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Fundamentals of Fiduciary Duty for Securities Brokers and Investment Advisers

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Fiduciary Duties of Investment Advisers

In crafting remedial legislation for stock market abuses in the wake of the 1929 crash, Congress aimed at three categories of market participants: securities broker dealers, investment management companies (i.e. investment pools) and investment advisers. The broker dealer industry was dealt with through the Securities Act of 1933 and Securties Exchange Act of 1934 (the "Exchange Act"). The Investment Company Act of 1940 and the the Investment Advisers Act of 1940 (the "Advisers Act") each dealt with the group for which it was named. Regulatory authority over all three groups was given to the Securities and Exchange Commission, newly created under the Exchange Act.

At the time of the Advisers Act promulgation, Congress mainly had in mind the regulation of professionals who guided clients in managing funds on an ongoing basis, and who, as distinguished from broker dealers, did not ordinarily execute transactions. Today, these professionals are sometimes labelled wealth managers or financial planners. The Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities…[with certain ennumerated exceptions]."[1] One of the exceptions is "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."[2]

The Advisers Act provides for registration of advisers, client disclosures, limitations on adviser advertising, and requirements regarding supervision of employees and safekeeping of customer funds (custody). The core of the Advisers Act is the anti-fraud and fiduciary duty provisions set forth in Section 206.

> Section 206
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> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
> (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any

[1] Section 202(a)(11); This definition captures, in addition to providers of personalized financial advice, authors of investment (e.g. stockpicking) newsletters.
[2] Section 202 (a) (11) (C).

> security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; or
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

The landmark case defining an adviser's fiduciary duty to his client under Section 206 remains *SEC v. Capital Gains Research Bureau*,[3] which construes Section 206(2). The SEC sought a preliminary injunction compelling a registered investment adviser to disclose to his clients his practice of purchasing shares of a security for his own account shortly before recommending that security in the "Capital Gains Report", a monthly newsletter (investment service) mailed to 5,000 subscribers, and then immediately selling the shares at a proft upon the rise in the market price following the recommendation. The adviser did not disclose this activity to his clients. The court concluded this activity "operates as a fraud or deceit upon any client or prospective client" within the meaning of Section 206(2). This reversed the circuit court, which had concluded there was no proof the adviser's advice was unsound or that there was an intent to injure clients and that therefore the elements of fraud or deceit necessary to a violation were not present.

In reversing the lower court, the court concluded that Congress did not incorporate the common law elements of fraud—including intent to deceive and actual injury—into the Advisers Act but rather intended a "broad remedial construction" that would encompass non-disclosure of material facts. The court cited an SEC study mandated by Congress that helped shape the Advisers Act. The study report concluded that investment advisers could not "completely perform their basic function—furnishing to clients on a personal basis competent unbiased, and continuous advice regarding the sound management of their investments—unless all conflicts of interest between the investment counsel and the client were removed."[4] The court noted that the report cited not only intentional acts but "subconscious motivation" that might color an adviser's advice in favor of the adviser's own financial interest. The court further noted that Congress recognized the adviser as a fiduciary, which provided further grounds for limiting the elements that might be required in a suit between parties to an arm's length transaction. Thus, the court ruled that the SEC was empowered under the Advisers Act to require an adviser to disclose his trading on the effect of his recommendations.[5]

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[3] 375 U.S. 180 (1963).
[4] Quoted, *Id*. at 187.
[5] While the SEC was initially charged with enforcement of the Advisers Act and supervision of advisers, 1996 amendments divide jurisdiction between state and federal authorities. Only advisers advising on assets of $100mm or more must register with SEC. Smaller advisers may not register with the SEC and are required to register in their state. Because there is not self regulatory organization such as FINRA (discussed below) for investment advisers, the SEC was overwhelmed by the responsibility to monitor

Title search: Fundamentals of Fiduciary Duty for Securities Brokers and Investment Advisers

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The Fundamentals of Fiduciary Duty

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