



Fiduciary Duties Applicable To Registered Investment  
Advisors and Broker/Dealers

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# Introduction

- Parties take on the role of being a fiduciary for others.
- This is a very necessary part of our society.
- With the incredible powers of a fiduciary, fiduciaries accept incredible duties.
- This presentation is intended to provide an update on fiduciary duties owed by RIAs and BDs.

# Definitions

- A Registered Investment Adviser (RIA) is an investment adviser (IA) registered with the SEC or a state's securities agency.
- Generally, individuals or firms that receive compensation for (i) managing portfolios of securities; (ii) advising private funds; and/or (iii) giving advice on investing in securities such as stocks, bonds, mutual funds, or exchange traded funds are deemed to be investment advisers.

# RIA's Fiduciary Duties

- All investment advisors (registered or unregistered) are subject to Section 206 of the Advisers Act, which makes it unlawful for an adviser to engage in fraudulent, deceptive, or manipulative conduct.
- Section 206 also imposes a fiduciary duty on investment advisors by operation of law. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
- The purpose is to eliminate conflicts of interest and to prevent an advisor from overreaching or taking unfair advantage of a client's trust.

# RIA's Fiduciary Duties

- As a fiduciary, RIAs have the following general duties:
- Duty of Loyalty;
- Duty of Disclosure;
- Duty to Act With Competence; and
- Duty to Avoid Self–Dealing.

# RIA's Fiduciary Duties

- The SEC has indicted that an RIA should meet the following obligations:
- Advice: a duty to have a reasonable, independent basis for its investment advice;
- Best Execution: a duty to obtain the best execution for clients' securities transactions where the advisor is in a position to direct brokerage transactions.

# RIA's Fiduciary Duties

- Suitability: a duty to ensure that its investment advice is suitable to the client's objectives, needs, and circumstances;
- Personal activities: a duty to refrain from effecting personal securities transactions inconsistent with client interests;
- Disclosure: a duty to disclose all material facts to clients, including conflicts of interest; and
- Loyalty: a duty to be loyal to a client.

# RIA's Fiduciary Duties

- Best Practices:
- Demonstrate an awareness of fiduciary duties and responsibilities;
- Investments are consistent with governing documents;
- Roles of all involved parties are defined and documented;
- Identify conflicts and address them consistent with duty of loyalty;
- Agreements with clients are in writing and do not contain terms that conflict with duty of care;
- Assets are protected from theft and embezzlement;



# RIA's Fiduciary Duties

- Investment time horizon has been identified for each investment objective;
- Risk level has been identified for client;
- Expected return has been identified to meet investment objective;
- Asset classes are consistent with time horizon, risk, and return objectives;
- Socially responsible investment strategies, if any, are structured appropriately;
- Decisions regarding investment strategies are documented and made in accordance with standard of care;

# RIA's Fiduciary Duties

- Generate periodic reports that compare results against appropriate index, peer group, and investment policy objectives;
- Periodic reviews are made of qualitative and/or organizational changes of managers and other service providers;
- Control and monitoring procedures are put into place for review of policies for trading practices, best execution, and proxy voting;
- Reviews are implemented to ensure that compensation, fees, and expenses are fair and reasonable; and
- Process to review the organization's effectiveness in meeting its fiduciary responsibilities.

# RIA's Fiduciary Duties

- An RIA has a duty to evaluate whether to initiate or participate in litigation.
- Factors include:
  - Amount of loss;
  - Cost of pursuing litigation;
  - Likely recovery (chance of success); and
  - Ability or likelihood of other parties adequately representing the plan's or client's interests.

# RIA's Fiduciary Duties

- Classic examples of breach of fiduciary duties:
- Cherry picking;
- Transactions between RIA and clients (principal transactions);
- Compensation issues.

# BD Duties

- Section 202(a)(11)(C) of the Investment Advisers Act of 1940 exempts from the definition of an Investment Adviser (and therefore the associated fiduciary standard) "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."

# BD Duties

- In Release 34-51523, the Financial Industry Regulatory Authority (FINRA) determined that BDs are "not to be deemed investment advisors" and therefore are not subject to the same fiduciary standards as IAs when recommending investments to clients.

# BDs Duties

- The FINRA "Suitability" standard requires that a member shall make reasonable efforts to obtain information concerning a client's:
  - 1. Financial status;
  - 2. Tax status;
  - 3. Investment objectives;
  - 4. Risk tolerance; and
  - 5. Other information used or considered to be reasonable

# BDs Duties

- Registered Representatives (RRs) affiliated with a BD who also engage in the business of providing investment advice are required to affiliate with a RIA.
- As Investment Adviser Representatives (IARs) they are held to the "Fiduciary Standard" as defined under the US Investment Advisers Act of 1940 when providing investment advice to clients.
- IARs have a duty to clearly communicate to their clients whether they are brokering a suitable security as a RR or providing investment advice as an IAR and therefore acting as a fiduciary.



# BDs Duties

- In 2012, FINRA rule 2111 expanded liability for recommendations of strategy.
- BDs may be liable for their product and service recommendations which are part of a “strategy.”
- A strategy could include tax, retirement, investments, funds, or even estate planning.
- A registered advisor may want to make better use of CPA advice or licensed attorneys.

# BDs Duties

- FINRA Rule 2111 requires that a firm or associated person have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile.

# BDs Duties

- BDs efforts to get to know their customers are now expressly governed by a reasonableness standard.
- The rules expressly direct that BDs should use reasonable diligence to know those facts required to (i) effectively service their customers' accounts, (ii) act in accordance with any special handling instructions for their customers' accounts, (iii) understand the authority of each person acting on behalf of their customers, and (iv) comply with applicable laws, regulations, and rules.
- BDs should use reasonable diligence to retain their customers' information and keep it up to date.

# BDs Duties

- The new suitability rule directs BDs to have a reasonable basis for believing an investment or strategy is “suitable” based on the information they obtain through reasonable diligence.
- The following information to be used in determining suitability: (i) customer's age, (ii) other investments, (iii) financial situation and needs, (iv) tax status, (v) investment objectives, (vi) investment experience, (vii) investment time horizon, (viii) liquidity needs, (ix) risk tolerance, and (x) any other information the customer may disclose.

# BD Duties

- Pursuant to Section 913 of the Dodd-Frank Act, the SEC released a study in January 2011 recommending that the SEC proceed with rulemaking to adopt a uniform fiduciary standard for brokers and investment advisers when providing personalized investment advice to retail consumers.
- On March 1, 2013, the SEC issued a release to request information for a cost-benefit analysis to determine the anticipated economic impacts of moving forward with that rulemaking.

# BD Duties

- The Department of Labor is expected to release a new rule this spring invoking a uniform fiduciary rule for RIAs and BDs that provide advice to retirement funds and IRAs that are controlled by ERISA.
- As proposed, this would include insurance agents, BDs, and other financial advisers.
- Hidden payments such as commissions and incentive compensation must be disclosed.

# Civil Liability

- An RIA or BD firm may be held liable for breaches of fiduciary duty under state common law.
- Further, there are three separate bases for imposing liability on an employee who carries out the fiduciary functions of an entity: (1) the employee owes a fiduciary duty directly as a subagent carrying out the employer's fiduciary functions, (2) the employee is liable if he 'participates' in the employer's breach of fiduciary duty, and (3) the employee is personally liable for any tort he commits in the course of his employment.
- *Medve v. JPMorgan Chase Bank, N.A.*, No. H-15-2277, 2016 U.S. Dist. LEXIS 11961 (S.D. Tex. February 2, 2016).

# Criminal Statutes

- SEC can seek civil fines and can potentially send matters to the Department of Justice for criminal prosecution.
- There are also state criminal statutes that may apply.
- There are a number of theft charges.
- In Texas, there are also a number of more exotic criminal offenses.



# State Law Criminal Statutes

- There is a criminal charge for misapplication of fiduciary property. Tex. Penal Code 32.45.
- A person commits the offense of misapplication of fiduciary property by intentionally, knowingly, or recklessly misapplying property he holds as a fiduciary in a manner that involves substantial risk of loss to the owner of the property. Tex. Penal Code Ann. § 32.45(b).

# State Law Criminal Statutes

- An offense under this statute ranges from a Class C misdemeanor if the property is less than \$100 to a first degree felony if the property misapplied is over \$300,000. Tex. Penal Code 32.45(c).
- Moreover, the punishment is increased to the next higher category if it is shown that the offense was committed against an elderly individual. *Id.* at 32.45(d).
- This offense can be a basis for busting exemplary damages cap in civil litigation.

# State Law Criminal Statutes

- Financial exploitation of the elderly is a criminal offense in Texas. Tex. Pen. Code § 32.53.
- “A person commits an offense if the person intentionally, knowingly, or recklessly causes the exploitation of a child, elderly individual, or disabled individual.” *Id.* at 32.53(b).
- “Exploitation” means the illegal or improper use of a child, elderly individual, or disabled individual or of the resources of a child, elderly individual, or disabled individual for monetary or personal benefit, profit, or gain. *Id.* at 32.53(a)(2).

# Conclusion

- Fiduciary obligations are certainly onerous.
- Clients rightfully seek out advisors who owe these duties.
- The author hopes that this presentation provides assistance to RIAs and BDs that take on fiduciary roles.