The Fiduciary Duty Of Investment Advisers – Understanding Its Murky Roots And A Guidepost

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The term “fiduciary” has received great attention in investment-services compliance recently. It should not be unexpected. There is discord surrounding the fiduciary obligation: the notion is at the foundation of investment adviser regulation, but the term “fiduciary” does not appear in the Investment Advisers Act (“Act”) nor in its Rules. Understanding how the fiduciary duty arrived in that central role helps to explain the lack of harmony in its investment-services-industry application, and also can help to navigate the duty’s requirements.

The law recognizes such a relationship of trust and commensurate responsibilities, a “fiduciary” role, in certain situations (e.g., lawyer-client, trustee-beneficiary). The fiduciary cannot engage in typical, arm’s-length market conduct towards his client, but must meet a higher standard corresponding with the well-being and trust placed in the fiduciary’s hands.[1]

But that duty found its way into the Act not because of what Congress explicitly stated there, but because the SEC and the courts concluded that Congress meant for it to be there. In a 1948 significant pronouncement, [2] the SEC stated unequivocally that an adviser “is a fiduciary,” with a duty “to act in the best interests of her clients”—due, in part, to learning the “personal and intimate details of the financial affairs” and making associated recommendations. (The SEC simultaneously noted those standards did not apply to broker-dealers without a “trust” relationship, a distinction causing discord 70 years later.)

However, it was not until 1963 that the United States Supreme Court established this conclusively. The case[3] involved an investment adviser purchasing specific securities shortly before recommending them to clients via a paid-subscription newsletter, and then selling those securities at a profit immediately after the rise in the market price and trading volume due to the recommendations (i.e., scalping), but without disclosure of the practice. The SEC successfully sought an injunction forcing that disclosure, with the Court focusing on the Act’s explicit prohibition against “fraud.” The Court observed that a typical, arm’s-length-relationship fraud case would require the actor to intend to both injure the victim and also actually cause harm. But the Court determined that this intent was not necessary in the investment-adviser context. The Act had been the last in a series of acts (e.g., the Securities Act of 1933, the Securities Exchange Act of 1934) designed to replace the caveat emptor philosophy with one of full disclosure, “thus to achieve a high standard of business ethics in the securities industry” following the 1929 stock market crash and 1930s’ Great Depression. The Court concluded the Act’s history and purpose (versus its actual language), “reflects a congressional recognition ‘of the delicate fiduciary nature of an investment advisory relationship.’” And so even if the adviser had intended to be honest and the security recommendations were made in good faith without malice towards the client, the adviser still must disclose the practice: it was the mere potential for abuse (the “conflict of interest”) that qualified as “fraud or deceit.” That is, the enhanced fiduciary duty/disclosure was imposed by operation of law (i.e., implied via the Court), and not the Act’s language.

Given that the Act’s “fiduciary” obligation is implied and not stated, it is not surprising that the investment-services industry still seeks clarity and harmony. Meanwhile, investment advisers should keep the basic fiduciary idea in mind: the client has placed its financial health in the adviser’s hands, and that trust deserves special treatment. A Director of the SEC Office of Compliance Inspections and Examinations once offered this singular guidepost: “even if advisory staff are not aware of specific legal requirements, if their decisions large and small and every day are motivated and informed by doing what’s right by the client, in all likelihood, the decision will be right under the securities laws.”[4]

[1] See, e.g., Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).
[2] In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948).
[3] Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

[4] Lori A. Richards, Speech by SEC Staff, Fiduciary Duty: Return to First Principles, Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006).

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