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**Fiduciary Duties of Investment Advisers under the
Investment Advisers Act of 1940, as General
Partners of Limited Partners, and as Managers of
Limited Liability Companies**

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1. Fiduciary Duties for Investment Advisers under the Investment Advisers Act of 1940

a. *Section 206 and Investment Advisers as Fiduciaries*

Section 206 (“**Section 206**”) of the Investment Advisers Act of 1940 (the “**Act**”) prohibits investment advisers from engaging in fraudulent, deceitful, or manipulative activity, including material misstatements or omission of material fact. Section 206 applies to all investment advisors irrespective of whether they are registered. Moreover, once an investment adviser engages in activities meeting the definition of an investment adviser with respect to any client (i.e. receiving compensation from any client to which it provides investment advice), the investment adviser’s obligations are owed to all who the investment adviser provides investment advice, irrespective of whether the investment advisor is compensated for such advice.¹

Although generally an anti-fraud provision, the Supreme Court, in *Capital Gains*, held that Congress, when adopting the Act and Section 206, recognized investment advisers as fiduciaries. Rather than apply the common law standard of fraud requiring intent and actual injury, the Court adopted a fiduciary standard in the application of Section 206.²

b. *Full Disclosure of Material Facts*

As a result of *Capital Gains*, investment advisors are fiduciaries and as such, they owe “an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading.”³ A fact is material if a reasonable investor would consider the fact important.⁴

c. *Conflicts of Interest*

Under Section 206, an investment adviser, as a fiduciary, must serve the best interests of its clients and seek to avoid conflicts of interests.⁵ However, if such conflict is not avoided, an investment adviser has an affirmative obligation to fully disclose all material conflicts of interest and potential conflicts of interest and obtain informed consent. The Securities and Exchange Commission (the “**SEC**”) has described required disclosure to include “all material information which might incline an adviser consciously or unconsciously to render advice which is not disinterested.”⁶

Adequate disclosure must be made so as to “apprise the client of relevant facts” so that the client is able “to make an informed decision about whether to engage an adviser and, having engaged the adviser, to manage that relationship.”⁷ Moreover, even if an investment adviser believes that it is acting in the client’s best interests, the investment adviser must disclose any

¹ Advisers Act Release No. 3222.

² SEC v. Capital Gains, 375 U.S. 180 (1963).

³ *Id.* (internal citations omitted).

⁴ See SEC v. Steadman, 967 F.2d 636, 643 (D.C. Cir. 1992).

⁵ Amendments to Form ADV, Release No. IA-3060 (July 28, 2010) (ADV Release) at 3.

⁶ In the Matter of Dawson-Samberg Capital Management, Inc, Advisers Act Release No. 1889 (August 3, 2000).

⁷ *Id.*; In the Matter of Kidder Peabody & Co., Inc., Advisers Act Release No. 232 (Oct. 16, 1968).

financial interest as the client is entitled to make the determination as to whether to waive the investment adviser's conflict.⁸

d. Principal Transactions

Under an investment adviser's Section 206 fiduciaries duties, one context where obligations arise is in transactions between the investment adviser and the investment adviser's clients (i.e. principal transactions). The SEC, in *In Re Kidder*⁹, expressed the obligations of an investment adviser, noting that an investment adviser "is required to serve the interests of his clients with undivided loyalty. " This means that prior to consummating a principal transaction, the investment adviser must make "a full disclosure of any adverse interest he may have and obtain informed consent of his client."¹⁰ According to the SEC, an adequate disclosure in a principal transactions "must include an explicit statement of the cost of the security to the adviser and market price when more favorable."¹¹ Moreover, a general or advanced consent found in an advisory contract will not constitute the requisite informed consent.

Section 206(3) also contains a statutory duty, separate from the abovementioned, requiring an investment adviser acting as principal for his own account to disclose the capacity in which it is acting prior to knowingly selling or purchasing a security from the account of a client.

Suitability Requirements

In 1994 the SEC proposed rule 206(4)-5 under which an investment adviser would have been prohibited from providing investment advice to a client unless the adviser made a reasonable inquiry into the financial situation, investment experience, and investment objectives of the client and reasonably determined that the investment advice was suitable for the client. Ultimately, proposed rule 206(4)-5 was not adopted; however, the SEC, at the time of proposal, took the position that the proposed rule simply sought to make explicit an obligation that preexisted the proposed rule. That is, the proposed rule simply reflected the SEC's interpretation of an adviser's suitability obligations that already existed under the Advisers Act.¹² Consistent with this interpretation of Section 206, the SEC continues to take the position that as fiduciaries, investment advisers owe a duty to provide only investment advice taking into consideration the client's financial situation, investment experience, and investment objectives.¹³

e. Due Diligence and Reasonable Basis for Recommendations

When giving investment advice or recommendations, investment advisers must have a reasonable basis for such advice or recommendations. Such duty may implicate an obligation to investigate the investment to form an independent basis for such recommendation. The SEC has

⁸ Feeley & Willcox Asset Mgmt. Corp, Advisers Act Rel. No. 2143 (July 10, 2003).

⁹ In the Matter of Kidder Peabody & Co., Inc., Advisers Act Release No. 232 (Oct. 16, 1968).

¹⁰ *Id.*

¹¹ *Id.*

¹² Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Advisers Act Release No. 1406 (March 16, 1994).

¹³ Speech by SEC Commissioner: A Shared Responsibility: Preserving the Fiduciary Standard.

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