker-dealers have suitability obligations
- To establish a violation of the antifraud provisions of Exchange Act Section 10(b) and Rule 10b-5 thereunder, the SEC must establish that a broker-dealer's unsuitable recommendation was a misrepresentation (or material omission) made with scienter (*i.e*., with a mental state embracing intent to deceive, manipulate or defraud)
  - *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (holding that a breach of a fiduciary duty in connection with a securities transaction, without misrepresentation, is not a fraud for purposes of Exchange Act Section 10(b) and Rule 10b-5 thereunder)
    - *Santa Fe* indicates that an unsuitable recommendation cannot serve as the basis for a fraud claim, unless the recommendation also entails an element of deception
- In the context of advisory services, however, the antifraud provisions of the Advisers Act will provide a basis of a claim by the SEC for unfair treatment and breach of a fiduciary duty of care and does not require proof of scienter
  - FINRA has adopted an enhanced suitability rule, Rule 2111, to be effective on October 7, 2011. *See FINRA Regulatory Notice 11-02*

Overview of Recent SEC Staff Study Regarding the Standards of Conduct of Investment Advisers and Broker-Dealers

- The Dodd-Frank Act directed the SEC staff to evaluate:
  - The effectiveness of existing legal and regulatory standards of care for providing personalized investment advice and recommendations about securities to retail customers; and
  - Whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute
- The SEC staff recently delivered to Congress its study entitled "Study on Investment Advisers and Broker-Dealers" (Study)

Overview of Recent SEC Staff Study Regarding the Standards of Conduct of Investment Advisers and Broker-Dealers

- The SEC staff made two core sets of recommendations in the Study:
  - the SEC should engage in rulemaking specifying a uniform fiduciary standard of conduct that (i) is no less stringent than currently applied to investment advisers under Advisers Act Sections 206(1) and (2) and (ii) would apply equally to broker-dealers and investment advisers when they provide personalized investment advice about securities to retail customers, and
  - regulatory protections related to personalized investment advice about securities given to retail customers should be harmonized - where harmonization would add meaningful investor protection

Overview of Recent SEC Staff Study Regarding the Standards of Conduct of Investment Advisers and Broker-Dealers

- The SEC staff found that in practice brokerage firms' disclosures of conflicts have been more limited than investment advisers' and have been made at different points in the customer relationship
- The SEC staff also found that the differences in the standards of conduct for investment advisers and broker-dealers are significant and are not well understood by retail customers
- The SEC staff recommended that the uniform fiduciary standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers should be to
  - act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice

Overview of Recent SEC Staff Study Regarding the Standards of Conduct of Investment Advisers and Broker-Dealers

- The uniform fiduciary standard would require an investment adviser or broker-dealer to either eliminate or provide full and fair disclosure about its material conflicts of interest
  - would not require broker-dealers to have a continuing duty of care or loyalty to a retail customer after providing personalized investment advice
- The SEC staff recommended that the SEC consider developing a uniform approach to disclosure saying "[t]his presumably would include extending to broker-dealers a requirement of a general relationship disclosure document analogous to Form ADV Part 2 at or prior to account opening"

Overview of Recent SEC Staff Study Regarding the Standards of Conduct of Investment Advisers and Broker-Dealers

- Under the proposed uniform fiduciary standard, a brokerage firm would be required, at a minimum, to disclose its conflicts of interest, including those related to principal transactions
  - When engaging in principal transactions, brokerage firms would remain subject to obligations relating to suitability, best execution and fair and reasonable pricing and compensation
- The SEC staff recommends that the SEC consider specifying uniform standards for the duty of care owed to retail customers
  - Minimum baseline professionalism standards could include, for example, specifying what informational basis a broker-dealer or investment adviser should have before making a recommendation to a retail customer

Overview of Recent SEC Staff Study Regarding the Standards of Conduct of Investment Advisers and Broker-Dealers

- The SEC staff recommended that the SEC define the term personalized investment advice about securities to provide clarity to brokerage firms, investment advisers and retail investors
  - The SEC staff said that "such a definition *at a minimum* should encompass the making of a 'recommendation,' as developed under applicable broker-dealer regulation, and should not include 'impersonal investment advice' as developed under the Advisers Act"

Overview of Recent SEC Staff Study Regarding the Standards of Conduct of Investment Advisers and Broker-Dealers

- The SEC staff posed the following questions that could result in potential changes to the regulatory regime for investment advisers:
  - *Licensing and Registration of Firms*
    - should investment advisers be subject to a substantive review prior to registration
  - *Licensing and Continuing Education Requirements for Persons Associated with Broker-Dealers and Investment Advisers*
    - should investment adviser representatives be subject to federal continuing education and licensing requirements
  - *Books and Records*
    - should the Advisers Act's books and records requirements be modified, including by adding a general requirement to retain all communications and agreements (including electronic information and communications and agreements) related to an investment adviser's "business as such," consistent with the standard applicable to broker-dealers

Overview of Recent SEC Staff Study Regarding Standards of Conduct of Investment Advisers and Broker-Dealers

- SEC Commissioners Casey and Paredes published a statement critical of the Study stating, in sum, that the Study:
  - "fails to adequately justify its recommendation that the SEC embark on fundamentally changing the regulatory regime for broker-dealers and investment advisers providing personalized investment advice to retail investors,"
  - "does not adequately recognize the risk that its recommendations could adversely impact investors," and
  - "does not identify whether retail investors are systematically being harmed or disadvantaged under one regulatory regime as compared to the other and, therefore, the Study lacks a basis to reasonably conclude that a uniform standard or harmonization would enhance investor protection"
- Commissioners Casey and Paredes also stated that they did not believe the Study fulfills the statutory mandate of the Dodd-Frank Act to evaluate the "effectiveness of existing legal or regulatory standards of care" applicable to broker-dealers and investment advisers

Practical Effects of Implementing Uniform Fiduciary Standard

- Practical Effects of Implementing Uniform Fiduciary Standard
  - A broker-dealer’s fiduciary duty may be limited to situations involving the provision of “personalized investment advice” in the form of “recommendations” in connection with a particular transaction and will be distinguished from an investment adviser’s continuing duties
  - When presenting mutual fund options to clients, a broker-dealer may have to clearly disclose conflicts arising from differences between particular funds, such as disparate compensation received and business affiliations
  - Registered representatives may be subject to additional litigation or arbitration if a uniform fiduciary standard is applied to them
  - The benefits to investors of applying a uniform fiduciary standard to broker-dealers may not outweigh the additional costs investors may ultimately bear directly or indirectly to implement such a standard
    - Broker-dealers would need to comply with greater disclosure and consent requirements
    - May result in fewer broker-dealers and investment advisers for the average investor to choose from
    - Investors may have access to fewer products and services
    - Investors may have to pay more for the advice and services that they receive

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Mutual Fund Fee Cases

Jones v. Harris Associates, 130 S.Ct. 1418 (2010)

- *Jones v. Harris Associates* decided March 30, 2010
- Interprets Investment Company Act § 36(b), 15 U.S.C. § 80a-35(b):

  > "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services . . . "

- § 36(b) does "not permit a compensation agreement to be reviewed in court for 'reasonableness'"
- "[T]o face liability under § 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*" (emphasis added)

Mutual Fund Fee Cases

Jones v. Harris Associates, 130 S.Ct. 1418 (2010)

- Court adopts *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), and identifies factors:

  (1) cost of providing services;

  (2) economies of scale;

  (3) volume of orders;

  (4) nature and quality of the services;

  (5) profitability;

  (6) fall-out benefits;

  (7) comparative fee structure; and

  (8) “the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation”

Mutual Fund Fee Cases

Life After *Jones v. Harris* Associates, 130 S.Ct. 1418 (2010)

- *Gallus v. Ameriprise Financial, Inc.*, 04-cv-4498 (D. Minn.):
  - Prior to *Jones v. Harris*, the Eighth Circuit reversed summary judgment in favor of defendants. 561 F.3d 816 (8th Cir. 2009)
    - Eighth Circuit held "that the district court erred in holding that no § 36(b) violation occurred simply because [defendants'] fee passed muster under the *Gartenberg* standard"
    - Specifically held that district court "erred in rejecting a comparison between the fees charged to [defendants'] institutional clients and its mutual fund clients"
  - Supreme Court vacated *Gallus* in light of *Jones v. Harris*. 130 S. Ct. 2340 (2010)
  - District Court reinstated the earlier summary judgment decision. 2010 WL 5137419 (Dec. 10, 2010)
  - Decision has again been appealed to the Eighth Circuit. No. 11-01091

Mutual Fund Fee Cases

Life After *Jones v. Harris* Associates, 130 S.Ct. 1418 (2010)

- *In re American Funds Fees Litig.*, 04-cv-05593, 2009 WL 5215755 (C.D. CA. Dec. 28, 2009):
  - Trial held July 28, 2009 - August 7, 2009
  - Judgment entered for defendants
    - *Gartenberg* "standard establishes a very low threshold for the mutual fund companies and a very high hurdle for a plaintiff"
  - Appeal to the Ninth Circuit, docket No. 10-55221
- *In Re Federated Mutual Funds Excessive Fee Litig.*, 04-cv-352 (W.D. Pa.):
  - Trial scheduled for April 12, 2011
  - Motions *in limine* filed February 1, 2011, including Plaintiffs' motion to exclude evidence of competition

Mutual Fund Fee Cases

Who is a Security Holder Entitled to Sue

- *Curran v. Principal Mgmt. Corp.*, No. 09-0433 (S.D. Iowa):
  - Purchasers of funds-of-funds challenged advisory and distribution fees of underlying funds under ICA § 36(b)
  - Defendants argued, among other things, that plaintiffs had no standing because they were not security holders
    - Court first denied the motion to dismiss, holding that “security holder” status was NOT “limited to a direct shareholder.” 2010 WL 2889752 (June 8, 2010)
    - On reconsideration, the court vacated the decision and dismissed the case, holding that indirect owners of securities were not “security holders.” 2011 WL 223872 (Jan. 24, 2011)

General ERISA Obligations Bearing on Fees

- Four principal fiduciary duties under ERISA § 404(a), 29 U.S.C. § 1104(a):
  - Duty of loyalty
    - Includes: "defraying reasonable expenses of administering the plan"
  - Duty of prudence
  - Duty to diversify
  - Duty to follow plan documents

General ERISA Obligations Bearing on Fees

- Prohibited Transactions under ERISA §§ 406(a), 406(b):
  - Generally prohibit transactions between the plan and parties in interest, and self-dealing
  - Relevant exceptions include:
    - "Contracting or making reasonable arrangements with a party in interest for . . . services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor." ERISA § 408(b)(2)
    - "Nothing in [ERISA §406] shall be construed to prohibit any fiduciary from . . . receiving any reasonable compensation for services rendered . . . ." ERISA § 408(c)(2)

Department of Labor Participant Disclosure Regulation

- DOL final regulations require administrators of 401(k)-type retirement plans to disclose to participants, among other things, certain fees. 75 Fed. Reg. 64910 et. seq. (Oct. 20, 2010)
  - Effective for plan years beginning on or after November 1, 2011
  - Fees include administrative and investment fees
    - Requires disclosing fact of revenue sharing, but not amounts of revenue sharing. 29 C.F.R. § 2550.404*a*–5(c)(2)(ii)(C)
  - For more information, *see* http://www.goodwinprocter.com/Publications/Newsletters/Financial-Services-Alert/2010/20101102.aspx?article=2#news_article_top
  - Welfare plan fee disclosure public hearing held December 7, 2010

Department of Labor Service Provider Disclosure Regulation

- DOL interim final regulations require certain retirement plan service providers to disclose certain fees to plan fiduciaries. 75 Fed. Reg. 41600 et. seq. (July 16, 2010)
  - First announced to be effective for contracts and arrangements in existence on July 16, 2011, then extended to January 1, 2012 to allow for finalized rules
  - Requires disclosure of indirect compensation received by covered service provider and its affiliates and subcontractors for plan services
    - Bundled recordkeeper to provide "a reasonable and good faith estimate" of costs. 29 C.F.R. § 2550.408b–2(c)(1)(iv)(D)(*2*)
  - For more information, *see* http://www.goodwinprocter.com/Publications/Newsletters/Financial-Services-Alert/2010/20100803.aspx?article=4#news_article_top

Tibble v. Edison International, No. CV 07-5359 (SVW), 2010 WL 2757153 (C.D. Ca. July 8, 2010)

- One of fifteen fee cases brought by same plaintiffs' firm, challenging as excessive the administrative and investment management fees of large (>$1B in assets) 401(k) plans
  - Includes challenge to revenue sharing practices
- Many claims dismissed pre-trial; bench trial on claims remaining in the case held on October 20-22, 2009
- Central trial holdings:
  - Imprudent to select retail as opposed to institutional share classes where (i) defendants did not evaluate or consider alternative share classes and (ii) "institutional share classes offered the exact same investment at a lower cost to the Plan participants"
  - Plan sponsor reliance on investment consultant was not a defense to imprudence
  - Money market fees of 8 to 18 basis points not imprudent
- Cross appeals filed with the Ninth Circuit, Nos. 10-5604 and 10-56415

Spano v. Boeing Co., *Beesley v. Intl. Paper Co.*, __ F.3d __, 2011 WL 183974 (7th Cir. Jan. 21, 2011)

- Reverses class certification in excessive fee cases
  - Claims included:
    - causing plans to pay allegedly excessive fees, including revenue sharing payments;
    - maintaining allegedly imprudent investment options; and
    - concealing material information from participants about the plans
- Classes defined as, in court's words: "Anyone, in the history of Time, who was ever a participant in the Boeing Plan, or who in the future may become a participant in the Boeing Plan"
- "a class representative in a defined-contribution case would at a minimum need to have invested in the same funds as the class members"

Department of Labor Proposed Fiduciary Definition Regulation

- Proposed rule announced October 22, 2010. 75 Fed. Reg. 65293 et. seq.
- Public hearing set for March 1 and 2, 2011
- Effective date is 180 days after final regulation is published
- Significantly modifies current regulatory definition of investment advice fiduciary status, now found at 29 C.F.R. § 2510.3-21(c), which sets forth five part test:

  (1) Advice as to security value or investment recommendation

  (2) ~~Provided on a regular basis~~

  (3) Pursuant to a mutual understanding

  (4) ~~Advice = primary basis for plan investment decisions~~

  (5) ~~Advice is individualized based on needs of the plan~~
- For more information, *see* http://www.goodwinprocter.com/Publications/Newsletters/Financial-Services-Alert/2010/20101123.aspx?article=3#news_article_top

A Note on Participant Direction

- ERISA § 404(c)(1)(A)(ii): "no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control . . ."
- *Langbecker v. EDS*, 476 F.3d 299 (5th Cir. 2007), reversed certification of a class of participants allegedly harmed by the inclusion of an imprudent investment option where the district court failed to consider the effect of § 404(c)
- Conversely, *Howell v. Motorola. Inc.*, __ F.3d __, 2011 WL 183966 (7th Cir. Jan. 21, 2011), held that § 404(c) does not apply to the "core decision" as to which investments will be presented to participants
  - DOL participant fee disclosure regulation states: "[404(c) regulation] does not serve to relieve a fiduciary from its duty to prudently select and monitor any service provider or designated investment alternative offered under the plan." 29 C.F.R. § 2550.404c–1(d)(2)(iv)