Chapter 6

Fiduciary Duty Claims Involving Investment Advisers and Other Financial Professionals

By Stephen L. Brodsky

I. Introduction

The financial services industry can be confusing. The nearly $75 trillion industry is filled with different types of professionals and companies. For example, there are investment advisers, financial advisers, financial planners, wealth managers, and investment consultants. There are also brokers, broker-dealers, and brokerage houses. Many advise their clients on investments and strategies, invest on their clients' behalf, and manage their clients' portfolios as they deem fit. Others execute trades and make investments as their customers instruct. Still others may recommend a financial plan based on investment objectives and a current financial position. Despite all these different types of financial professionals who may do different things, nearly half of all retail investors in the United States believe that all owe the same duties and are subject to the same standards of care. That is incorrect. As discussed in this chapter, investment advisers and certain others owe fiduciary duties to their clients, while others do not.

At the same time, financial professionals themselves must ensure they understand and satisfy their legal obligations, which have evolved over the years. This is due in large part to proposed regulations that may or may not be finalized and enacted and agency statements that clarify or expand upon existing law. One example is the Department of Labor's (DOL) Fiduciary Rule. The DOL proposed the Fiduciary Rule in April 2015, intending that it mandate fiduciary obligations for all professionals in the retirement industry, in addition to ERISA plan fiduciaries. Though the Fifth Circuit Court of Appeals struck down the Fiduciary Rule in 2018, the DOL proposed a modified version in 2020. Another example is Regulation Best Interest (Reg BI), which the Securities Exchange Commission (SEC) adopted in early June 2020. Reg BI enhanced the standard of conduct for broker-dealers beyond existing suitability obligations, and clarifies that broker-dealers must act in the "best interest" of their customers.[1] It is not yet clear whether Reg BI helped or made matters worse—both for investors and financial professionals—and although the Second Circuit Court of Appeals upheld Reg BI, vigorous public and industry debate over Reg BI is ongoing.

With this backdrop in mind, in this chapter we discuss the duties that investment advisers and other financial professionals owe to their clients and customers. First, we discuss the different types of services that various financial professionals provide. Then, we review the legal framework underlying the duties and standards of care for these professionals—statutory, regulatory, and at common law. We then discuss why investment advisers owe fiduciary duties to their clients, why others are typically subject to lesser, nonfiduciary standards of care, and when those professionals may be deemed to owe fiduciary duties to their retail customers. We also discuss breach of fiduciary duty claims that investment advisers and broker-dealers may face, when and why such relationships may arise, and the considerations courts may assess and weigh when resolving the claims.

Finally, we address the ongoing industry debate whether all financial service professionals should owe fiduciary duties to those they service. We consider the unintended result that the United Kingdom experienced after it banned commissions for all professionals, and analyze the different types of professional relationships in the industry that sit on opposite ends of a spectrum—the fiduciary relationship of the investment adviser/client relationship on one end, and the contractual relationship of the broker-dealer/customer on the other.

[1] *See* Financial Insurance Regulatory Authority (FINRA) Rule 2111, as amended by SR-FINRA-2020-007.

II. Financial Professionals

A. Investment Advisers

1. Services

Broadly speaking, investment advisers (also spelled "advisors") provide investment advice and related financial advisory services to their clients on an ongoing basis. They may recommend investment strategies and types of investments to their clients, execute transactions on their clients' behalf, and manage their clients' investment portfolios and other financial affairs. They may also provide related financial services such as tax advice, recommendations as to insurance coverage and products, and even "home office" services. Their recommended investments and strategies may derive from their own education, professional experience, and even their particular investment models and philosophies. Over time, and in response to market or other events, they may adjust their clients' investments as they believe appropriate and in the interest of their clients.

Certainly, the relationships that investment advisers may have with each of their clients can differ greatly. Some clients may demand to be involved in all decisions and strategies. Others may not have the time or desire to be engaged in this manner; they may simply want an annual report and a telephone call about the prior year's performance and recommendations for the next year. Investment advisers understand that, in their roles as "trusted advisers," they may need to say things to their clients they may not want to hear, to protect their clients from making unwise, emotional, or reactive decisions. Bill Hammer Jr., founder and CEO of Hammer Wealth Group, states, "Over a lifetime, a few big mistakes can dramatically change where you end up financially. That's why having an adviser who isn't afraid tell you the uncomfortable truth is so important. I believe part of my duty is to tell my clients uncomfortable truths to protect them."

The investment adviser/client relationship is a fiduciary one. Clients place their trust and confidence in their advisers, relying upon them for their knowledge and skill. Advisers, in turn, take on a position of superiority, control, and authority over their clients. Stacy Francis, president and CEO of Francis Financial, a firm that serves divorced and widowed women, states,

> I equate the faith that a person puts in an investment adviser to the confidence that a patient places in her physician. The patient is not a medical expert and relies on the doctor to give

> the best possible advice for her overall well-being and health. This relationship is built on a solid foundation of trust, confidence, and reliance. The same is true of an investment adviser and her client.

Avani Ramnani, managing director with Francis Financial, adds that "It is also essential to educate your clientele. To some, financial terms can be challenging to understand and overly complicated. An investment adviser must explain these terms, concepts, and recommendations as neglecting to do so can lead to misunderstandings, misinterpretations, or misguided advice."

Trust is an intrinsic aspect of the relationship. Edward J. Mooney, senior family wealth strategist with BNY Mellon Wealth Management, states, "So when I think about the fiduciary standard, I come at it as being somewhat akin to the standard of a trustee where you review the terms of the trust and discuss with the beneficiaries their risk tolerances and income needs to determine the appropriate course of action." He adds,

> But more personally I think of the fiduciary standard as being a question of trust in its most basic sense, trust in that as the investment adviser you are taking on the management of what could be only a small amount of client's wealth to fulfill a distinct investment allocation or it may be managing the bulk of a client's life savings. In either case, the stewardship of the client's funds is an enormous responsibility.

Larry Heller, the president of Heller Wealth Management, echoes this sentiment, adding that, "Our clients can think of us as the quarterback of their team, coordinating the players for a successful retirement. This is one of our chief roles as a trusted financial adviser to our clients."

2. Compensation

As compensation for their services, investment advisers typically charge a percentage of assets under management (AUM), a fixed hourly fee, or a combination of both. These compensation arrangements are considered transparent and most unlikely to result in bias or conflicts of interest, and, therefore, they are considered most appropriate for investment advisers.

Investors who retain investment advisers generally pay more than investors who use the services of broker-dealers and financial planners. This is not surprising, given the comprehensive, ongoing advisory and other services investment advisers provide. It is important to note that many investors may not need, desire, or be able to afford an investment adviser. For them, broker-dealers and financial planners are sufficient and at the right price point.

3. Licenses

U.S. investment advisers must be licensed, as any other financial professional. FINRA and the North American Securities Administrators Association (NASAA) oversee securities licensing procedures and requirements. Investment advisers and others who provide investment advice on a percentage of AUM or hourly fee require at a minimum a Series 65 license issued by NASAA, which is needed to provide any financial advice or service on a noncommission basis.

4. Designations

One may notice three- or four-letter designations, such as CFP®, ChFC®, or CFA®, after an investment adviser's name. The letters denote certifications that an adviser received, which are granted based on degrees, coursework, work experience, and/or examinations. The CFP board oversees the Certified Financial Planner (CFP®) certification, while the American College of Financial Services renders the Chartered Financial Consultant (ChFC®) certification. The CFA Institute grants the Chartered Financial Analyst (CFA®) certification for financial analysts, as opposed to financial advisers.

B. Broker-Dealers

1. Services

Broker-dealers execute investments and other securities transactions on behalf of their retail customers, as they instruct. They may also recommend investments to their customers, based on their customers' investment objectives and financial circumstances.[2] It is important to note that the duties that broker-dealers owe to their customers depends in large part on the scope and nature of their authority. For example, those who trade in a nondiscretionary account for their customers owe

[2] Broker-dealers provide the same broker services for their customers and also may invest on their own account. The terms "broker" and "broker-dealer" will be used interchangeably.

no fiduciary duties. Their duties are limited to faithfully and competently executing transactions and providing accurate, unbiased, and complete information when making investment recommendations or dealing with other matters within their purview. As discussed later in the chapter, Reg BI expanded broker-dealer duties and mandates that a broker-dealer act in the "best interest" of its customer. This best-interest obligation, however, is still a nonfiduciary duty.

Nonetheless, there are times when a broker-dealer may be deemed to owe fiduciary duties to its customer. For example, many state courts hold that a broker who trades in a discretionary account for its customer will owe fiduciary duties to its customer, by virtue of the agency authority that the customer has given to the broker-dealers. Apart from this rather bright-line case, it is always possible that the particular facts and circumstances may implicate fiduciary obligations. Certainly, when and why a fiduciary relationship may arise is immensely fact specific.

2. Compensation

Brokers-dealers are usually compensated by commissions, which may be based on the investment products sold to the customer and/or the transactions executed. Reg BI was intended to address the possibility that broker-dealers may have an incentive to recommend trades or investments that benefit them. Therefore, Reg BI enhances the disclosures that broker-dealers must undertake and the considerations they must weigh, before recommending any trade or investment to their customers.

3. Licenses

Brokers, at a minimum, require a Series 7 license issued by FINRA. A Series 7 license authorizes licensees to sell virtually any type of individual security, except for commodities futures, real estate, and life insurance. It is known in the industry as the general securities' representative license.

C. Financial Planners and Other Professionals

The range of services that different financial professionals provide is beneficial. There is no one size fits all. One investor may want an investment adviser for ongoing portfolio management and oversight, while another may want a broker to execute trades for it, and still another may want someone to provide a financial plan. FINRA makes clear that the last group of professionals, known as "financial planners," may come from a variety of backgrounds and offer a variety of services.[3] Financial planners could be brokers, investment advisers, insurance agents, or accountants, or they may have no financial credentials at all. The scope of services a financial planner may provide will vary; while some may create comprehensive plans that address every aspect of an individual's financial plans, others may have a much more limited focus. They are regulated in relation to the "other" services they provide. A financial planner who is also a registered investment adviser will be regulated by the SEC or the state regulatory in which he or she does business, while an accountant who also prepares financial plans will be regulated by the state Board of Accountancy for the state in which the accountant practices.

Like the range of services available to investors, it is helpful to view the relationships between financial professionals and their clients or customers on a spectrum. On one end is the limited, "arm's-length" relationship between a broker-dealer and a retail customer. The broker-dealer's duty to its customer is fundamentally contractual in nature, though augmented by governing regulations. On the other end is the special relationship of trust and confidence between an investment adviser and its client. The investment adviser owes a fiduciary duty to its client (the strictest duty recognized at law), due to the faith and reliance that the client places in the adviser, and the position of superiority, control, and discretionary authority the adviser has over its client's affairs. To best understand the bases for these duties and standards of care, we should understand their legal underpinnings.

III. Statutory and Regulatory Framework

A. Investment Advisers Act

Congress enacted the Investment Advisers Act of 1940 (IAA) in response to a 1935 report by the SEC after the stock market crash of 1929 and the ensuing Great Depression. The IAA provides the statutory framework for monitoring those who provide investment advice to individuals, institutions, and pension funds.[4] It defines an "investment adviser"

[3] *See* https://www.finra.org/investors/learn-to-invest/choosing-investment-professional/financial-planners.

[4] *See* 15 U.S.C. §§ 80b-1 *et seq*.

as a "person or firm that, for compensation, is engaged in the act of providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications."[5] Among others, the IAA excludes banks, attorneys, and any broker or dealer whose performance of advisory services is "solely incidental" to their business and who receive no "special compensation" for those services.[6]

The IAA mandates that investment advisers register either with the SEC or state regulators based upon certain AUM thresholds. In July 2020, the Dodd-Frank Wall Street Reform and Consumer Protection Act and SEC rules increased the IAA's monetary thresholds. Presently, investment advisers with $110 million or more AUM must register with the SEC. Those with less than $110 AUM must register with the state securities authority for the state in which the adviser has its principal place of business.[7] Registration is not meant to reflect an endorsement or recommendation by the SEC or state authority. It simply means that the investment adviser has fulfilled all of its registration requirements, including providing certain information, and that it is subject to the jurisdiction and regulation of the SEC and/or state regulator. An investment adviser registered pursuant to the IAA is commonly known as a "registered investment adviser," or "RIA." Often, such advisers refer to themselves by this term.

The IAA imposes broad fiduciary duties on investment advisers. Notably, the IAA does not itself expressly state that investment advisers are fiduciaries to their clients. The U.S. Supreme Court, however, has held that an investment adviser's fiduciary duties are both mandated and apparent, in light of the IAA's overall framework and legislative history,[8] its antifraud provisions in section 206,[9] and the very nature of

[5] 15 U.S.C. § 80b-2(a)(11).

[6] *Id.* § 80b-2(a)(11)(A)-(C).

[7] *See also* Form ADV, App. B.

[8] SEC v. Capital Gains Research Bureau, Inc., 375 US. 180, 191–92 (1963) (the IAA "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser—consciously or unconsciously—to render advice which was not disinterested."); Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11 (1970) ("The Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.").

[9] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472, n.11 (1977) (the IAA "prohibits, as a 'fraud or deceit upon any client,' a registered investment adviser's failure to disclose to his clients his own financial interest in his recommendations). Although Capital Gains involved a federal securities statute, the Court's references to fraud in the 'equitable' sense of the term were premised on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers."). *See also* Hollerich, v. Acri,

relationship between an investment adviser and its client.[10] The seminal decision by the U.S. Supreme Court, *Capital Gains Research*,[11] has been interpreted to establish a federal fiduciary standard for investment advisers based upon the IAA. The SEC, which oversees and regulates the IAA, has issued its own guidance concerning the fiduciary duties of investment advisers. As discussed later, the SEC issued its final "interpretation" of the fiduciary duties owed by investment advisers to their clients in Release No. IA-5248, Commission Interpretation Regarding Standard of Conduct for Investment Advisers ("Release IA-5248").[12]

B. Investment Companies Act

At the time that Congress enacted the IAA, it also enacted the Investment Company Act of 1940 (ICA). The ICA regulates investment companies (such as mutual funds) and provides the statutory basis for the fiduciary duties that investment advisers owe to these companies. The fiduciary duties reflect the unique relationships that investment advisers have to investment companies.[13] The ICA addresses other matters, such as financial disclosures, retail investment products, accounting and recordkeeping, changes to investment policies, and actions in the event of fraud or a breach of fiduciary duty. As with the IAA, the SEC oversees and regulates the ICA.

C. DOL's Fiduciary Duty Rule

In April 2015, the DOL proposed new legislation concerning professionals in the retirement industry. The DOL's proposal was in response to the Obama administration's call to clarify the duties and obligations of retirement industry professionals. The DOL's intended legislation, which became known as the "fiduciary rule," expanded the definition of an "investment advice fiduciary" in the Employee Retirement Income

259 F. Supp. 3d 806 (N.D. Ill. 2017); Morris v. Wachovia Securities, Inc., 277 F. Supp. 2d 622 (E.D. Va. 2003).

[10] *Capital Gains Research*, 375 U.S. at 191–92.

[11] 375 U.S. 180, 191–92 (1963).

[12] Release IA-5248 became effective on July 12, 2019.

[13] For example, a mutual fund is a pool of assets, typically consisting of securities, that belong to the investors, or shareholders, who hold shares in the fund. Burks v. Lasker, 441 U.S. 471, 480 (1979). Mutual funds usually have no employees of their own. Typically, an investment adviser sets up the mutual fund, selects the fund's directors, manages the investments and provides other advisory services for a fee. Jones v. Harris Assocs., L.P., 559 U.S. 335, 346 (2010).

Security Act of 1974 (ERISA). In so doing, the fiduciary rule sought to make all who work with retirement plans or provide retirement planning advice "fiduciaries." However, it thereby imposed new fiduciary status upon retail service providers in the retirement industry, including brokers, dealers, and insurance agents who sell annuities to IRAs. The fiduciary rule resulted in extremely vigorous public and industry debate, and even controversy. The Trump administration ultimately delayed implementation of the fiduciary rule to allow for additional analyses of its potential impact. During that time, six court actions were filed that challenged the fiduciary rule's validity and lawfulness.

On June 21, 2018, the Fifth Circuit Court of Appeals, in *Chamber of Commerce v. U.S. Dep't of Labor*, struck down the fiduciary rule *in toto*.[14] While the DOL did not contest the Fifth Circuit's ruling, then DOL Secretary Alexander Acosta announced plans to present a redrafting of the rule in the future. On June 29, 2020, the DOL issued a new modified, proposed "fiduciary rule" to regulate "investment advice fiduciaries" under ERISA. This has resulted in yet another strident debate. One issue is whether the DOL's proposal comports with the distinctions between fiduciary conduct and nonfiduciary conduct, in the manner that the Model Regulation of the National Association of Insurance Commissioners (NAIC) and Reg BI do. Another issue is that the DOL's proposal confers ERISA fiduciary status and standards to rollover recommendations not previously viewed as fiduciary advice. It is unclear whether the DOL's "new" fiduciary rule will be adopted in its present form.

D. SEC Release IA-5248: Investment Adviser's Fiduciary Duties under the IAA

On June 5, 2019, the SEC adopted Release IA-5248, in which the SEC commented upon and gave guidance concerning the fiduciary duties of investment advisers pursuant to the IAA. Release IA-5248 has also become known as the SEC's "final interpretation" of the IAA. The SEC issued the final interpretation after it had reviewed over 150 comment letters to an April 18, 2018, proposed interpretation of the IAA. The

[14] *See* Chamber of Commerce, 885 F.3d 360 (5th Cir. 2018). The Fifth Circuit held that the DOL's new definition of "fiduciary" was inconsistent with ERISA, the Internal Revenue Code, and common law meanings of the term, predicated on a special relationship of trust and confidence. It also held that Fiduciary Rule impermissibly created private rights of action against brokers and insurance agents with no congressional authorization. Therefore, it vacated the fiduciary rule, on the ground that it was arbitrary and capricious abuse of power by the DOL. 885 F.3d at 388.

comment letters provided to the SEC were submitted by individuals, investment advisers, trade and professional organizations, consumer advocacy groups, law firms, and bar associations.

In Release IA-5248, the SEC stated that the IAA set a federal fiduciary duty for investment advisers based upon common law principles and the nature of the adviser/client relationship, which the SEC described as one of "trust and confidence." The fiduciary duty the SEC enunciated encompasses an overarching obligation to serve the best interests of its client, such that the adviser may never place its own interests ahead those of its client. Moreover, the fiduciary duty is comprised of two components: the duty of care and the duty of loyalty. The duty of care requires the investment adviser to provide investment advice in the best interest of its client, based on its client's objectives. The duty of loyalty obligates the adviser to eliminate or make full and fair disclosure of all conflicts of interest that might incline the adviser—consciously or unconsciously—to render advice that is not impartial and disinterested. This is so that the client may provide informed consent to any conflict.

The fiduciary duty, the SEC stated in Release IA-5248, equally applies whether the client is a retail investor with limited assets, experience, and knowledge or an institutional client with exceptionally large portfolios and substantial knowledge, experience, and analytical resources. However, the SEC elaborated that the fiduciary duty has "sufficient flexibility" to address the various types of relationships that advisers may have with different clients based on the services rendered. Thus, the investment adviser's fiduciary duty must be viewed in the specific context of the agreed-upon scope of the relationship between the adviser and client.

An investment adviser's fiduciary obligations flow from the role and functions that the adviser, as agent, has agreed to assume for the client, as principal. As a result, the obligations of an investment adviser providing comprehensive, discretionary advice in an ongoing relationship with a retail client (including, for example, portfolio monitoring and periodic realignment, with very limited restrictions) will differ significantly from those of an adviser to a registered investment company or private fund, where the advisory agreement defines the adviser's scope of services, and the limitations on its authority, with substantial specificity (for example, a mandate to manage a fixed income portfolio subject to specified parameters). In sum, while application of an investment adviser's fiduciary duty may vary with the scope of the relationship, the relationship in all cases remains a fiduciary one.

"[A]n adviser's federal fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon scope of the relationship."[15] By this statement in its final interpretation of the IAA, the SEC appears to acknowledge that an adviser and client may, by contract, circumscribe the matters as to which the fiduciary duty may apply, but they may not waive the fiduciary duty altogether. Thus, a contract provision purporting to waive the adviser's federal fiduciary duty generally would be inconsistent with the IAA. Examples of impermissible waivers might include (1) a statement that the adviser will not act as a fiduciary; (2) a blanket waiver of all conflicts of interest; or (3) a waiver of any specific obligations under the IAA.

As significantly, the SEC stated in Release IA-5248 that "[t]he Final Interpretation does not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law." The SEC's apparent distinction between a federal fiduciary duty and a state fiduciary duty may yield conflicting law, or at least ambiguity. Because the IAA does not itself set forth the contours of an investment adviser's fiduciary duty—other than through the antifraud provisions of section 206, and the SEC's own "interpretation" of that duty—courts may apply state common law principles to determine if a breach of a fiduciary duty has occurred. The SEC's final interpretation may result in doctrinal tiers as to whether fiduciary duties may be contractually waived: one where courts apply "federal law" and render waivers unenforceable, and another, where courts apply "state common law" fiduciary duties and contract principles to enforce a waiver or disclaimer.

E. Reg BI's "Best Interest" Standard for Brokers and Dealers

Along with its final interpretation of the IAA, the SEC also adopted "Regulation Best Interest" for brokers and broker-dealers.[16] Reg BI, as it is commonly known, enhances the standard of conduct for brokers and broker-dealers beyond existing suitability obligations, to make it clear that they may not put their financial interests ahead of the interests of retail customers when making recommendations. Under Reg BI, a broker-dealer is required to act in the best interest of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer.

[15] 17 C.F.R. part 276, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

[16] 17 C.F.R. § 240.15l-1.

Reg BI sets forth a general, overarching “best interest obligation,” which mandates that broker-dealers and those associated with them, when recommending a securities transaction or investment strategy,

> shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.[17]

Two points are immediately clear. First, Reg BI does not define “best interest” in its text. Second, Reg BI does not mandate a broker-dealer to place its customer’s interests ahead of its own. For comparison, an investment adviser’s fiduciary duty to its client requires the adviser to place its client’s interests ahead of its own interests. In this manner, Reg BI’s “best interest” rule requires more than the previously applicable “suitability” standard of care, but less than an investment adviser’s fiduciary duty. While an adviser owes a fiduciary duty to its client, a broker-dealer owes a lesser, nonfiduciary duty to its customer.

Reg BI sets forth four composite obligations that, together, comprise the “best interest obligation.” These are the (1) “disclosure obligation,” (2) “care obligation,” (3) “conflict of interest obligation,” and (4) “compliance obligation.” Under Reg BI, if a broker (or dealer or associated person) satisfies these four obligations, the broker is deemed to have acted in the “best interest” of the customer.

The “disclosure obligation” requires a broker, before or when recommending a securities investment or strategy to a customer, to disclose in writing “all material facts” related to (1) the scope and terms of the broker’s relationship with the customer, including the broker’s fees and costs and the scope of services provided to the customer, and (2) conflicts of interests associated with the recommendation.[18]

The “care obligation” mandates a broker to exercise “reasonable diligence, care and skill” when making recommendations based on an understanding of the potential risks, rewards, and costs, and the broker must have a reasonable basis to believe (1) the recommendation could be in the best interest of some customers; (2) the recommendation is in the particular customer’s best interest, in light of its investment profile and the potential risks, rewards, and costs associated with the recommendation; and (3) a series of recommended transactions, even if in the

[17] *Id.* § 240.15l-1(a)(1).

[18] *Id.* § 240.15l-1(a)(2)(i).

customer's best interest in isolation, are also in the customer's best interest and are not excessive when viewed together.[19]

The "conflict of interest obligation" requires a broker to establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest and mitigate against their occurrence.[20]

Finally, the "compliance obligation" requires a broker to establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Reg BI.[21]

The purpose and intent of Reg BI is clear. Reg BI does not intend to alter an arm's-length contractual, relationship between a broker and its customer. Rather, it seeks to reinforce this contractual relationship by ensuring a level playing field for the customer. For this reason, Reg BI focuses on enhancing a broker's disclosures obligations, obligations of care when making investment recommendations, obligations to avoid conflicts of interest, and compliance obligations. The goal of Reg BI is to buttress and support an equality of bargaining power between the customer and broker. In other words, Reg BI recognizes the bifurcation of the fiduciary duties owed by investment advisers to their clients and the nonfiduciary, contractual duties owed by broker-dealers to their customers. This is appropriate. Many investors do not need nor desire the comprehensive, portfolio management services of an investment adviser. Moreover, as noted, many investors simply cannot afford the services of an adviser.

F. Form CRS–Relationship Summary Form

Finally, along with Reg BI, the SEC also expanded and revamped the types of disclosures that investment advisers and brokers-dealers must make to their clients and customer, through a new "Form CRS." Form CRS includes information about the adviser's or broker-dealer's services, fees, costs, conflicts of interest, the applicable legal standard of conduct and any disciplinary history of the firm and its professionals. The SEC intended Form CRS to provide investors with simple, easy-to-understand information about the nature of their relationship with their financial professional. While facilitating layered disclosure, the format of the relationship summary allows for comparability among

[19] *Id.* § 240.15l-1(a)(2)(ii).
[20] *Id.* § 240.15l-1(a)(2)(iii).
[21] *Id.* § 240.15l-1(a)(2)(iv).

the two different types of firms (investment advisers versus broker-dealers) in a way that is distinct from other required disclosures.

IV. Differing Duties among Financial Professionals

A. Fiduciary Duty versus Contractual Duty

As is evident from the preceding, investment advisers and broker-dealers have different duties and standards of care. Differing duties and standards do not reflect inconsistency in the financial industry, as some may contend. Rather, they are warranted and appropriate in light of different kinds of relationships at opposite ends of a spectrum. On one side is the fiduciary relationship between an investment adviser and client, where the client reposes its trust and confidence in its adviser who is in a position of authority and control over its client. Given the trust and confidence reposed by the client in its adviser, and the conversely superior position of the adviser, the adviser is obligated not to abuse is superior position and to safeguard the interest of its client. On the other side is an arm's-length, contractual relationship between a broker-dealer and its retail customer. In this relationship, full disclosure, objectivity, and reasonableness are important to maintain an equal playing field between the parties. When viewed in this manner, the different standards simply reflect the different types of relationships in the investment industry.

The IAA and SEC's final interpretation recognizes the fiduciary nature of the investment adviser/client relationship and the resulting obligations that apply. The investment adviser/client relationship is not unique. It is merely one of many fiduciary relationships of trust and confidence recognized under the law. The examples are many: a trustee is a fiduciary of a trust; corporate officers and directors are fiduciaries for their corporations; a privately held company's majority shareholders owe fiduciary duties to the minority shareholders; and partners are fiduciaries to each other.

Importantly, Reg BI does not change the fundamental arm's-length nature of the broker/retail customer relationship into a fiduciary relationship of trust and confidence. It does not require the broker to place its customer's interests ahead of its own. To the contrary, it seeks to maintain the nature of the relationship by enhancing the broker's obligation to provide the customer with appropriate facts so that the customer may make its own informed decisions. To address concerns as to possible conflicts of interest, Reg BI "enhances" broker duties as to disclosures, obligations of reasonable care, and compliance.

B. Should All Financial Services Professionals Be Fiduciaries?

There is debate presently roiling the financial services industry over whether all financial services professionals should be subject to fiduciary standards of care. Some contend that imposing fiduciary duties upon all financial services professionals is the only way it can be ensured that all investors receive unbiased and unconflicted services. They contend that the SEC's Reg BI did not go far enough to expunge the potential for conflicts of interest. Based on this line of thought, broker-dealers who are presently subject to Reg BI's "best interest" standard of care (nonfiduciary standard) should instead be subject to fiduciary standards such as those mandated by the IAA for investment advisers. Others caution, however, that mandating fiduciary duties for all financial services professionals may result in a situation where the cost of financial services rises across the board, and a segment of investors no longer able to afford the available services are left unable to access any—the so-called guidance gap.

Sheila Murphy, an expert with Bates Group and consultant with more than 30 years of legal, insurance, regulatory, and compliance experience, notes that this potential unintended consequence of a universal fiduciary rule is not merely speculative. She cites studies after the United Kingdom banned commissions for all retail investment advice:

> While not a replica of the U.S. rule, the U.K.'s Retail Distribution Review (RDR) is close enough to be informative as to areas that the U.S. may want to monitor. Professor Andrew Clare of London's Cass Business School is the principal author of two studies: "The Guidance Gap" and "The Impact of the RDR on U.K.'s Market for Financial Advice." These studies provide insights as to what may happen in the U.S. Based on the studies' results, what we may see is a bifurcation of financial advice. High net worth clients are more likely to receive more transparent information and improved advice from a smaller force of better-qualified and less-conflicted advisers. But an unintended consequence of RDR and similar acts would likely be that the lower and middle-market investors may have limited access to investment advice, and the guidance gap will expand.

According to Professor Clare's studies, the RDR in the United Kingdom had both positive and negative results: improved investment advice for high-net-worth investors and no investment advice for certain other investors.

Other commentators have the same concerns. Charlotte Baumanns, at Oxford University Commercial Law Centre, referenced the United Kingdom's experience after the RDR when she contemplated a rule banning commissions for investment advice in Germany:

> [T]he RDR reforms led to a higher quality of advice, and higher business standards in the financial services sector; however, the UK now faces an advice gap with many investors now finding investment advice unaffordable, and a significant number of banks advising high-income investors only. Though it might be argued that no advice is better than biased advice, in the face of the current low-interest phase and the April 2015 introduction of pension flexibility in the UK, a significant number of people will be exposed to the risk of making ruinous investment decisions.[22]

Lastly, Emma Wall, a commentator for Morningstar, wrote the following about the state of financial services in the United Kingdom after the RDR:

> It is now harder for investors with small portfolios to get advice post-RDR. Many advisers have segmented their advice depending on the size of investor portfolios, meaning that for investors with small portfolios, it's very hard to get bespoke advice.[23]

Thus, two intractable questions remain. First, can a universal fiduciary standard of care be mandated for all financial professionals in the United State without causing a "guidance gap"? Second, is affordable nonfiduciary financial advice better than none?

[22] Charlotte Baumanns, The UK Ban on Commissions Relating to Retail Investment Advice—A Good Example for German Law? (Oxford Commercial Law Centre, May 29, 2017).

[23] Emma Wall, *How RDR Has Changed the Advice Landscape* (Morningstar, May 11, 2017).

V. Claims for Breach of Fiduciary Duties

A. Claims under the IAA

While the IAA mandates that an "investment adviser" owes fiduciary duties to its client, the IAA does not provide a client with a private cause of action against its adviser for damages for a breach of fiduciary duties. The SEC may impose sanctions, including monetary fines and/or registration revocation, upon the adviser. But a client has only a limited private remedy under the IAA for rescission of the adviser contract and recovery of consideration paid. Nonetheless, clients may sue their investment advisers for monetary damages predicated on state common law breach of fiduciary duty claims. If an investment adviser is registered with the SEC, the adviser will be deemed, as a matter of statutory and regulatory law, a fiduciary of its clients. Courts have even gone beyond the application of the IAA, holding that the investment adviser/client relationship in and of itself is a fiduciary relationship as a matter of law.

Because of IAA's federal fiduciary standard for registered investment advisers, some courts facing alleged breaches by investment advisers have sought to rely upon "federal common law" when determining whether a breach occurred. Other courts, however, have relied upon state common law. These courts observe that, although they may look to federal law for the statement of the investment adviser's fiduciary duty and the standard to which investment advisers are to be held, they must still view a cause of action against an investment adviser for breach of fiduciary duty as springing from state law, because no federal cause of action for damages is permitted.[24] As is apparent, this results in unnecessary, conflicting legal doctrine, even though the results are the same. If the investment adviser breached its fiduciary duty to its client, the adviser is liable, and damages may be awarded to the client for the breach.

B. Claims under Common Law

Aside from the IAA, an investment adviser (or any other financial professional, for that matter) may face liability and damages for breach of

[24] Belmont v. MB Inv. Partners, Inc., 708 F.3d 470, 501–04 (3d Cir. 2013) (explaining that some state courts have looked to the federal standard to determine whether there is a fiduciary relationship in the investment-adviser context, but others apply both state and federal standards).

fiduciary duty if a fiduciary relationship arose between the professional and its client or customer. Registration under the IAA is not necessary for the professional to be deemed a fiduciary. Fundamental principles governing a fiduciary relationship may always apply, given the circumstances. The existence of an investment advisory contract is not determinative. If the client reasonably relied upon the financial professional, reposing its trust and confidence in it, while the financial professional knowingly assumed a position of superiority and control over the client's affairs (for example, by assuming discretionary authority to manage the client's investment account and trade on behalf of the client), a fiduciary relationship may exist between the two. The totality of the evidence may demonstrate that a professional was either rendering investment advice to the investor or was otherwise in a position of trust and confidence to its client.

At times, there may be multiple groups of investors and investment advisers with varying interactions among them. An investment adviser also may stand in different roles with regard to investors and firms. As a result, whether an investment adviser may face liability for a breach of fiduciary duty will turn on the specific relationships that the adviser had with each of the various parties. The legal analysis becomes extremely fact intensive. Some relationships may be advisory, while others may not. At issue is whether an investor was an advisory client of the adviser, either by virtue of an advisory agreement or because the adviser had assumed an advisory role with regard to that investor. Courts will first examine who had an investment advisory contract with whom. If there is no advisory contract, courts will then examine other facts, such as communications among the parties involving investment advice. The goal is to tease apart the relationships and determine who was the "client" to whom the adviser was rendering advice.

Even if a court determines that an investment adviser or other financial professional owes a fiduciary duty to its client, it still must determine whether the adviser breached its fiduciary duty. Courts have relied upon "the prudent investor" standard to assess the adviser's conduct. Understandably, there is no precise formula as to what constitutes "imprudence." Generally, whether an investment adviser breached its fiduciary duty to its client is a factual determination to be made by the trial court. Courts may engage in a balancing analysis of the investment adviser's considerations and its actions, considering the history of each individual investment, viewed at the time of its action or its omission to act. If the adviser acted prudently, considering all the information available to it at the time, an error of judgment alone is not a breach of fiduciary duty. In other words, it is not enough that hindsight may suggest that another course would have been more beneficial.

C. Breach of Fiduciary Claims under the ICA

As noted, an investment adviser typically will set up a mutual fund, select the fund's directors, manage its investments, and provide other advisory services for a fee. The law acknowledges that, given the unique nature of the relationship between the adviser and the mutual fund, it is difficult, if not impossible, for the two to maintain an arm's-length, independent relationship. For this reason, the ICA imposes a fiduciary duty upon an investment adviser with regard to the compensation for its services.[25] Unlike the IAA, the ICA additionally grants mutual fund shareholders a private right of action for damages for breach of an investment adviser's fiduciary duty with regard to its compensation.[26] The clam is generally limited to alleged excessive compensation, and does not encompass broader issues, such as personal misconduct or general malfeasance.

The Supreme Court in *Jones v. Harris Assocs. L.P.*[27] set the standard for a mutual fund adviser's breach of fiduciary duty. An investment adviser to a mutual fund breaches its fiduciary duty if it charges an advisory fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been based on arm's-length bargaining. When evaluating the amount of the fee, courts consider all relevant circumstances, including, for example, the fees of similarly situated funds, profitability, and economies of scale. However, the court cannot second-guess informed board decisions or engage in precise fee calculations. Instead, the court should simply determine whether the fees themselves are excessive.

In *Jones*, the Supreme Court also approved use of the Second Circuit's multifactor test in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*[28] to assess whether a fee is excessive. Under that test, breach of fiduciary duty claims by mutual fund shareholders against their funds' investment advisers have failed, for example, when the funds' boards were independent, qualified, and they engaged in a robust, or even adequate, process to approve the advisers' arrangements and fees; the advisers' fees were within the range of comparable funds, including competitors; the advisers provided high-quality services; and the shareholders failed to show that economies of scale were not shared with shareholders or that the advisers had received significant other benefits.

[25] 15 U.S.C. § 80a-35(b)(1)-(2).

[26] *Id.*

[27] 559 U.S. 335 (2010).

[28] 694 F.2d 923 (2d Cir. 1982).

D. When a Broker-Dealer May Owe a Fiduciary Duty to a Retail Customer

A broker for a nondiscretionary account, in the ordinary course of business, does not owe a fiduciary duty to its customer. In such a case, the broker is simply executing transactions that the customer instructs it to make. It is the customer, rather than the broker, who determines which purchases and sales to make. Certainly, the broker's duty of care, set forth in Reg BI, bears on the appropriateness of any investment recommendation or series of recommendations. Apart from Reg BI's mandates, when assessing the broker's duty with regard to a nondiscretionary account, each transaction is viewed singly. Generally, the broker owes its customer duties of diligence and competence when executing a nondiscretionary customer's trade orders. The broker must execute upon the customer's orders promptly, in a manner best suited to serve the client's interests. The broker's obligation to the customer ceases when the transaction is closed. Some courts have referred to the broker's duty to appropriately execute a customer's trade as a fiduciary duty; that is, the broker has a fiduciary duty limited to the narrow task of consummating the transaction requested. Notably, other courts may consider such a narrow "fiduciary duty" as duplicative of the broker's contractual obligation.

In contrast, a broker that manages a discretionary account for its customer may owe a fiduciary duty to its customer. The facts and circumstances may establish the broker's practical control over the customer's account, which, in turn, may give rise to fiduciary duties. Courts will consider evidence that the customer placed his or her trust and confidence in the broker, with the broker's knowledge, to manage the customer's account for the customer's benefit. For example, if the customer relinquishes control over his or her brokerage account to its broker, the broker may owe a fiduciary duty to the customer to manage the account in accordance with the customer's needs and objectives. The broker's failure to manage the customer's discretionary account may give rise to a breach of the broker's fiduciary duty if it failed to exercise due care, skills, and diligence to protect the customer's interests. A fact finder, such as a jury, must assess the facts.

E. General Principles Regarding Fiduciary Duties Always Apply

It is apparent that one must always be mindful of both fundamental legal principles governing fiduciary relationships and the specific facts in the given case, to discern whether a fiduciary duty exists. Investment advisers are fiduciaries to their clients not merely because the IAA mandates them to be. The investment adviser/client relationship is fiduciary by its very nature. It is not unique though. Indeed, this book discusses many other fiduciary relationships that arise in other contexts and industries, for example, the relationships of trustees to trust beneficiaries, of directors and officers to their corporations, and of the majority shareholders to the minority shareholders in a private corporation.

VI. Conclusion

We have repeatedly acknowledged the well-known, ongoing debate whether all financial professionals should owe fiduciary duties to their clients and customers. Some contend that Reg BI does not go far enough, and that the potential for conflicts of interest cannot be expunged unless fiduciary obligations are mandated upon all financial professionals. It is submitted that the varying fiduciary and nonfiduciary duties are appropriate for the different types of services rendered in the financial industry. Having different types of financial services professionals, some with fiduciary obligations and others with nonfiduciary contractual obligations (as enhanced by the SEC's Reg. BI), may not be as bad as some contend.

There may be no one size fits all for consumers of investment services. Certain investors may want and can afford an investment adviser for comprehensive ongoing portfolio management. The adviser may have full discretionary authority and control over its client's portfolio to make investments and changes, while its client goes about his or her life and daily activities, working, eating, sleeping, relying upon and trusting its adviser to handle things. Others with may simply desire a professional to provide general recommendations and place investments based upon an agreed financial plan. Undeniably, investors also have different price points for what they want to spend or, indeed, can afford for financial services. Finally, there is support for caution that if all financial services professionals were made fiduciaries, the price for investment advice may rise across the board, and some investors will end up with none. There may be no ideal solution. Freedom of choice and access for all may be the next best thing.

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