MEMORANDUM

To: Investor Advisory Committee

From: Investor as Purchaser Subcommittee

Date: February 15, 2010

Re: Fiduciary Duty Issue

The purpose of this memorandum is to provide a framework for a Committee discussion of the fiduciary duty at our Feb. 22nd meeting. The fiduciary duty means different things to different people, which necessitates that we establish a common baseline if we are to develop recommendations to the Commission. There are aspects of the fiduciary duty that are not directly within the SEC's purview. It is important that we establish parameters for the "fiduciary duty issue" to ensure relevance to the SEC's mission. We have used the term "federal fiduciary duty," as discussed further below, to refer to the fiduciary duty as it relates to the Committee's work.

This memorandum is also intended to stimulate thinking about the appropriate substance and scope of the federal fiduciary duty. Some of the circumstances around which debates about the fiduciary duty have revolved are discussed starting on page 10. These are presented, at this time, not for purposes of deciding on specific recommendations, but to facilitate a productive initial discussion of these issues by the Committee. We hope that the February 22nd meeting will enable the Subcommittee to: (1) confirm a shared understanding of the framework of the fiduciary duty issue and (2) receive initial guidance regarding the development of recommendations on the substance and scope of the federal fiduciary duty.

This memorandum is divided into the following sections:

I. The Federal Fiduciary Duty

The Subcommittee believes that it is important to establish a shared understanding of the fiduciary duty as that duty is relevant to the work of the Commission.

For purposes of developing recommendations, the Subcommittee intends to focus on the "federal fiduciary duty" as described below. The "federal fiduciary duty" refers to the fiduciary duty owed by an investment adviser to his clients as determined under the Investment Advisers Act of 1940 ("Advisers Act"). It should be emphasized that this understanding of the federal fiduciary duty incorporates statutory provisions and SEC rules that impose a fiduciary duty, as well as the duty as imposed in specific cases. Although the term "fiduciary duty" is sometimes used to describe duties only as established in specific cases (*i.e.*, common law), this understanding is not adequate to comprehend the full scope of the SEC's regulatory role. Statutes and SEC rules, in addition to common law principles, comprise an important aspect of the SEC's role in developing and implementing the federal fiduciary duty.[1]

[1] The Subcommittee does not intend, at this time, to address specific pending legislation regarding the fiduciary duty for two primary reasons. First, the fate of such legislation is highly uncertain. Second, regardless of the fate of such legislation it is very likely that the Commission will retain substantial authority regarding the substance and scope of the federal fiduciary duty and that any Committee recommendations on this subject will continue to be valid.

In the financial services arena, it is generally accepted that an investment adviser owes a fiduciary duty to his clients. This is only the beginning of the inquiry, however, because it does not explain the substance or scope of the duty. What is an “investment adviser?” When is an investment adviser acting in that capacity such that the fiduciary duty applies? When the fiduciary duty applies, what standard of conduct does it require? For example, if a broker recommends that a client invest in a particular mutual fund and the broker receives 12b-1 fees: Is the broker acting as an investment adviser? If he is, then what does the fiduciary duty require with respect to the disclosure of the 12b-1 fees?

Another layer of the fiduciary duty issue is the question of the substance and scope of the fiduciary duty for *federal* purposes, that is, as it is relevant to the SEC’s mission. The federal fiduciary duty comprises a subset of the general fiduciary duty that an investment adviser owes to his clients. The source of the federal fiduciary duty is the Investment Advisers Act of 1940 (“Advisers Act”). More specifically, the most commonly cited source of the federal fiduciary duty is the Supreme Court’s 1963 *Capital Gains* decision.[2] In *Capital Gains*, the Court generally held that an investment adviser has a fiduciary duty under the Act. The Court held that an investment adviser violated its fiduciary duty under the Act by failing to disclose that the adviser traded in securities prior to recommending the securities for long-term investment. There was no provision in the Act or any SEC rule specifically requiring such disclosure.

It is not entirely clear whether the federal fiduciary duty established by the Court in *Capital Gains* is an example of judge-made common law, an interpretation of the Section 206 of the Advisers Act,[3] which is a general antifraud provision

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[2] *See SEC v. Capital Gains Bureau*, 375 U.S. 180 (1963).

[3] Section 206 states, in part: “It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

similar to Section 10(b) and Rule 10b-5 under the Exchange Act, or some part of each. There is no doubt, however, that an investment adviser is subject to the federal fiduciary duty, but there is substantial debate about who should be regulated as an investment adviser.

It should also be noted that the federal fiduciary duty, as that term is used herein, is a form of *public* law. In other words, advisory clients do not have a private right to sue for damages for a violation of the federal fiduciary duty.[4] The Commission can act in a quasi-plaintiffs-lawyer capacity, however. It has an established practice of recovering disgorgement in enforcement proceedings that may be distributed to victims of securities fraud. In 2002, Congress enacted the Fair Funds provision, which generally allows penalties collected from securities defendants to be paid to victims rather than to the U.S. Treasury. Under the Fair Funds provision, the Commission could be viewed as bringing private claims based on public law, including the federal fiduciary duty.

The Subcommittee views the SEC's plaintiffs-lawyer role, however, as secondary in its development and enforcement of the *public* federal fiduciary duty. Private claims based on the federal fiduciary duty therefore will not be a primary focus in the Subcommittee's development of recommendations for the Committee to consider. Nonetheless, the indirect effect of the federal fiduciary duty on private claims, whether brought by the Commission or plaintiffs in private actions, is an important consideration for the Subcommittee's task. The effect of the SEC's role in

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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. [engage in a principal transaction with an advisory client without providing disclosure];
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."

[4] *See Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (there is no private right of action for a violation of section 206 of the Advisers Act).

developing with the federal fiduciary duty on private claims is discussed further below.

II. The Broker Exclusion in the Definition of Investment Adviser

The Subcommittee believes that a shared understanding of the Advisers Act's exclusion from the definition of "investment adviser" for brokers is essential for the Committee to make helpful recommendations to the Commission regarding the federal fiduciary duty.

As the federal fiduciary duty finds its source in the Advisers Act, that duty applies only to persons who are acting as investment advisers under the Act. The Act generally defines the term "investment adviser" as a person who is engaged in the business of advising persons (individuals or entities) about investing in securities. For example, a broker who recommends that a client invest in a mutual fund and receives 12b-1 fees is generally considered to satisfy this definition. The broker might fit within an exclusion from the definition, however. It is the application of this exclusion, more than the definition of investment adviser, that has been the frequent subject of debate.

The broker exclusion is available if two conditions are satisfied: (1) no special compensation is received and (2) the advice is solely incidental to the broker's brokerage activities.[5] The Commission takes the position that 12b-1 fees (and commissions) are not necessarily "special compensation" and that a broker's recommendation to invest in a particular mutual fund may be "solely incidental." This means that a broker who recommends mutual funds and receives commissions or 12b-1 fees may be able to rely on the broker exclusion. The broker accordingly would not be subject to the federal fiduciary duty with respect to the

[5] Section 202(a)(11)(C) excludes from the definition of "investment adviser:" "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 therefore . . .."

recommendation or the compensation received, although he would be subject to the Financial Industry Regulatory Authority ("FINRA," formerly the NASD) requirement that the recommendation be "suitable"[6] and that the compensation be reasonable and otherwise comply with FINRA rules.

The scope of the broker exclusion became a high profile issue in the late 1990s, when there was a shift in brokers' compensation from a commission-based to an asset-based model. As long as brokers received only commissions, the broker exclusion had been considered to be available, even if the broker exercised discretion over a client's account. The Commission generally viewed the receipt of asset-based compensation, however, as special compensation, thereby rendering the broker exclusion unavailable. Some in the broker community have argued that the exclusion should not be lost merely because of a change in the form of compensation. Conversely, some investor advocates have argued that commission-based advice often was not solely incidental and should not qualify for the exclusion.

The Commission responded to the increasing prevalence of asset-based compensation by proposing a rule that eliminated the special compensation prong, thereby allowing brokers who received asset-based fees to qualify for the broker exclusion if their advice was solely incidental. In promulgating this rule, the Commission stated that investment advice could be considered solely incidental if it was "in connection with and reasonably related to" the brokerage services provided. Some investor advocates and investment adviser groups have argued that this interpretation of "solely incidental" is overbroad. The Commission further held that discretionary accounts would no longer be considered solely incidental and would be subject to Act, regardless of the type of compensation received.

The rule eliminating the special compensation prong was ultimately vacated by a federal appeals court. This decision restored the special compensation prong,

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[6] *See* NASD Rule 2310.

but the SEC's interpretation of "solely incidental" and its position on discretionary accounts were unaffected. As a result, a broker who receives asset-based compensation for investment advisory services generally is subject to the Act (and the federal fiduciary duty), whereas a broker who charges only commissions is not, despite the fact that the brokers may be providing essentially the same services and have a similar relationship with their clients, and their clients may have similar expectations regarding the brokers' duties. There is general agreement that this kind of inconsistency should be corrected, but little agreement about how to do so.

III. The Non-Federal Fiduciary Duty

The Subcommittee believes that is it important to establish a shared understanding of the effect of the substance and scope of the federal fiduciary duty on the fiduciary duty in other contexts ("non-federal fiduciary duty").

A broker who is *not* subject to the Advisers Act nonetheless may be subject to a fiduciary duty in other contexts. For example, a court may find that a broker has fiduciary duty to a client under state common law, which may result in private liability. One of the most common claims brought against brokers in arbitration proceedings is that the broker violated his duty in the context of a relationship of "trust and confidence," which is akin to a fiduciary duty standard. A broker's relationship with a client may be subject to ERISA and thereby trigger a fiduciary duty under that statute, which may be actionable by private litigants and federal enforcement officials. Brokers may be subject to a fiduciary duty under state securities laws as enforced by state securities regulators.

Broker rules promulgated by the Commission and FINRA can impose fiduciary requirements outside of the purview of the Advisers Act. For example, both the Commission and FINRA have pending rules that would require certain disclosures at the time that a sale of mutual fund shares occurs. The Commission and FINRA might object to the suggestion that they have shoehorned fiduciary standards into a non-fiduciary regulatory scheme, but the content of some broker rules have a decidedly fiduciary flavor. In any case, there is no debate that the Commission and FINRA have, as a practical matter, broad authority to impose conduct rules on brokers who are not subject to the Advisers Act.

In summary, while the federal fiduciary duty applies only when the Advisers Act applies, a fiduciary duty as a practical matter can apply in many contexts when the Act does not apply.[7] In each of these contexts, the federal fiduciary duty may affect the substance and scope of the non-federal duty. The *scope* of non-federal fiduciary duties can be narrowed, for example, where a federal statute or SEC rule has preempted state law, or effectively expanded where Congressional or SEC inaction has left the development of fiduciary standards to other actors (*e.g.*, plaintiffs lawyers, state regulators and FINRA). The *substance* of non-federal fiduciary duties similarly can be determined or guided by SEC action. This effect may range from explicit preemption by SEC rule to influential guidance from SEC staff. Conversely, SEC inaction may leave the development of fiduciary law to other actors and, to some extent, limit the influence of the federal fiduciary duty.

Thus, the substance and scope of the federal fiduciary duty plays an important and often decisive role in the development and application of non-federal fiduciary duties. The effect of Commission action may range from informally guiding other parties in their application of the fiduciary duty to formally preempting the imposition of a conflicting or higher fiduciary standard. The Commission can fill the fiduciary duty "space" by taking positions in litigated matters, expressing its views in interpretive releases, adopting substantive rules, and otherwise giving content to the federal fiduciary duty. Alternatively, Commission inaction may leave the fiduciary space open to be filled by a variety of

[7] In practice, the debate surrounding the fiduciary duty goes not to which entities should be registered under the Act, as many brokers are registered advisers, but to the circumstances in which a broker is acting as an investment adviser, thereby triggering the application of the Act to the broker's activities that are in question.

actors in that space, including state and federal courts, state regulators, FINRA and arbitration panels.

IV. The Common Law, Rule-Based Law Distinction

The Subcommittee believes that it is important to establish a shared understanding of the two primary mechanisms by which the federal fiduciary duty is applied in practice: common law and rule-based law.

For purposes of this discussion, the *common law* federal fiduciary duty is promulgated through enforcement actions in which specific conduct is alleged to violate the fiduciary duty but not necessarily a specific rule or provision of the Act, and through interpretive and other guidance that identifies conduct that violates the duty. Promulgating the federal fiduciary duty under the common law has the advantage of flexibility because the application of the duty can be tailored to the particular facts and circumstances of each case and its application can be adjusted relatively easily to reflect industry developments. For example, the application of the fiduciary duty at common law often depends on the actual financial sophistication of the client or the specific communications between the adviser and the client. These factors are more amenable to *ex post*, case-specific discovery than to *ex ante*, broad categorization. The common law has the disadvantage that it can be less predictable for purposes of planning compliance, modifying behavior, and guiding client expectations.

The *rule-based* federal fiduciary duty is promulgated through and statutory provisions and SEC rules that embody fiduciary principles. Promulgating the duty through statutes and rules has the advantage of greater predictability, but lacks the flexibility to cover misconduct occurring outside of the four corners of the rule or to excuse unobjectionable conduct that constitutes a technical violation but should not be prohibited. In this sense, statutes and rules can be over-inclusive or under-inclusive. As an illustration of rule-based under-inclusiveness, the Commission once took the position that antifraud rules might require the disclosure of 12b-1 fees although such disclosure was not specifically required in the confirmation rule.[8] A federal appeals court rejected this position in finding that the rule, although arguably inadequate, set forth in full a broker's duty to disclose 12b-1 fees.[9] As an illustration of rule-based over-inclusiveness, the Advisers Act's principal trading restriction applies to transactions with clients that may be sufficiently sophisticated so as not to need this protection.[10] The problems of over- and under-inclusivity can be more difficult to correct because rules and especially statutes are less able to respond to changes in the industry.

Neither the common law nor rule-based law has an inherent advantage in the application of the federal fiduciary duty. The choice between the two, stripped of any factual context, is a false choice. The appropriateness of the mechanism used depends on the particular situation. Whether the fiduciary aspects of 12b-1 fee disclosure or principal transactions between advisers and their clients, for example, is better regulated by rule or common law depends on the nature of the transactions. When applying the scope and content of the federal fiduciary duty, the Commission therefore should consider the particular advantages and disadvantages of the common law and rule-based law in determining the most effective mechanism to achieve its goals.

V. The Substance and Scope of the Federal Fiduciary Duty: Illustrative Issues

The Subcommittee has reached informal agreement as to certain, relatively uncontroversial aspects of the appropriate substance and scope of the federal fiduciary duty. These are provided below and accompanied by further clarification

[8] *See Press v. Quick & Reilly, Inc.*, 218 F.3d (2d Cir. 2000) (brief of the Commission).

[9] *See Press v. Quick & Reilly, Inc.*, *supra*.

[10] *See* Advisers Act Section 206(3). The Commission has adopted certain rules to address the potential over-inclusiveness of this provision.

and questions for consideration by the Committee. ***The Subcommittee is seeking comments on the following issues during the Committee meeting on Feb. 22.***

1. The federal fiduciary duty should be able to be triggered in either of two circumstances: (1) the nature of the advisory relationship or (2) the client's reasonable expectations regarding the relationship.

    a. In other words, a client's reasonable expectations, *i.e.*, the "apparent" relationship, can trigger the federal fiduciary duty even if the "actual" relationship would not.

    b. The nature of the relationship refers to the totality of factors that entail the actual adviser/client relationship, including, but not limited to: the adviser's degree of control over the client's account, the client's reliance on the adviser's advice, the client's financial sophistication, and the personalized nature of the advice.

    c. The client's "reasonable expectations" standard is an objective one, *i.e.,* the expectations that a reasonable client in similar situation would have based on the external indicia of a fiduciary relationship, as opposed to the solely subjective expectations of a particular client.

2. The federal fiduciary duty standard is a higher standard than the suitability standard that applies to brokers.

    a. In other words, the federal fiduciary duty imposes requirements that do not apply under the suitability standard.

        i. For example, under the federal fiduciary standard an adviser would be required to have a reasonable belief that his recommendation to a client was in the client's best interests.

        ii. Under the suitability standard, the recommendation would only be required to be suitable.

3. An unsolicited order placed with a broker should not, by itself, trigger the federal fiduciary duty.

    a. What degree of advice provided in connection with an unsolicited order should trigger the federal fiduciary duty?

4. The exercise of discretionary control over a client's account should be subject to the Act and the federal fiduciary duty under the Act.

a. What constitutes discretionary control? Should this term be defined by rule or left to common law application?

5. The receipt of a commission should not, by itself, violate the federal fiduciary duty or trigger regulation under the Advisers Act.

    a. Does the receipt of a commission require special disclosure? Of the fact of the commission? Of the amount? Of the amount relative to commissions receive selling other products?

        i. Should compensation disclosure obligations be established by rule or the common law?

        ii. Should a federal fiduciary duty be applied to brokers by means other than by bringing brokers under the Advisers Act, such as through SEC or FINRA rules applicable to brokers?

6. The offering of a limited menu of products or exclusively proprietary products should not, by itself, violate the federal fiduciary duty.

    a. How might offering limited options affect an adviser's federal fiduciary duty?

        i. Should the federal fiduciary duty require disclosure of the extent to which products sold by the adviser are limited? Should disclosure be required regarding competitors' products? Regarding the relative advantages of competitors' products?

        ii. Could offering objectively inferior or client-inappropriate products violate the federal fiduciary duty where it would not also have violated the suitability standard? In other words, should the federal fiduciary duty impose a higher standard as to the objective quality or client-appropriateness of the product?

7. When should retail, personalized investment advice trigger a fiduciary duty?

    a. Should a *federal* fiduciary duty apply in this situation? In other words, should retail, personalized advice make the broker exclusion unavailable because it is not solely incidental, thereby bringing the broker under the Advisers Act? Or should the duty be imposed through SEC or FINRA rulemaking or legislation outside of the Advisers Act?

8. The federal fiduciary duty should require the disclosure to advisory clients of information regarding material conflicts of interest, including conflicts of interest relating to the adviser's compensation.

    a. In this context, the term "conflicts of interest" is not limited to actual conflicts, but includes the appearance of a material conflict of interest, such as when an adviser is paid more for selling one product than another.

    b. What should be disclosed regarding compensation? Should only the fact that different funds or fund managers may pay an adviser different levels of compensation (commissions, 12b-1 fees or revenue sharing) be disclosed? Or should the different *amounts* paid by different funds/managers be disclosed?

9. Should the federal fiduciary duty permit mandatory arbitration clauses in advisory contracts?

    a. Should this depend on whether the Commission has plenary authority to regulate arbitration, which pending legislation would grant?

10. Should clients be able to contract out of all or parts of the federal fiduciary duty?

    a. Should the opt-out terms depend on the sophistication or wealth of the client? On the nature of the transaction?

    b. On what terms should advisers be permitted to engage in principal transactions with their clients?

11. What is the significance of investor understanding of the legal standard that applies to investment advice? How does the fiduciary issue matter to investors?

    a. How would different approaches to the fiduciary issue affect investor understanding (*e.g.*, eliminating the broker exclusion)? Investor behavior? What is the role of investor education in the context of the fiduciary issue?

12. What is the meaning of the shared goal "harmonization" in the context of the fiduciary issue?

    a. Does harmonization refer to harmony between the legal standard and the business practices to which it applies? Or harmony between the legal standards that apply to similar client relationships? Or something else?

b. Is the broker-dealer “business model” different in a way that should affect the fiduciary duty? If yes, how?