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Ethics and Fiduciary Duties in Investment Advisory

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Foundations of Ethical Standards in Investment Advisory

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Ethical Principles for Investment Advisers

Investment Advisors Representatives (IARs) have a fiduciary duty to their clients. This includes both a duty of loyalty and duty of care. Under your duty of loyalty, you must not put your needs above the needs of your clients. Under your duty of care, you must act as you would if you were in your client's position while maintaining your own knowledge and experience of the financial markets and investing.

As opposed to FINRA rule-based regulation, the SEC and State Securities divisions utilize a principle-based regulatory scheme.

What this means to you is that you have more flexibility but a higher level of obligation to develop and understand your compliance program while ensuring that it is designed to keep your firm compliant based on the principles of your fiduciary duties.

Foundations of Ethical Standards in Investment Advisory

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Historical Context and Evolution of Ethical Standards

- The Securities and Exchange Commission (SEC) is a U.S. government oversight agency responsible for regulating the securities markets and protecting investors.

- The SEC was established by the passage of the U.S. Securities Act of 1933 and the Securities and Exchange Act of 1934, largely in response to the stock market crash of 1929 that led to the Great Depression.

- The SEC can itself bring civil actions against lawbreakers and also works with the Justice Department on criminal cases.

The SEC's concept of principles-based regulation is not at all new. Broad rules have been set forth in the 1933, 1934, and 1490 Acts as well as in numerous rulemakings more recently. Where possible, we in the U.S. use principles to guide our actions. Then, our system of enforcement and the court system develop these principles into enforceable rules and standards over time.

Historical Context and Evolution of Ethical Standards

In recent years, the SEC has been making a move toward more “principles-based” regulation, in which regulatory guidance provides broad compliance principles and leaves regulated firms to figure out how to apply those principles to their own circumstances.

Regulators cannot conceive of every possible situation that may be important to investors, especially in the context of unique companies, so specific rulemaking runs the risk of leaving out valuable information.

Foundations of Ethical Standards in Investment Advisory

Overview of Professional Codes of Ethics

In August of 2004, The Securities and Exchange Commission adopted a new rule and related rule amendments under the Investment Advisers Act of 1940 that require registered advisers to adopt codes of ethics. The codes of ethics must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.

Among other things, the rule requires advisers' supervised persons to report their personal securities transactions, including transactions in any mutual fund managed by the adviser. The Commission also adopted amendments to rule 17j-1 to conform certain provisions to the new rule. The rule and rule amendments are designed to promote compliance with fiduciary standards by advisers and their personnel.

Fiduciary Duties and Responsibilities

Defining Fiduciary Duty in the Investment Advisory Context

The law has, for reasons that should be apparent, always held that persons in a position of the utmost trust (those whose decisions can materially impact the individual giving such trust) owe certain heightened duties for their protection. These are called fiduciary duties.

For an investment adviser, there are two principal duties the SEC is concerned with: the duty of care and the duty of loyalty.

In the RIA realm, the SEC has stated that its authority to enforce this rule in a regulatory setting comes from Section 206 of the 1940 Act. However, the duties described in this presentation are derived from federal case law. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979).

The law enforces these duties by several means:

- Civil liability (breach of fiduciary duty)
- Civil penalties (fines imposed, other official sanctions)
- Criminal penalties (gross violations of fiduciary duties – e.g. fraud, embezzlement, theft, etc.)

Fiduciary Duties and Responsibilities

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Defining Fiduciary Duty in the Investment Advisory Context

As an investment adviser, you are a fiduciary under federal law. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194

Other examples of fiduciaries include trustees, conservators, and personal representatives of an estate.

Other fiduciaries (i.e. a trustee) can be found liable for breach of fiduciary duty in cases where they were negligent in selecting qualified professionals (e.g. investment advisers, accountants, lawyers, etc.).

If a fiduciary uses reasonable diligence in selection, they cannot be liable for the negligence or malpractice of those professionals duly selected.

Fiduciary duties can never be waived through an agreement with the client.

Fiduciary Duties and Responsibilities

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Legal and Ethical Obligations to Clients

Per SEC guidance, the duty of care includes, but is not necessarily limited to since it's defined by case law, the following:

- The duty to provide advice that is in the best interest of the client
- The duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades
- The duty to provide advice and monitoring over the course of the relationship

Ethics represents internal system of controls, and Law refers to an external mechanism of control.

While the SEC has created guidance, it is up to the individual IAR to act in an ethical manner as a fiduciary.

Avoiding Conflicts of Interest and Ensuring Transparency

A conflict of interest is defined as "an interest that might incline an investment adviser - consciously or unconsciously - to render advice that is not disinterested." For financial firms, there is rarely a way to conduct business and completely avoid all conflicts of interest.

Recently, the SEC has been focused on investment adviser conflicts of interest and it comes on the heels of the SEC's recent investment adviser rulemaking, which was also focused on mandating disclosure of specific conflicts of interest. The SEC appears to continue its focus on making full and fair disclosure of conflicts of interest a priority in its oversight of investment advisers.

What does this mean to you?

For everything that you do in your business, you must always be thinking, "how do I benefit and are my client's interests being put above my own?"

Regulatory Framework and Compliance

Understanding the Investment Advisers Act of 1940

Financial advisers must adhere to the Investment Advisers Act of 1940, which calls on them to perform fiduciary duty and act primarily on behalf of their clients. The Act imposes upon the adviser the “affirmative duty of ‘utmost good faith’ and full and fair disclosure of material facts” as part of their duty to exercise client loyalty and care.

Investment advisers are required to pass a qualifying exam and register with a regulatory body as part of the Act.

The act is very specific in defining what a fiduciary means. It stipulates a duty of loyalty and duty of care, which means that the adviser must put their client's interests above their own.

For example, the adviser cannot buy securities for their account prior to buying them for a client (front-running) and is prohibited from making trades that may result in higher commissions for the adviser or their investment firm (churning). It also means that the adviser must do their best to make sure investment advice is made using accurate and complete information – basically, the analysis must be as thorough and as accurate as possible.

Additionally, the adviser needs to place trades under a "best execution" standard, meaning that they must strive to trade securities with the best combination of low-cost and efficient execution.

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Compliance Programs and Procedural Requirements

A compliance department typically has five areas of responsibility:

- Identification
- Prevention
- Monitoring and Detection
- Resolution
- Advisory

A compliance department identifies risks that an organization faces and advises on how to avoid or address them. It implements controls to protect the organization from those risks. Compliance monitors and reports on the effectiveness of controls in the management of the organization's risk exposure. The department also resolves compliance issues as they arise and advises the business on all rules and controls.

Client Communications and Disclosures

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Best Practices in Client Communications

Client communications must not only be truthful, but they also cannot be misleading.

As a fiduciary, you owe your client any information that you yourself would want in order to make an informed decision.

Written client communications must be archived and reviewed by the Chief Compliance Officer or their designee.

Client Communications and Disclosures

Full and Fair Disclosure Obligations

The SEC recently passed a marketing rule that is very clear about what information may be included in the marketing of your firm and the transparency that is required.

Further, your Form ADV Part 1A, 2A, 2B, and 3(CRS) serve as your firm's disclosure documents that must be provided prior to opening a new investment advisory account, when there are material changes, or, at minimum, annually.

Handling Material Nonpublic Information

The SEC regulation SP outlines advisors' obligations to investors regarding the handling of their non-public information (Personally Identifiable Information "PII").

PII is defined as: Any representation of information that permits the identity of an individual to whom the information applies to be reasonably inferred by either direct or indirect means.

Although each state defines PII by statute, they're generally substantively similar. Below is California's definition:

"Personal information" means any information that identifies, relates to, describes, or is capable of being associated with, a particular individual, including, but not limited to, his or her name, signature, social security number, physical characteristics or description, address, telephone number, passport number, driver's license or state identification card number, insurance policy number, education, employment, employment history, bank account number, credit card number, debit card number, or any other financial information, medical information, or health insurance information.

Risk Assessment and Risk Tolerance Evaluation

Every IAR has an obligation to understand each individual client’s needs, values, and risk tolerance.

Generally, this includes an investor profile that includes net worth, liquid net worth, risk tolerance, time horizon, objectives, and family or entity structure.

For an RIA, how this information is gathered is not prescribed. However, it is important that you document what information you have obtained to determine the advice you are giving each client.

Risk Management and Suitability

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Suitability of Investment Advice

The advice you give each client must be tailored to their investor profile.

The advice must be in their best interest, and it must be tailored to their individual risk tolerance and objectives.

Case Studies: Navigating Suitability and Risk Dilemmas

John has a client, Bob. Bob is 73 years old. Bob is still in good health, but he has never really understood investing. Luckily, he was required to save through his company's 401(k) program and now he retired 3 years ago with $1.2 million in his IRA. When Bob became a client, he completed a risk tolerance/investor profile worksheet. The results were that Bob's risk tolerance is moderate. Bob has begun taking his RMDs and therefore needs annual liquidity.

Bob comes into John's office and tells him that his neighbor earned 25% return last year by purchasing 100% clean energy stocks. Bob's returns, while good, were only 8% last year. He asks John to sell all of his conservative positions and put his IRA money 100% into clean energy equity. He wants him to do it today, or he is going to leave and he will find another advisor who will do it for him.

Case Studies: Navigating Suitability and Risk Dilemmas

Sarah meets with a prospect, Linda, and asks Linda to complete a risk profile questionnaire. The questionnaire asks, "What is the rate of return that you would like to get in your portfolio?" Linda answers, "20%." The next question asks, "What would you do if you experienced 10% loss in your portfolio?" Linda answers, "Sell everything."

Sarah then opens the account and places Linda in an aggressive growth portfolio.

Case Studies: Navigating Suitability and Risk Dilemmas

Chad sits down to meet with Zach. Zach tells Chad that he earned $2.5 million when he sold his startup sunglasses business. He plans to reinvest a million dollars into his next business but wants to give Chad $500,000 for an aggressive portfolio.

Chad wants to impress Zach, so he opens a portfolio and puts half of the portfolio into leveraged exchanged traded funds. Chad leaves those positions for six months.

Managing Conflicts of Interest

Identifying Potential Conflicts of Interest

Some examples of conflicts of interest are:

a. Proprietary Products: Investments that are issued, sponsored, or managed by you or your affiliates.

b. Third-Party Payments: Compensation you receive from third parties when you recommend or sell certain investments.

c. Revenue Sharing: Investments where the manager or sponsor of those investments or another third party (such as an intermediary) shares with you the revenue it earns on those investments.

d. Principal Trading: Investments you buy from a retail investor, and/or investments you sell to a retail investor, for or from your own accounts, respectively.

There may be others. It is important to consider conflicts of interest with each and every aspect of your business.

Managing Conflicts of Interest

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Mitigation and Management Strategies

Some conflicts of interest may be managed and disclosed such as investing in the same security as your clients. This can be achieved by utilizing block-trading.

Other conflicts of interest may not be managed away. An example of this would be a client investing in your advisory firm.

Each conflict is unique and should be analyzed and documented appropriately.

Ethical Decision-Making in Practice

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Frameworks for Ethical Decision-Making

For each and every decision that you make as it relates to your clients or their investments, you must think about your duty to the client and if your action will be in service of that duty.

If you are in doubt, that decision is probably not one that you want to take. When you have questions, you should always take them to your compliance team. They can help you make a sound decision in service of your license and the firm's interest.

Ethical Decision-Making in Practice

Applying Ethical Reasoning to Complex Scenarios

Mike and Tom own an RIA firm. They are looking to grow the firm and are seeking partners to raise capital and increase their marketing budget.

One of their wealthier clients, Kevin, is looking for new investment opportunities outside of the market. Mike suggests that Kevin could invest $250,000 for a 10% share in the RIA.

Developing an Ethical Corporate Culture

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Leadership and the Promotion of Ethical Standards

Compliance officers within the compliance department have a duty to their employer to work with management and staff to identify and manage regulatory risk. Their objective is to ensure that an organization has internal controls that adequately measure and manage the risks it faces. Compliance officers provide an in-house service that effectively supports business areas in their duty to comply with relevant laws and regulations and internal procedures.

Ethical leadership at the top encourages an ethical organization.

Developing an Ethical Corporate Culture

Creating and Enforcing an Ethical Workplace

When the executive team supports an ethical and compliant organization through both example and enforcement, the organization will flourish.

If an individual questions a firm's CEO's ethical decision making, this will lead to others in the firm making poor decisions.

However, if bad actors are not tolerated, this too will send a strong message.

Training and Development for Ongoing Ethical Competence

Firms should provide every member of their staff ongoing training and development in ethical decision making.

Courses are provided by a number of third-party vendors, however, modeling good behavior is the best path forward.

Technology's Impact on Ethical Investment Practices

In the modern world, most communications are electronic, and these communications must be monitored carefully by supervisors of the firm.

Occasionally, a supervisor may uncover an issue that is not yet a rule violation, but it doesn’t “feel” right. It is important that these issues be addressed immediately to avoid escalation.

AI seems to be the future and an important technology, and its use must be monitored and supervised appropriately.

Enforcement and Sanctions

Regulatory Enforcement Actions and Case Law

Back to our prior example where Sarah invested Linda outside of her investment profile. What happened?

Linda's portfolio, as could be expected, dropped 20% midyear during an election year. Linda was shocked and found a lawyer. Once the claim was received, Sarah's compliance department reported the compliant as required. While Sarah was dealing with this customer dispute, the SEC opened an investigation into Sarah's actions with Linda's account. The SEC wanted to see all of Sarah's client's accounts for the past 3 years and each one's risk profile for their investigation.

Ultimately, Sarah and her firm settled the complaint with Linda and her attorney for $100,000. However, the SEC also determined Sarah's decision was not suitable, and she settled with the SEC for a two-week suspension and a $10,000 fine.

Enforcement and Sanctions

Consequences of Ethical Breaches and Non-Compliance

Not only could a poor decision put your career in jeopardy, but it could also damage your reputation.

Each year, investment advisors are barred in the industry by the SEC or state regulators.

Even more IARs lose credibility with clients and prospects due to perceived self-interested decisions.

Questions?