

The elusive fiduciary duty definition

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Although broker-dealers and investment advisers perform similar duties, they have been held to standards of care that differ in subtle but significant ways. Whereas broker-dealers are required to ensure that the products and services they sell are "suitable" for their clients, investment advisers have been held to the more stringent common law standard of fiduciary duty. As the line between broker-dealers and investment advisers continues to blur, it has become more and more likely that the fiduciary duty standard will be extended to cover both sectors.

But what is this duty? Defining this duty more precisely, identifying how it is to be applied, and establishing the penalties for flouting the standard of care it mandates are considered high-priority action items for the regulators to address.

This is where *Complinet* comes in – and our experts are ready to weigh in on the matter.

The duty of care, loyalty, honesty and good faith

Not having a firm definition of fiduciary "is part of the reason it works," says Investment Adviser Association (IAA) executive director David Tittsworth. If you come up with a definition that is too specific, such that it would provide "a roadmap for wrongdoers," they could check the boxes but miss the point of acting in the client's best interests.

You won't find the word fiduciary in the Adviser's Act, Tittsworth adds. The concept, rooted in centuries of common law, became an integral part of the Advisers Act in a 1963 US Supreme Court decision ruling that an investment adviser owes a fiduciary duty under the law. He also noted that finding a violation of fiduciary duty requires an examination of particular facts and circumstances.

An investment adviser stands in a special relationship of trust and confidence with its clients, and is therefore a fiduciary to them. As a fiduciary, an investment adviser has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients.

The parameters of an investment adviser's duty depend on the scope of the advisory relationship. The IAA attaches seven principles to fiduciary duty, which are:

1. the duty to place the interests of clients first, at all times;
2. the duty to have a reasonable basis for its investment advice;
3. the duty to seek best execution for client securities transactions where the adviser directs such transactions;
4. the duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines, and restrictions;
5. the duty to treat clients fairly;
6. the duty to make full and fair disclosure to clients of all material facts about the advisory relationship, particularly regarding conflicts of interest; and
7. the duty to respect the confidentiality of client information.

Contrast this with the five principles of fiduciary duty being espoused by a group of 11 fee-only advisers and consultants calling themselves the Committee for the Fiduciary Standard, which is lobbying Congress to adopt a strong fiduciary standard in connection with regulatory reform. Their definition mandates that investment advisers take the following proactive steps:

1. Put the client's best interest first.
2. Act with prudence; that is, with the skill, care, diligence and good judgment of a professional.
3. Do not mislead clients – provide conspicuous, full and fair disclosure of all important facts.
4. Avoid conflicts of interest.
5. Fully disclose and fairly manage, in the clients favor, unavoidable conflicts.

What about commission collection?

A lingering and related question here is how compensation practices might need to change. As fiduciaries, could brokers still earn a commission? Proposed legislation by the US Treasury would impose a fiduciary standard on brokers and empower the SEC to study compensation practices and prohibit those contrary to investors' best interests.

Tamar Frankel, a professor at Boston University School of Law, says commissions can exist in a fiduciary relationship – provided clients are informed about the fees they pay to their broker, as well as the fees the broker receives from other parties. "A fiduciary must earn a living," she says in a Wall Street Journal online article dated August 3, 2009.

Nancy Lininger, founder of The Consortium, provides her perspective on the issue: "While conflicts of interest may exist with commissions, client disclosure is the key. There are instances in which commissions can be less expensive than fees in the long run (for a buy-and-hold investor). Some investors need investment advice, albeit not financial planning or ongoing management services. A broker-dealer can serve as a fiduciary, because, in some instances, commissions are in the best interest of the client. A dual-registered firm can offer the best option based on client needs."

This article is composed of information from Nancy Lininger's *Compliance E-News*, dated August 29, 2009. Information about Lininger's publication and her many services for financial services professionals can be found at www.liftburden.com. The IAA may be located at www.investmentadviser.org, and a copy of Tittsworth's comments on fiduciary duty can be found in the publication *IA Watch*, dated August 17, 2009, and accessible at www.iawatch.com.