Forthcoming in RESEARCH HANDBOOK ON MUTUAL FUNDS (John D. Morley & William A. Birdthistle, eds.) (Elgar Publishing)

The Fiduciary Structure of Investment Management Regulation

Arthur B. Laby[*]

Draft – September 2016

I. Introduction

The mutual fund industry is enormous, dynamic, and growing. At the end of 2014, assets in investment companies registered with the U.S. Securities and Exchange Commission ("SEC" or "Commission") exceeded $18 trillion. There are over 16,000 registered funds and, as of January 2015, SEC-registered investment managers numbered approximately 11,500. Another 2,845 managers, although not registered, must file reports with the Commission. The industry is developing new products, such as new forms of exchange-traded funds and alternative or "alt" funds, and it is increasingly using derivatives and other alternative strategies.[1]

Regulatory developments in the fund industry garner significant attention from lawyers, academics, and others, but little attention is paid to the underlying structure of investment management regulation. What are regulators trying to achieve, and what are their primary concerns? This Chapter addresses one aspect of these questions – the relationship between investment managers' fiduciary obligation and regulators' efforts to control the investment management industry through rules and enforcement actions that comprise much of investment management law.

An investment manager owes a fiduciary obligation to clients, including both institutional clients, such as mutual funds, and individual clients, such as retail investors. The fiduciary obligation includes duties of loyalty and care. A persistent question is what precisely is required by these duties. What does loyalty mean in the fiduciary context? How can one ensure loyalty to a principal? Similarly, under the duty of care, an investment manager might ask about the amount of diligence to be undertaken on a client's behalf with regard to management of client assets. How much time and effort must an investment manager expend to satisfy the duty of care? These questions have no clear answers. To reply that an investment manager must use reasonable efforts, or act as a reasonably prudent professional, hardly provides meaningful guidance.

In this Chapter, I shall argue that much of investment management law is a response by regulators to the uncertainties inherent in the fiduciary obligation. The claim

---

[*] Professor, Rutgers Law School; Co-Director, Rutgers Center for Corporate Law and Governance. I am grateful to William Birdthistle, Jay Feinman, Robert Plaze, and Eric Roiter for comments.

[1] *See* Investment Company Reporting Modernization, Investment Company Act Release No. 31610, 80 Fed. Reg. 33590, 33591-92 (June 12, 2015).

is that regulators design investment management law to guide investment managers regarding the proscriptions imposed by the duty of loyalty and the diligence required by the duty of care. On one issue after another, regulators attempt to specify what precisely is required of investment managers in the context of exercising their fiduciary duty to clients.

Regulators specify the fiduciary duty through agency rulemaking, agency enforcement actions, and other formal and informal statements offered by agency officials. As to rulemaking, the Investment Advisers Act of 1940 authorizes the SEC to adopt rules to guard against fraud and the SEC has used this authority to prescribe detailed conduct for investment managers. In many cases, the SEC has outlined specific steps managers must take in carrying out their fiduciary responsibility. Absent these steps, the SEC will consider a manager to have breached its fiduciary duty and to have engaged in fraudulent conduct. Examples discussed below include requirements to disclose information, vote proxies for shares held by clients, and establish compliance policies and procedures. In each context, the SEC uses its rulemaking authority to outline specific steps managers must take to fulfill their fiduciary obligation.

The second way regulators address an investment manager's fiduciary duty is through agency enforcement actions. The Advisers Act is the primary federal statue regulating investment managers. Although there is only a limited private right of action under the Advisers Act,[2] the SEC and the Department of Justice ("DOJ") actively enforce the law.[3] Moreover, under the Advisers Act, mere negligent conduct is sufficient for fraud liability.[4] Thus, if the SEC deems an investment manager's conduct, or lack of conduct, to be inappropriate, the SEC can bring an enforcement action under the negligence provision of the Advisers Act's antifraud section.[5] With negligence as the standard, such cases often are not difficult to prove.

Moreover, the vast majority of SEC actions settle,[6] resulting in an SEC statement or Order reviewing the misconduct and explaining that it is inconsistent with the Advisers Act. Such SEC statements, while not packing the same legal punch as litigated cases, are followed closely by members of the investment management bar, who counsel investment managers and funds on their behavior. Such statements are also followed by industry groups, which prepare best practices and other industry guidance drawn in large part from settled actions. The Commission, therefore, uses the potent weapon of an

---

[2] Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11, 24 (1979).

[3] *See* SEC, AGENCY FINANCIAL REPORT: FISCAL YEAR 2015 154-56.

[4] SEC v. Capital Gains Research Bur., Inc., 375 U.S. 180, 195 (1963) (quoting Investment Advisers Act § 206(2)).

[5] The SEC can enforce an investment adviser's fiduciary duty through Adviser Act section 206. Section 206(1) requires a showing of intent; section 206(2) requires a showing of negligence. SEC v. Steadman, 967 F.2d 636, 641-43 & n.5 (D.C. Cir. 1992).

[6] JAMES D. COX, ET AL., SECURITIES REGULATION: CASES AND MATERIALS 834 (2013) ("Most SEC enforcement proceedings (over 90 percent) are settled, not litigated.").

enforcement action to announce to the industry the level of conduct the SEC believes is consistent with investment managers' fiduciary obligation.

Viewing investment management law as I propose in this Chapter leads to an important insight and challenges an alternative view of the fiduciary obligation. Some writers claim that detailed rules prescribing or proscribing conduct effectively displace fiduciary duties. According to this approach, regulators prepare conduct rules as an alternative to detailed duties.[7] Under this approach, once Congress or the SEC has spoken on a topic, there is no place for fiduciary duties, which serve to fill a gap in the *absence* of detailed rules. This Chapter demonstrates that, far from being an alternative to the fiduciary obligation, investment management law serves to explicate what the fiduciary obligation entails. Such rules are not a substitute for the fiduciary duty; they compose its essence.

This Chapter proceeds as follows. Part II describes the fiduciary duties of loyalty and care. It explains how the duties differ as well as the need to specify what they entail. Part III demonstrates that investment management law, both administrative rules and agency enforcement actions, explicate and instantiate what is required by the fiduciary duties of loyalty and care. Part IV examines the alternative view that detailed rules displace fiduciary duties, and it explains why the better view is that rules and enforcement actions, which form the substance of investment management law, clarify what is required of a fiduciary. Part V concludes.

II. The Fiduciary Duties of Loyalty and Care

Although disagreement exists over the definition of a fiduciary relationship, for purposes of this Chapter, a fiduciary duty generally arises when one person agrees to act on behalf of and for the benefit of another.[8] Investment managers typically owe a fiduciary duty to their clients. Over 50 years ago, the U.S. Supreme Court, in *SEC v. Capital Gains Research Bureau, Inc.*, stated that investment managers must adhere to a strict fiduciary standard, including a duty of utmost good faith, full and fair disclosure of material facts, and an obligation to use reasonable care to avoid misleading clients.[9]

---

[7] *See* Mercer Bullard, *The Fiduciary Study: A Triumph of Substance over Form?*, 30 REV. OF BANKING & FIN. L. 171, 175 (2011). As discussed below, this is arguably the approach taken in the United Kingdom. *See infra* note 130 and accompanying text.

[8] *See* Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99, 129-37 (2008); Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 542 (1997) (describing the fiduciary duty as one of unselfishness). The definition of fiduciary and a determination of when fiduciary duties arise are controversial but that controversy need not detain us here because, as discussed below, investment managers are generally considered fiduciaries to their clients.

[9] *Capital Gains*, 375 U.S. at 194.

A. Duties of loyalty and care

1. Differentiating loyalty from care

The fiduciary obligation divides neatly into the duty of loyalty and the duty of care.[10] This division is based in part on the risks attendant to fiduciary relationships. The relationship exposes the principal to a risk of malfeasance, such as misappropriation, and to a risk of nonfeasance, such as neglect. The duty of loyalty addresses the risk of the first; the duty of care addresses the risk of the second.[11]

The duty of loyalty, therefore, is largely negative. It is a duty to prevent misconduct, refrain from self-interested behavior, and avoid conflicts of interest.[12] Under "Duty of Loyalty," the *Restatement (Second) of Trusts* states that a fiduciary must not profit at the beneficiary's expense and must not compete with the beneficiary without consent.[13] By contrast, the duty of care is largely positive. It is a duty to pursue the beneficiary's interests with diligence and skill, and it mandates good behavior.[14] The *Restatement (Third) of Agency* states that an agent has a duty of care, competence, and diligence normally exercised by agents in similar circumstances.[15] The *Restatement* explains that the duty of care expressed in section 8.08 is a duty to make reasonable efforts to achieve a result.[16] An investment adviser, for example, has a duty to clients to undertake a reasonable investigation before providing information to investors.[17]

The negative component of the duty of loyalty and the positive component of the duty of care form the keystone of the Prudent Investor Rule, which governs the investment of trust funds.[18] According to the *Restatement (Third) of Trusts*, the duty of loyalty in trust law prohibits the trustee from investing or managing trust assets in a way that will lead to a conflict of interest.[19] The duty of care requires the trustee to exercise reasonable effort and diligence in making and monitoring investments, paying attention

---

[10] Air Line Pilots Ass'n Int'l v. O'Neill, 499 U.S. 65, 75 (1991) (explaining that the fiduciary duty consists of a duty of care and a duty of loyalty).

[11] Robert Cooter and Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1047 (1991).

[12] *See* Deborah A. DeMott, *Disloyal Agents*, 59 Ala. L. Rev. 949, 952 (2007); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1406-11 (2002); Julian Velasco, *A Defense of the Corporate Law Duty of Care*, 40 J. CORP. L. 647, 664 (2015).

[13] RESTATEMENT (SECOND) OF TRUSTS § 170 CMT. A (2012); *see* Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75, 100-106 (2004).

[14] Velasco, *supra* note 12 at 664.

[15] RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).

[16] *Id.* at § 8.08 CMT. D.

[17] *See* SEC v. Blavin, 557 F. Supp. 1304, 1314 (E.D. Mich. 1983), *aff'd*, 760 F.2d 706 (6th Cir. 1985).

[18] *See* RESTATEMENT (THIRD) OF TRUSTS § 90 (2007).

[19] *See Id.* at § 90 CMT. C.

to the trust's objectives.[20]

The Prudent Investor Rule can be traced to the 1830 case of *Harvard College v. Amory*.[21] The court in that case stated that trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds . . . ."[22] As should be apparent, neither the positive nor the negative formulation of the fiduciary duty, nor the Prudent Investor Rule, provides clear guidance for investment managers who seek to satisfy their fiduciary obligation.

2. The need to specify the duties of loyalty and care

The term "fiduciary duty" lacks clarity and its meaning often depends on context.[23] The 2009 edition of *Black's Law Dictionary* observes that "fiduciary" is a "vague term, and it has been pressed into service for a number of ends."[24] As the Supreme Court famously remarked in *SEC v. Chenery*, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry."[25] This uncertainty holds true for both the duty of loyalty, which is primarily negative, and the duty of care, which is primarily positive. Each presents challenges in specifying the duties that an investment manager must perform in the asset management context.

a. The duty of loyalty

The fiduciary duty of loyalty is more precise than the duty of care in terms of what it demands of the fiduciary: Do not engage in theft, fraud, or self-dealing; avoid conflicts of interest, or if a conflict of interest cannot be avoided, it must be disclosed. Notwithstanding the precise nature of the obligation, enforcement of the duty of loyalty poses problems because of the subtle opportunities that arise for theft or self-dealing, and because conflicts of interest can affect a fiduciary's conduct in ways he or she might not fully understand. The U.S. Supreme Court recognized this difficulty in *Capital Gains*, stating that the Advisers Act reflects Congressional intent to eliminate or, at a minimum,

---

[20] *Id.* at CMT. D.

[21] Harvard College v. Amory, 26 Mass. 446 (Mass. 1831); *See* RESTATEMENT (THIRD) OF TRUSTS, Prudent Investor Rule, General Note (describing origin of Prudent Investor Rule).

[22] *Harvard College*, 26 Mass. at 461.

[23] Wall Street and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations, Hearings Before the S. Subcomm. on Crime and Drugs, 111th Cong. 1 (2010) (statement of Larry E. Ribstein, Mildred Van Voorhis Jones Chair, University of Illinois College of Law) ("'Fiduciary duty' is one of the most amorphous concepts in the law."); Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 456 (2010) ("[A]n open-ended broker fiduciary obligation is so loaded with unanswered questions that baseline predictability would come slowly, if at all.").

[24] Fiduciary, BLACK'S LAW DICTIONARY 702 (9th ed. 2009) (quoting D.W.M. Waters, *The Constructive Trust: The Case for a New Approach in English Law* 4 (1964)); *see also* Velasco, *supra* note 12 at 664.

[25] SEC v. Chenery, 318 U.S. 80, 85-86 (1942).

to expose conflicts of interest that could lead an adviser "consciously or unconsciously" to provide conflicted advice.[26]

Subtle temptations to engage in deception offered in fiduciary relationships are well recognized. Courts respond by imposing prohibitions to ensure that an investment manager, who is tempted by wrongdoing, or who might unconsciously step over the line, is unable to do so. A persistent theme in fiduciary relationships is the high cost of detecting whether and when a fiduciary will engage in misappropriation.[27] In *U.S. v. Chenery*, the Supreme Court stated that corporate position and access to information present temptations to wrongdoing. The law can only address such temptations through prohibitions unconcerned with the fairness of a transaction.[28]

The concern over temptation is particularly severe when an investment manager has discretion over investment assets. When a manager has discretion, the manager has authority to make investment decisions on a client's behalf without notifying the client in advance.[29] John Langbein has explained that a trust relationship places trust beneficiaries at the mercy of the trustees' misconduct, such as misappropriation and mismanagement, and that trust law's central concern is to guard against such dangers.[30]

Langbein further explained that as trustees have gained additional discretionary authority over trust assets, fiduciary law has replaced old safeguards, such as limitations on investments and disempowering trustees from engaging in particular conduct. Discretion presents risk of harm as well investment opportunity. The fiduciary duties of loyalty and care, according to Langbein, developed to replace former restrictions on trustees and serve to protect investors from abuse.[31] But this development leaves open the question of which conduct should be prohibited, or limited, by the fiduciary duty of loyalty. The legal list of acceptable investment assets, while providing clarity, is an historical artifact.[32] A general injunction to act in a client's best interest, however, is insufficient guidance to navigate the duty of loyalty.

b. The duty of care

The duty of care is different from the duty of loyalty and even more prone to uncertainty. The duty of care is generally positive; it focuses on process and the diligence

---

[26] *Capital Gains*, 375 U.S. at 191-92.

[27] *See, e.g.*, Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1217-18 (1995); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. AND ECON., 425, 427 (1993).

[28] *Chenery*, 318 U.S. at 92; *see also* Reading v. Regum, [1948] 2 All ER 27 (explaining that agent must disgorge his profits regardless of whether the principal has lost profit or suffered any other damage).

[29] Securities Exchange Act of 1934, § 3(a)(35), 15 U.S.C. § 78c(a)(35) (2012).

[30] John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 629 (1995).

[31] *Id*. at 642.

[32] HARVEY E. BINES & STEVE THEL, INVESTMENT MANAGEMENT LAW AND REGULATION 15 (2d ed. 2004).

a fiduciary must undertake.[33] Some situations require more process than others.[34] Under Duties of Care, the *Restatement (Third) of Agency* explains that the duty of diligence is a duty to make "reasonable efforts" to achieve a result as opposed to a duty to achieve the result regardless of the effort expended. As long as an agent makes "reasonable" efforts, the agent will not be subject to liability even if the agent does not achieve the principal's desired objectives.[35]

The difficulty lies in specifying what is "reasonable." Corporate law cases recognize that a director's duty to be informed does not require the director to have detailed knowledge about all facets of the corporation's business.[36] In *Barnes v. Andrews*, Judge Learned Hand stated that a director's duty to pay attention to the corporation's affairs is "uncertain." He remarked that courts content themselves with vague statements, for example, a director must give reasonable attention to the corporation's affairs.[37] Legal tests in a variety of contexts ask whether an individual is "fully informed" of all relevant facts.[38] A state of being "fully informed," however, is difficult to achieve. The complete truth on any topic is unknowable or would take weeks or months of explanation.[39]

The uncertainty inherent in the fiduciary duty of care is one reason the duty is seldom enforced. Although the duty of loyalty is often enforced aggressively, fewer cases allege breach of the duty of care.[40] In the corporate law context, the lack of duty of care cases might be due to the presence of the business judgment rule: the business judgment rule often protects directors from allegations of a lack of due care.[41] The business judgment rule, however, is generally inapplicable outside of corporate law. Trust law, for example, lacks an analog to corporate law's business judgment rule.[42] And investment managers can be liable for breach of the duty of care in a variety of contexts.[43] But care

---

[33] *See* Velasco, *supra* note 12 at 664 (2015); Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

[34] Velasco, *supra* note 12 at 666.

[35] RESTATEMENT (THIRD) OF AGENCY § 8.08 CMT. D (2006).

[36] *See* In re Caremark Int'l, Inc., 698 A.2d 959, 972 (Del. Ch. 1996).

[37] Barnes v. Andrews, 298 F. 614, 615 (S.D.N.Y. 1924); *see also* BINES & THEL, *supra* note 32 at 24.

[38] U.S. v. O'Brien, 18 F. Supp. 3d 25, 32 (D. Mass. 2014) (judicial recusal standard); Campbell Harrison & Dagley L.L.P. v. Lisa Blue/Baron and Blue, 843 F. Supp. 2d 673, 688-89 (N.D. Tex. 2011) (client release in attorney-client relationship).

[39] SISSELA BOK, LYING: MORAL CHOICE IN PUBLIC AND PRIVATE LIFE 4 (1999); *see* Laby, *supra* note 13 at 114-16.

[40] *See* BINES & THEL, *supra* note 32 at 24; *see also* Christopher M. Bruner, *Is The Corporate Director's Duty of Care A "Fiduciary" Duty? Does it Matter?*, 48 WAKE FOREST L. REV. 1027, 1029 (2013).

[41] Velasco, *supra* note 12 at 649; *see* Bruner, *supra* note 40 at 1030.

[42] *See* Howard v. Shay, 100 F.3d 1484, 1489 (9th Cir. 1996) ("The business judgment rule is a creature of corporate, not trust, law."); *see also* Melanie Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 96, 99 (2005) ("Courts adjudicating [trust law] cases alleging breach of the duty of care never developed a doctrine analogous to the business judgment rule.").

[43] *See, e.g.*, SEC No-Action Letter, Institutional Shareholder Services, Inc., pub. avail., Sept. 15, 2004 (proxy voting context.).

cases are seldom brought because of the difficulty in proving that what the manager *failed* to do was the cause of harm.

The investment manager's fiduciary duty, composed of the duties of loyalty and care, is imprecise. The fiduciary obligation alone does not provide an investment manager with certainty about what behavior is prohibited by loyalty or prescribed by due care. A well-functioning regulatory scheme requires more clarity than a general directive to act in another's best interest.[44]

III. Mapping Investment Managers' Fiduciary Obligation

Investment managers are fiduciaries, subject to the duties of loyalty and care discussed above. An investment manager's fiduciary obligation is embodied in Advisers Act section 206, the general antifraud provision of the Act. Unlike section 10(b) of the Securities Exchange Act of 1934, Advisers Act section 206(2) is considered more than an antifraud provision; it is viewed as establishing a fiduciary duty for advisers.[45] The fiduciary duty is imposed on investment managers because of the nature of the relationship between the manager and the client, including a fund client, and it is enforced through section 206 of the Advisers Act.[46]

Under the regulatory scheme outlined above, investment managers owe clients a fiduciary duty absent SEC rules governing the investment management industry. Thus, in substantive areas, such as disclosure, proxy voting, and custody, managers would be required to exercise their fiduciary duty even if no relevant rule were adopted. By adopting rules and prosecuting enforcement actions, however, the SEC fills in the details of what is required by the fiduciary duties of loyalty and care, and brings uniformity to the industry.

As a result of the SEC's activity, investment managers generally know how to behave and clients know what to expect. Although a client might bargain for additional protections, administrative rules provide a fiduciary floor – rules that managers must follow. In other words, requirements set forth in applicable rules help clarify a manger's fiduciary responsibilities, and failure to follow them often constitute an independent breach of fiduciary duty.

---

[44] *Cf.* REINIER KRAAKMAN, ET AL., THE ANATOMY OF CORPORATE LAW 103 (2d ed. 2009) (stating that "the injunction to boards to pursue their corporations' interests is less a species of equal sharing than, at best, a vague counsel of virtue, and, at worst, a smokescreen for board discretion.").

[45] *See* Morris v. Wachovia Sec., Inc., 277 F. Supp. 2d 622, 644 (E.D. Va. 2003). For an historical discussion of how this view arose *see* Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051 (2011).

[46] *See generally* Arleen W. Hughes, Exchange Act Release No. 4048, (Feb. 18, 1948), *aff'd sub. nom*. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); *see also* Robert E. Plaze, Regulation of Investment Advisers by the U.S. Securities and Exchange Commission, Oct. 2015, at 30, *available at* http://www.stroock.com/siteFiles/PAFile120.pdf.

A. Rules

Rules governing a profession or an industry are often detailed prescriptions or proscriptions, which put individuals on notice, ex ante, of what they can and cannot do. Rules are contrasted with standards, which also govern behavior, but which typically provide a general sense of what is required and leave discretion, ex post, for adjudicators to determine whether a violation has occurred.[47] In some contexts, standards are preferable. Specific regulation might be harmful and render decision-making wooden and not necessarily in investors' best interest.[48] In those cases, standards are necessary to instruct a manager that he must act in the investor's best interest but provide the manager with the flexibility to exercise discretion as appropriate.[49]

Consider, for example, regulation of an investment manager's discretion regarding securities selection. It would be difficult to specify exactly what an investment manager must do before deciding whether to buy or sell one security or another. By contrast, there are many areas where regulators can and do require minimum conduct necessary to fulfill the fiduciary duties of loyalty and care. I shall provide three examples to illustrate how regulators prescribe for investment managers what the fiduciary duty entails.

1. Disclosure

An investment manager's duty to disclose can be viewed as arising under both the duty of loyalty and the duty of care, depending on the context.[50] When a manager discloses information to address a conflict of interest, the manager is disclosing information to ensure that it refrains from fraudulent conduct.[51] As a result, one can view such disclosure as a means to satisfy the fiduciary duty of loyalty. Recall that the duty of loyalty is primarily negative – a duty to avoid self-dealing and conflicts of interest. Thus, to the extent disclosure addresses a conflict, one can place the disclosure squarely under the duty of loyalty. By contrast, when a manager discloses information about the manager and its business, which allows a client to decide whether to select the adviser, one can place the disclosure under the fiduciary duty of care.[52]

---

[47] *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); KRAAKMAN, ET AL., *supra* note 44 at 39-40; *see also* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976). A large body of work, including the articles cited here, discusses rules versus standards. The issues are complex and assessing them in detail is not necessary for my analysis.

[48] *Cf.* Velasco, *supra* note 12 at 668.

[49] *Cf. id.*

[50] *See, e.g.*, Bd. of Trs. of AFTRA Ret. Fund v. JPMorgan Chase Bank, N.A., 806 F. Supp. 2d 695 (S.D.N.Y. 2011) (duty of prudence and care); Metro Commun. Corp. BVI v. Advanced Mobilecomm Tech., Inc., 854 A.2d 121, 157 (Del.Ch. 2004) (a "duty of disclosure" is a component of the fiduciary duty of loyalty).

[51] *See* Plaze, *supra* note 46 at 31.

[52] I recognize that the line can blur. Disclosure about the manager's business, which also references a conflict, might move the disclosure back to the duty of loyalty.

In either case, a difficult consideration for any investment manager is what types of facts must be disclosed and what level of detail is necessary. Provide too little information and an investor will have insufficient data to determine whether to engage a particular asset manager or consent to a conflict of interest. Provide too much information and the investor will be buried under an avalanche of useless data, unable to separate the wheat from the chaff.[53]

In responding to the question of what information must be disclosed, one might point to the SEC's injunction to disclose all facts material to an engagement and avoid misleading clients.[54] The problem, of course, lies in the definition of "material." Materiality turns on whether there is a "substantial likelihood" that a reasonable client would consider the information important.[55] There are no clear rules regarding materiality; it is a "facts and circumstances" test.[56] In its discussion of materiality, the SEC concluded that it is not appropriate to define materiality or provide a bright line test.[57]

In the absence of a definition of materiality, the SEC has adopted detailed rules describing the information an investment manager must disclose. The Commission has set forth these requirements in Part 2 of Form ADV, the general registration form for investment managers that register with the SEC. Part 2 of the form is the section designed for, and delivered to, clients.[58] Form ADV Part 2 includes detailed categories of information that must be disclosed, such as fees and compensation (Item 5), types of clients (Item 7), methods of analysis (Item 8), disciplinary information (Item 9), and brokerage practices (Item 12). The form elucidates additional information that must be disclosed within each category. Under disciplinary information, for example, the form sets forth in detail particular criminal actions, civil actions, administrative proceedings, and self-regulatory organization proceedings that the adviser must reveal. (Item 9).

---

[53] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976) (expressing the concern that "bury[ing] the shareholders in an avalanche of trivial information" is "a result that is hardly conducive to informed decisionmaking."); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 160 (2006) (explaining that too much information can result in confusion, cognitive strain, and poor decision-making, and is worse than receiving too little information).

[54] *See Capital Gains*, 375 U.S. at 200; Arleen W. Hughes, Exchange Act Release No. 4048.

[55] *TSC Indus.*, 426 U.S. at 449; Sullivan v. Chase Inv. Serv. of Boston, Inc., 79 F.R.D. 246, 259 (N.D. Cal. 1978); *see also* Amendments to Form ADV, 75 Fed. Reg. 49234, 49237 n.35 (Aug. 12, 2010).

[56] *See, e.g.*, In re Moody's Corp. Sec. Litig., 274 F.R.D. 480, 489 (S.D.N.Y. 2011) ("materiality is not definitively established by an impact on price alone, rather it is an inquiry that looks at all the facts and circumstances of a particular case.").

[57] *Id.*

[58] Part 1 of Form ADV, although publicly available, is designed to assist the SEC with the regulation of asset managers; it is not designed with client needs in mind.

The SEC has clarified that an investment manager has a fiduciary obligation to disclose material information to clients, and that failure to make such disclosure can result in a violation of the Advisers Act.[59] Form ADV's detailed requirements specify the disclosure necessary for the investment manager to fulfill its fiduciary duty. According to the instructions prepared by the SEC, "much of the disclosure required in Part 2A addresses an adviser's conflicts of interest with its clients, and is disclosure that the adviser, as a fiduciary, must make to clients in some manner regardless of the form requirements."[60] Thus, disclosure required by Form ADV is meant to codify an adviser's fiduciary obligation, not displace it.

According to the SEC, an investment manager can use the disclosure statement required by Form ADV Part 2 to satisfy its fiduciary duty to disclose information to clients.[61] This stance regarding the relationship between investment manager's fiduciary duty and the SEC's disclosure rules is not new. When the SEC adopted a predecessor rule, Advisers Act Rule 206(4)-4, it stated that the rule was intended to "codify" an investment manager's fiduciary duty to disclose material facts to clients regarding financial and disciplinary information.[62]

The SEC has explicitly instructed advisers that the detailed disclosures required by Form ADV Part 2 do not displace an ongoing fiduciary obligation. Instructions to completing the Form ADV state as follows:

> Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them. To satisfy this obligation, you therefore may have to disclose to clients information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require.[63]

That the SEC's rules codify an investment manager's fiduciary duty is made plain by the SEC's attitude toward investment advisory relationships not covered by the disclosure rules. The Commission has clarified that investment managers owe a general

---

[59] Amendments to Form ADV, 75 Fed Reg. at 49240 and n.89.

[60] *Id.* at 49236.

[61] *Id.* at 49234-35.

[62] Financial and Disciplinary Information That Investment Advisers Must Disclose to Clients, Investment Advisers Act Release No. 1035 (Sept. 19, 1986), 51 Fed. Reg. 34229 (Sept. 26, 1986).

[63] Amendments to Form ADV, General Instructions for Part 2 of Form ADV, 75 Fed. Reg. 49234, Appendix C.

duty to disclose financial and disciplinary information to clients, including clients to whom they are not required to deliver the specific information set forth in its rules. This clarification demonstrates that an investment manager's fiduciary duty is universal, that the duty includes a requirement to disclose financial and disciplinary information, and that the SEC, using its regulatory authority, has set forth what is entailed for an adviser to satisfy its fiduciary duty of disclosure.[64]

The SEC staff has made the same point in another disclosure context. Investment Advisers Act section 206(3) addresses an adviser's trading as a principal with advisory clients.[65] The provision prohibits an adviser from trading as a principal absent written disclosure and consent. Although the provision is quite specific, the staff has explained in a no-action letter that the statutory language is not a complete statement of an adviser's fiduciary duty in this context. According to the SEC staff:

> While section 206(3) of the Investment Advisers Act of 1940 ("Act") requires disclosure of such interest and the client's consent to enter into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent. The adviser must have a reasonable belief that the entry of the client into the transaction is in the client's interest.[66]

Thus, the disclosure required by section 206(3) does not satisfy the adviser's obligations with respect to the relevant principal transaction. The adviser must be mindful of its background fiduciary obligation, which continues to govern the purchase or sale.

Members of the investment management industry understand that the SEC rules are designed to implement the fiduciary obligation. Commenters on the SEC's proposed disclosure requirements argued that certain disclosure was already required by a manager's general fiduciary duty.[67] In responding to such comments, the SEC did not deny the premise that an investment manager's fiduciary obligation required general disclosure of the particular topic. (In this case the topic was additional compensation

---

[64] *See* Amendments to Form ADV, 75 Fed Reg. at 49245-46, n. 191 ("[A]n adviser's fiduciary duty of full and fair disclosure, however, may require it to continue to disclose any material legal event or precarious financial condition promptly to all clients, even clients to whom it may not be required to deliver a brochure or amended brochure.").

[65] Investment Advisers Act § 206(3), 15 U.S.C. § 80b-6(3) (2012).

[66] Rocky Mountain Financial Planning, Inc., SEC No-Action Letter (Feb. 28, 1983), 1983 WL 31004 (Feb. 28, 1983).

[67] *See* Amendments to Form ADV, 75 Fed Reg. at 49250 & n.245; *see also* Letter from Justine Kirby, Legal and Compliance Division, Morgan Stanley & Co., Inc. to Nancy M. Morris, Secretary, Securities and Exchange Commission (May 16, 2008) ("To the extent that advisory representatives receive compensation or other economic benefits that may constitute a conflict of interest, these must be disclosed under the general law relating to fiduciary obligations."); Letter from David Riggs, Vice President and Associate General Counsel, Charles Schwab & Co., Inc. to Jonathan G. Katz, Secretary, Securities and Exchange Commission (June 13, 2000) ("objecting to requirement to deliver brochure "stickers" and stating that "adviser's fiduciary duty to fully disclose to its clients all material facts and the broad antifraud provisions of the Advisers Act and state securities laws currently require an adviser to timely disclose material changes to clients.").

received by a manager provided by someone other than a client.) The SEC stated, however, that disclosure that might appear in response to one's general fiduciary obligation was insufficient. The SEC believed it was important for investment managers to make the particular detailed disclosure prescribed in its new rules.[68]

2. Proxy voting

Investment managers that exercise voting authority over client securities must vote in clients' best interest and not in the manager's interest. The SEC adopted a rule, Investment Advisers Act Rule 206(4)-6, which sets forth requirements for asset managers that have such voting authority. The premise underlying the rule is that investment managers are fiduciaries subject to the duties of loyalty and care. The securities laws, however, do not address how an asset manager should exercise its proxy voting authority for clients.[69] As a result, the SEC has stepped into the breach and clarified the conduct.

When adopting the proxy voting rule, the SEC began with the observation that an investment manager is a fiduciary and owes duties of loyalty and care with respect to all of its activities, including proxy voting.[70] Under the duty of loyalty, a manger must vote proxies consistent with a client's best interest and the manager cannot subrogate the client's interests to the manager's interests. Under the duty of care, the manager must monitor corporate events and vote.[71] The rule establishes a fiduciary floor for investment managers regarding proxy voting. The SEC made clear that nothing in the rule is intended to reduce or change the fiduciary responsibility of any investment manager, or person associated with an investment manager.[72]

Under the rule, an investment manager cannot exercise voting authority with respect to proxies unless it does the following: (1) adopt and implement written policies and procedures reasonably designed to ensure that the manager votes client securities in the clients' best interest, including procedures that address how the manager addresses conflicts of interest in the voting context; (2) disclose to clients how they can obtain information about the manager's proxy voting; and (3) disclose to clients the manager's proxy voting policies and how they can obtain a copy.[73] Thus, this rule, unlike others with more precise prescriptions or proscriptions, forces each investment manager that votes proxies to deliberate about how it can ensure that it fulfill its duty of loyalty and vote proxies in the clients' best interest.

According to the rule, the procedures must include methods by which the manager addresses conflicts of interest between the manager and its clients in the voting

[68] *See* Amendments to Form ADV, 75 Fed Reg. at 49250.

[69] Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, 6586 (Feb. 7, 2003).

[70] *Id.*

[71] *Id.*

[72] *Id.* at 6586 n.8.

[73] *See* 17 C.F.R. § 275.206(4)-6.

context. Further, disclosing the manager's record of voting to clients will likely lead managers to pay greater attention to their fiduciary responsibilities. According to the SEC, fully informed clients will "serve as a check" on managers carrying out their obligations with respect to voting.[74] Moreover, in its adopting release, consistent with the fiduciary duty of care, the SEC clarified that once an investment manager has assumed the responsibility of voting proxies, it cannot refrain from doing so; it must actually vote.[75]

The premise of the rule is that investment managers, as part of their general fiduciary obligation, owe clients a duty to vote proxies in the clients' best interest and to provide them with information on how their proxies were voted. This obligation exists absent an SEC proxy-voting rule.[76] As the SEC explained in the proposing release, many investment managers previously had adopted policies to ensure they voted proxies properly, avoided conflicts of interest, and otherwise fulfilled their fiduciary duties. Other managers did not take these steps. The SEC, therefore, proposed the proxy voting rules to ensure that all registered investment managers acted consistently with their fiduciary obligation.[77] A policy of disclosing conflicts of interest to clients and obtaining their consent to the conflict before voting occurs fulfills the manager's fiduciary obligation under the Advisers Act.[78] This rule is meant not as a substitute for the fiduciary obligation, but rather to help ensure that investment managers carry out their fiduciary obligations.

In the proxy voting rule, the SEC attempted to codify what it believed was already the law under an investment manager's fiduciary obligation. In the proposing release, where the agency takes the time to explain the background and reasons behind a rule, the SEC stated that under the Advisers Act, an investment manager with a material conflict of interest must disclose the conflict to a client before voting proxies.[79] The SEC explained that pre-existing law (the law before the proxy voting rule was adopted) entitled clients to the benefits of the fiduciary duties of loyalty and care in connection with proxy voting. It also entitled clients to information about how the manager voted the proxies – and some managers had previously adopted policies and procedures regarding proxy voting.[80]

The SEC was concerned because some, but not all, managers had adopted policies and procedures to ensure that proxies were voted properly, that conflicts were avoided, and that managers' fiduciary duties were otherwise fulfilled. Of those managers with such policies and procedures, not all made them available to clients, and not all managers

---

[74] Proxy Voting by Investment Advisers, 68 Fed. Reg. at 6589.

[75] *Id*. at 6588 n.23.

[76] *Id*. at 6586 and n.8.

[77] Proxy Voting by Investment Advisers, 67 Fed. Reg. 60841, 60847 (Sep. 26, 2002).

[78] Proxy Voting by Investment Advisers, 68 Fed. Reg. at 6587.

[79] Proxy Voting by Investment Advisers, 67 Fed. Reg. at 60842.

[80] *Id*. at 60847.

who voted disclosed their voting record to clients. The SEC explained that the importance of voting by investment managers and the potential conflicts in voting demonstrate a need for the SEC to address proxy voting in a rule.[81] Thus, a fiduciary duty governing proxy voting existed before the SEC adopted its proxy voting rule; the rule clarifies what the fiduciary obligation entails but nothing in the rule changes the overarching fiduciary obligation.

3. Compliance programs

The requirement for SEC-registered investment managers to adopt a compliance program is another example of where the Commission has defined what is required by the fiduciary obligation. Under the SEC's compliance rule adopted in 2003, registered investment managers and registered investment companies must adopt and implement written policies and procedures to prevent violation of the federal securities laws.[82] In addition, these entities must designate a chief compliance officer ("CCO") to administer the firm's compliance policies and procedures. The SEC explained that each investment manager should identify the risks presented by its respective firm and design policies and procedures to address those risks. To give additional guidance, the SEC wrote that a firm's procedures should address particular issues, if relevant, such as portfolio management processes, trading practices, valuation practices, safeguarding client assets, and business continuity.[83]

The SEC adopted this rule in the wake of discovering, along with state regulators, unlawful conduct, such as inappropriate market timing, late trading, and misuse of material non-public information about fund portfolios.[84] The SEC began its analysis by explaining that, in some instances, personnel of investment managers have placed their personal interests ahead of their clients' interests. The SEC indicated that it would aggressively pursue any persons who violated the securities laws and breached their fiduciary obligations. The SEC also said it would take stock of its rules to determine what changes might be made to prevent misconduct.[85] Under the compliance rule, it is unlawful for a registered investment manager to provide investment advice unless it has adopted the policies and procedures referred to above.

This rule, although meant to sketch a manager's fiduciary obligation, is different in character from the disclosure and proxy voting rules discussed above. The compliance rule requires that investment managers actually consider their fiduciary obligations and

---

[81] *Id*. at 60842-43.

[82] *See* Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74714 (Dec. 24, 2003).

[83] *Id*. at 74716.

[84] *Id.* at 74714.

[85] *Id*. at 74715.

formalize procedures to satisfy them.[86] The compliance rule for both managers and funds is meant as a prophylactic to help ensure no breach of fiduciary duty occurs.

Take the example of business continuity plans, which is one area where the SEC said it expects a firm will have policies and procedures. When preparing a business continuity plan, the SEC stated that an investment manager's fiduciary duty includes the duty to protect client assets from being put at risk as a result of the inability to provide services after a natural disaster or the loss of key personnel. Clients would be at risk if an adviser ceased operations.[87] As a result, an investment manager's fiduciary duty, even absent this rule, according to the Commission, would require it to address business continuity. Thus, requiring policies and procedures in this context is nothing more than the SEC clarifying for managers what is already required by a preexisting fiduciary obligation.

The three rule areas discussed above – disclosure, proxy voting, and compliance policies and procedures – are examples demonstrating that the SEC has effectively clarified what is required by an investment manager's fiduciary duty. In each of these areas, the fiduciary obligation places requirements on investment managers even absent an SEC rule. The adoption of a rule does not remove the applicability of the fiduciary duty to act in a client's best interest in the context of the areas addressed by the rules.

B. Enforcement cases

Regulators also elucidate investment managers' fiduciary obligation through enforcement actions. I shall focus exclusively on actions brought by the SEC, the primary regulator of the investment management industry, under the Investment Advisers Act of 1940, the primary federal law regulating investment managers. There is no private right of action under the Advisers Act's antifraud provision and, therefore, only the SEC (or the DOJ in criminal cases) can bring a fraud action under the Act.[88] If the SEC deems an investment manager's conduct to be a breach of fiduciary duty, the SEC and courts equate the breach of fiduciary duty with a violation of the antifraud provision of the Act. Consequently, the SEC, through enforcement actions, guides the investment management industry on conduct necessary to fulfill one's fiduciary duty.

1. Litigated cases

The seminal SEC enforcement action against an investment adviser under the Advisers Act was the *Capital Gains Research Bureau* case mentioned above, which continues to be the leading case under the Advisers Act.[89] In that case, the Capital Gains

---

[86] *Id.*

[87] *Id*. at 74716 n.22.

[88] *Transamerica Mortg. Advisors*, 444 U.S. at 24.

[89] *Capital Gains*, 375 U.S. 180; *see* Belmont v. MB Inv. Partners, Inc., 708 F.3d 470, 502-03 (3d Cir. 2013) ("Half a century later, courts still look primarily to Capital Gains Research for a description of an investment adviser's fiduciary duties.")

firm, which published investment newsletters, engaged in front running. It purchased certain securities for the firm's own account and, at the same time, advised clients to buy those same securities. The firm, however, did not disclose its ownership of the securities to clients. After the price of the shares increased, the firm sold its shares at a profit.[90]

The SEC alleged that this conduct violated sections 206(1) and 206(2) of the Advisers Act. The U.S. Supreme Court agreed. It reversed the court of appeals and held that the conduct operated as a fraud and deceit on clients or prospective clients.[91] The Court, quoting the venerated Louis Loss, stated that the Advisers Act reflected a congressional recognition "of the delicate fiduciary nature" of the investment management relationship and a congressional intent to address conflicts of interest.[92] A later Supreme Court case, *Santa Fe Industries v. Green*, relying on *Capital Gains*, stated that "Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers."[93] Although evidence of this Congressional intent is scant,[94] subsequent courts and the SEC have embraced the language in *Santa Fe* and it is now often said that Congress created a federal fiduciary duty for investment managers.[95]

In subsequent decades, the SEC has examined investment managers' conduct and determined whether it violated fiduciary principles and, accordingly, violated the Advisers Act. The cases are too numerous to discuss here, but a good example is *Geman v. SEC*.[96] In that case, a registered investment adviser and broker-dealer, in need of

[90] *Capital Gains*, 375 U.S. at 181.

[91] *Id.*

[92] *Id*. at 191-92 (citing 2 LOUIS LOSS, SECURITIES REGULATION 1412 (2d ed. 1961)).

[93] Santa Fe Industries v. Green, 430 U.S. 462, 471 n.11 (1977).

[94] *See* Laby, *supra* note 45. The lack of Congressional intent is unsurprising because, as the *Capital Gains* Court recognized, an adviser had a pre-existing fiduciary duty to clients. *Capital Gains Research Bureau*, 180 U.S. at 191-92. There is little evidence that Congress intended the Advisers Act to "establish" federal fiduciary duties for advisers.

[95] *See* Financial Planning Ass'n v. SEC, 482 F.3d 481, 490 (D.C. Cir. 2007) ("The overall statutory scheme of the IAA addresses the problems identified to Congress . . . by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined . . . ."); Political Contributions By Certain Investment Advisers, Advisers Act Release No. 3043, 75 Fed. Reg. 41,018, 41,022 (adopted July 10, 2010) (final rule) ("The Supreme Court has construed section 206 as establishing a Federal fiduciary standard governing the conduct of advisers."); F.X.C. Inv. Corp., SEC Release No. 218, 2002 WL 31741561 (Dec. 9, 2002) (ALJ decision) ("Section 206 establishes "federal fiduciary standards" to govern the conduct of investment advisers.").

[96] 334 F.3d 1183 (10th Cir. 2003); *see also* SEC v. Slocum, Gordon, & Co., 334 F. Supp. 2d 144 (D.R.I. 2004) (finding breach of fiduciary duty for failure to disclose comingling of firm and client assets); SEC v. Moran, 922 F. Supp. 867, 896-98 (S.D.N.Y. 1996) (holding the defendants negligently put their interests ahead of clients' interests in breach of fiduciary duty); SEC v. Treadway, 430 F. Supp. 2d 293, 338-39 (S.D.N.Y. 2006) (market timing); Medcap Mgmt. & Research LLC, Investment Advisers Act Release No. 2802 (Oct. 16, 2008) ("portfolio pumping"); Strong Cap. Mgmt., Inc., Investment Advisers Act Release No. 2239 (May 20, 2004) (undisclosed short-term trading in portfolio managers' own managed funds); Hennessee Group LLC, Investment Advisers Act Release No. 2871 (Apr. 22, 2009) (failure to conduct due diligence evaluations); Scwendiman Partners, LLC, Investment Advisers Act Release No. 2043, WL 1484401 (2002) (taking advantage of investment opportunities); Barr Rosenberg, Investment Advisers Act

additional income, changed its business model and began to execute customer trades as a principal as opposed to acting only as an agent. Over an 18-month period, the firm executed over 8,000 trades as a principal, generating profits of over $460,000.[97]

In *Geman*, customers consented to a modification of an agreement to allow the firm to trade as a principal. The firm's fatal flaw, however, was the failure to disclose its intent to profit from the principal transactions. The firm said merely that the change was due to new regulatory interpretations and improvements to the firm's technological capabilities. The firm, however, adduced evidence of neither regulatory changes nor technological improvements.[98] The SEC staff alleged that the purported reasons for the change were not actually factors in the firm's decision to change its business model. Moreover, this conduct constituted a breach of the firm's fiduciary duty of full disclosure. The SEC agreed.[99]

Step back and examine the move that the SEC made in the *Geman* case. Recall that the firm disclosed that it would be acting as a principal in certain customer trades. Geman emphasized this point in litigation.[100] The SEC, however, believed that the fiduciary obligation required more than disclosure of the firm's role as principal. The SEC argued that when a firm has a fiduciary relationship with a customer, it cannot execute trades as a principal absent full disclosure of the capacity in which it is trading, and full disclosure of additional information bears on the desirability of the transaction from the customer's perspective.[101] The court of appeals agreed with the Commission, stating that the firm did not live up to its duties of disclosure "as a fiduciary."[102]

The SEC has a critical role to play in defining an investment manager's fiduciary obligation. The U.S. Supreme Court, in *Herman & MacLean v. Huddleston*, explained that the antifraud provisions of the federal securities do not merely codify common law fraud.[103] As the Court stated, a primary purpose of the securities laws was to address deficiencies in the common law of fraud and establish higher standards of conduct in the securities industry.[104] Precisely what those higher standards should be is not answered in the statute. Thus, it is through agency rulemaking and enforcement cases, like *Geman*,

---

Release No. 3285 (Sept. 22, 2011) (failure to disclose risk modeling error); Dawson-Samberg Cap. Mgmt., Inc., Investment Advisers Act Release No. 1889 (Aug. 3, 2000) (failure to disclose soft dollar or other brokerage practices).

[97] *Geman*, 334 F.3d at 1186-87. Trading as a principal presents a conflict of interest with clients because the firm, as principal, is conflicted between seeking the best terms for itself and, at the same time, acting in the best interest of its customer, with whom it is transacting.

[98] *Id.* at 1187.

[99] *Id*.

[100] *Id.* at 1189.

[101] *Id*.

[102] *Id*. at 1189-90.

[103] Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983).

[104] *Id.*

that the SEC can give precise guidance on the standards applicable to the investment management industry. Because the courts give the SEC deference to interpret the federal securities laws, the SEC's view of what is required by the fiduciary duty has broad and deep influence in the structure of investment management law.[105]

2. Settled actions

Although the matters discussed above were litigated cases, the vast majority of SEC actions settle.[106] Settled actions result in a Litigation Release for federal court matters and an administrative order for administrative proceedings. These materials review the relevant misconduct and explain why the Commission believes it is illegal. These settlements are closely watched by the investment management industry. They are also carefully analyzed by investment management lawyers, who advise clients on how to adjust their behavior so that it is permissible in the eyes of the Commission and its staff.

The SEC uses settled enforcement actions, among other reasons, as a means to explain to the industry the conduct that the Commission believes is consistent with a manger's fiduciary obligation.[107] An example of the Commission using settlements to clarify conduct it believed was a breach of a manager's fiduciary duty is a series of actions brought for market timing. Market timing is the frequent purchase and sale of mutual fund shares with the intent to profit from arbitrage between the net asset value of the fund and the value of the fund's underlying portfolio securities.[108] Market timing can harm fund shareholders (other than the market timer) by diluting the value of their holdings, increasing transaction costs, disturbing the fund's management strategy, and forcing the fund to hold excess cash.[109]

Market timing is not necessarily illegal. Although the practice was often discouraged in fund prospectuses, by 2003, many fund managers did not stop market timing in their funds, and some fund managers may have encouraged it.[110] The

---

[105] Chevron U.S.A., Inc. v. NRDC, 467 U.S. 837 (1984); *see also* Kornman v. SEC, 592 F.3d 173, 181 (D.C. Cir. 2010) ("The Commission's interpretation of its authorizing statutes is entitled to deference under the familiar two-pronged test set forth in *Chevron* . . . .").

[106] COX, ET AL., *supra* note 6 at 834 ("Most SEC enforcement proceedings (over 90 percent) are settled, not litigated.").

[107] Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Sec. & Exch. Comm'n, Fiduciary duty: Return to First Principles, Remarks at Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006) (available at https://www.sec.gov/news/speech/spch022706lar.htm); Anne C. Flannery, *Time for Change: A Re-examination of the Settlement Policies of the Securities and Exchange Commission*, 51 WASH. & LEE L. REV. 1015 (1994).

[108] *See* THOMAS P. LEMKE, GERALD T. LINS, & THOMAS A. SMITH, III, REGULATION OF INVESTMENT COMPANIES § 9.02[2][a][5][A] (2015).

[109] *Id*.

[110] Banc of America Capital Management, LLC, et al., Advisers Act Release No. 2355 (Feb. 9, 2005); Alliance Cap. Mgmt., L.P., Investment Advisers Act Release No. 2205 (Dec. 18, 2003); Pilgrim Baxter & Assoc., LTD., Investment Advisers Act Release No. 2251 (June 21, 2004); *see also* Massachusetts Fin.

opportunity to engage in market timing apparently was used by mutual fund managers to attract investments by certain hedge funds, thereby increasing the funds' assets under management and the managers' compensation.[111] In a surprise move in September 2003, New York Attorney General Eliot Spitzer announced a settlement for $40 million against a hedge fund called Canary Capital Partners, LLC for abusive practices in the trading of mutual funds, including market timing and late trading.[112]

The SEC then launched its own investigation of this conduct and brought and settled cases against numerous investment management firms for a breach of fiduciary duty and a violation of the Advisers Act's antifraud provision.[113] There were several ways in which mutual fund firms allowing market timing violated fiduciary principles. First, mutual funds that state they prohibit or discourage market timing while privately encouraging or allowing it to occur are deceiving investors. In addition, market timing arrangements violated fiduciary principles to the extent that fund managers benefited from market timing at investors' expense.[114] Thus, these cases provide a clear example of the SEC using its prosecutorial authority to explain why market timing was a breach of fiduciary duty and a violation of the antifraud provisions.

A closer look at one of these cases illustrates the SEC's attempt to demonstrate a fiduciary breach. Take the 2005 settlement with Banc of America Capital Management, LLC ("BACAP").[115] BACAP was the investment manager for mutual funds in the Nations Funds investment company complex. BACAP allowed certain market timing clients to engage in short-term or excessive trading in the Nations Funds and did not disclose the arrangement to other investors. BACAP entered into arrangements with two entities, TransSierra Capital, LLC and Canary Capital Partners, LLC, and allowed them

---

Servs. Co., Investment Advisers Act Release No. 2213 (Feb. 5, 2004); Banc One Inv. Advisors Corp., Investment Advisers Act Release No. 2254 (June 29, 2004).

[111] *See* Richard A. Booth, *Who Should Recover What for Late Trading and Market Timing?*, 1 J. BUS. & TECH. L. 101, 109 (2006).

[112] New York Attorney General, Press Release, State Investigation Reveals Mutual Fund Fraud, Sept. 3, 2003 (available at http://www.ag.ny.gov/press-release/state-investigation-reveals-mutual-fund-fraud).

[113] *See, e.g.*, Securities and Exchange Commission, Press Release, Strong Capital Management and Founder Richard Strong Agree to Pay $140 Million to Settle Fraud Charges Concerning Undisclosed Mutual Fund Trading, May 20, 2004 (available at https://www.sec.gov/news/press/2004-69.htm); Securities and Exchange Commission, Press Release, SEC Brings Enforcement Action Against Banc of America Securities for Repeated Document Production Failures During a Pending Investigation, March 10, 2004 (available at https://www.sec.gov/news/press/2004-29.htm); Securities and Exchange Commission, Press Release, Massachusetts Financial Services Co. Will Pay $225 Million and Make Significant Governance and Compliance Reforms to Settle SEC Fraud Charges Concerning Mutual Fund Market Timing, Feb. 5, 2004 (available at https://www.sec.gov/news/press/2004-14.htm).

[114] *See* James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L. J. 625, 661-62 (2007).

[115] In re Banc of America Capital Management, LLC, et al., Advisers Act Release No. 2355 (Feb. 9, 2005). The case against BACAP was broader than described here. It included allegations against BACAP Distributors, distributor and fund administrator, and against BAS, a Bank of America subsidiary. Moreover, the action included allegations of late trading in addition to market timing.

to engage in short-term trading in 13 funds in the Nations Funds complex. BACAP permitted this arrangement although it knew that the trading could be harmful to other Nations Funds' shareholders. The arrangements increased investment management fees earned by BACAP.[116]

In bringing its action, the SEC stated that market timing is not per se illegal.[117] BACAP, however, had a fiduciary duty to act in the best interest of Nations Funds and their shareholders. Tracking the language of *Capital Gains*, the SEC stated that BACAP had an affirmative obligation to Nations Funds' shareholders to act with utmost good faith and provide full and fair disclosure of all material facts. It had an affirmative obligation to act with reasonable care to avoid misleading prospective Nations Funds investors.[118] The SEC concluded that, by BACAP placing its interests in enhancing fees above the interests of Nations Funds shareholders, and by failing to disclose the arrangements and the attendant conflicts of interest, BACAP breached its fiduciary duty to shareholders of the funds in which the trading occurred.[119]

That the SEC was concerned with BACAP's breach of fiduciary duty is clear from the undertakings required in the settlement. As part of the settlement, the Nations Funds mutual funds agreed to designate an independent compliance officer to assist the fund board of directors in monitoring BACAP's compliance with its fiduciary duties owed to fund shareholders. Furthermore, the compliance officer was required to report to the fund board of directors on any material breach of fiduciary duty of which the compliance officer became aware.[120] Although I have highlighted the matter against Banc of America, the SEC brought similar breach of fiduciary duty claims against other fund managers.[121]

In addition to SEC rules, the Commission has the ability through enforcement actions to communicate to the parties and to the investment management industry the scope of an investment manager's fiduciary obligation. As the law has developed, the SEC has the authority to enforce breaches of fiduciary duty under section 206 of the Advisers Act because a breach of fiduciary duty constitutes a violation of the Act. In addition, the SEC can bring section 206 cases alleging breach of fiduciary duty where the conduct was merely negligent and not intentional. Thus, by bringing breach of fiduciary duty cases under Advisers Act section 206, the SEC, since the *Capital Gains* case over 50 years ago, has continued to explain, refine, and clarify the standard of conduct to which a fiduciary must adhere.

---

[116] *Id*. at ¶1-2.

[117] *Id*. at ¶19.

[118] *Id*. at ¶5.

[119] *Id*. at ¶6.

[120] *Id.* at ¶134(h).

[121] *See supra* note 113; *see also* In re Columbia Mgt. Advisors, Inc. and Columbia Funds Distributor, Inc., Advisers Act Release No. 2351 (Feb. 9, 2005).

IV. Codifying Fiduciary Norms

Part III demonstrated that much of investment management regulation consists of detailed rules that implement and clarify the fiduciary duties of loyalty and care. When regulators adopt investment management rules, or prosecute enforcement actions, they are often explicating or clarifying the investment manager's fiduciary obligation in a particular context. They are not, as some argue, preparing conduct rules as an alternative to the fiduciary obligation. The overarching fiduciary duty does not vanish with the appearance of a detailed rule. In this Part, I shall examine this opposing view – that specific conduct rules displace fiduciary standards – and explain why it is less compelling.

A. Conduct-based rules as an alternative to the fiduciary obligation

Let us explore the opposing view that a conduct-based rule is an alternative to the fiduciary obligation as opposed to an embodiment of it. According to this view, the fiduciary duty is principles-based regulation that establishes standards – a series of requirements – developed through case law.[122] The fiduciary duty governs misconduct not addressed by rule and, therefore, addressed only by the common law.[123] Under this view, when regulators decide, by rule, that particular conduct is required or prohibited, the rule displaces fiduciary duties.[124] Regulating conduct by rule removes the conduct from the ambit of what the fiduciary obligation entails. Accordingly, as Professor Mercer Bullard writes, "the essence of the fiduciary duty is conduct that is not prohibited by rule."[125]

Additional evidence of this approach is found in the text of the federal securities laws. Advisers Act section 211(d) provides, "No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission . . . ."[126] The Investment Company Act has a similar provision.[127] These provisions, however, do not appear to be invoked in federal securities laws litigation. Moreover, the SEC staff has invoked them to state only that reliance on SEC orders or no-action letters will preclude an SEC action or private action for acts taken in reliance on the order.[128] In other words, if the a party applies for an exemption from the law, which is granted, the SEC will not subsequently take enforcement against the same party for conduct specifically exempted by the order. In addition, it is noteworthy that applicants seeking a legal exemption recognize their

[122] *See* Bullard, *supra* note 7 at 173-74.

[123] *Id*. at 174.

[124] *See* Bullard *supra* note 7; Velasco, *supra* note 12 at 667.

[125] Bullard, *supra* note 7 at 175.

[126] Investment Advisers Act § 211(d), 15 U.S.C. § 80b-11(d) (2012).

[127] Investment Company Act § 38(c), 15 U.S.C. § 80a-37 (2012).

[128] *See* Elizabeth G. Osterman, Investment Company Registration and Compliance, ALI-ABA Course of Study, SP019 ALI-ABA 467 (July 16, 2008).

ongoing fiduciary obligations in the context of their business operations.[129]

This opposing view, where rules displace fiduciary standards, was looked upon favorably as a possible approach by courts in the United Kingdom. In the UK, compliance with particular trading rules might act as a safe harbor and satisfy applicable fiduciary duties. According to a UK Law Commission Consultation Paper, where a regulatory rule permits a lower level of disclosure than that required by fiduciary standards, a court might hold that an implied term of the relevant customer contract is that the customer is entitled only to the disclosure required by the rule.[130]

This same opposing view, whereby rules displace general standards (although not fiduciary duties) is also taken in the United States in some contexts. Under the Truth in Lending Act ("TILA"), for example, disclosure requirements are quite detailed.[131] As long as the required TILA disclosures are made, I am unaware of any comprehensive principle stating that the creditor must disclose all material facts about its relationship with the customer. Customers are entitled only to the disclosures set forth in the applicable regulations; they cannot fall back on all-embracing standard, such as a generalized duty on a bank to provide complete information or not to mislead. There is no reason, however, why the opposing view should always prevail. As we shall see, in many familiar instances, detailed rules do not displace generalized standards.

B. The relationship between conduct-based rules and generalized standards

Rules and standards touching the same subject can co-exist. A detailed rule can prescribe or proscribe particular conduct, and a generalized standard can continue to exist in the background to address conduct not specifically addressed by rule. Take the familiar example of our traffic laws. A speed limit on a roadway is a rule that sets forth in advance the maximum speed allowed. The speed limit, however, does not displace applicable principles, such as the principle stating that no person shall drive at a speed greater than is prudent under current conditions and with regard to hazards that might exist at the time.[132] The specific speed restriction does not displace the generalized standard of prudent behavior, and the standard can form the basis for liability even if the motorist drives under the posted limit.

---

[129] *See, e.g.*, Alex. Brown Cash Reserve Fund, Inc., et al., Application for an Order Granting Exemptions, Investment Company Act Release No. 14220 (Oct. 31, 1984); Shearson Lehman/Coast Savings Housing Partners, Limited, et al., Application for an Order for Exemption, Investment Company Act Release No. 14185 (Oct. 9, 1984); Wingate Housing Partners, Ltd. II and Continental Wingate Co., Inc., filing of Application for an Order Granting Exemption from all Provisions of the Act, Investment Company Act Release No. 13243 (May 13, 1983).

[130] The Law Comm'n, Fiduciary Duties and Regulatory Rules 44-45 (Law Com No. 236, Dec. 1995).

[131] *See* Content of Disclosures, 12 C.F.R. § 1026.18 (2016).

[132] *See, e.g.*, NY Vehicle and Traffic Law, Article 30, § 1180, available at http://ypdcrime.com/vt/article30.htm.

The same relationship between rules and standards appears in the federal securities laws. The securities industry is governed by both rules aimed at specific misconduct and standards potentially applicable to a wide range of conduct.[133] Above I discussed the relationship between an investment manager's particular disclosure obligations set forth in Form ADV and the ongoing fiduciary obligation to disclose information not necessarily covered by the Form.[134] The fiduciary obligation, however, is only one such generalized standard; another is the antifraud prohibition that exists in several of the securities acts.[135] In the Securities Exchange Act context, the U.S. Supreme Court has explicitly described the antifraud provision as a "catchall."[136]

Other examples abound. A disclosure rule under the federal securities laws states that, in addition to information "expressly required" in a registration statement, the registration statement also must include additional information necessary to make the required statements not misleading.[137] In other words, making the required disclosure is insufficient. As the SEC expressed in *In the Matter of Franchard Corporation*:

> The registration forms promulgated by us are guides intended to assist registrants in discharging their statutory duty of full disclosure. They are not and cannot possibly be exhaustive enumerations of each and every item material to investors in the particular circumstances relevant to a specific offering. The kaleidoscopic variety of economic life precludes any attempt at such an enumeration. The preparation of a registration statement is not satisfied, as registrant's position suggests, by a mechanical process of responding narrowly to the specific items of the applicable registration form.[138]

Similarly, in a broker-dealer anti-manipulation rule, the SEC has stated that the scope of the broker-dealer antifraud provision will not be limited by specific definitions of the terms manipulative, deceptive, or fraudulent device or contrivance contained in other rules adopted under section 15(c).[139]

---

[133] Park, *supra* note 114 at 640.

[134] *Supra* note 63 and accompanying text.

[135] Securities Act § 17(a), 15 U.S.C. § 77q(a) (2012); Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2012); Investment Advisers Act § 206, 15 U.S.C. § 80b-6 (2012).

[136] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202-03 (1976) ("The section was described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.'") (quoting Hearings on H.R. 7852 *203 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934)).

[137] *See* Securities Act Rule 408(a), 17 C.F.R. § 230.408(a) (2016).

[138] In the Matter of Franchard Corp., 42 SEC 163 (1964); *see also* In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 689 (S.D.N.Y. 2004) ("[N]on-disclosure of an underwriter or issuer's conflicts of interest can constitute material omissions, even where no regulation expressly compels the disclosure of such conflicts."); Brady v. UBS Fin. Serv., Inc., 2013 WL 1309250 (N.D. Okla., March 26, 2013) (ruling that defendants are not entitled to summary judgment on multiple omissions in a registration statement).

[139] *See* 17 C.F.R. § 240.15c1-2(c).

Regulators have prosecuted misconduct not prohibited by rule, but which violated generalized standards.[140] In the 1990s, the NASD (now FINRA) addressed several sales practices, such as laddering and spinning, through detailed rules. A risk in adopting such rules is that they could be viewed as an exhaustive list of prohibited practices. These rules, however, were not prepared with this intent and the rules should not be viewed as safe harbors, displacing the general prohibition on deceptive practices. As Thomas Hazen has explained, such rules must be viewed as supplementing, not replacing, general principles and standards that apply to broker-dealers.[141]

Accounting rules addressing misconduct work this way too. Detailed accounting rules are set forth in Generally Accepted Accounting Principles ("GAAP"). Strict compliance with GAAP rules, however, will not preclude an enforcement action alleging violation of a standard, which states that the financial statements must fairly present the financial condition of the audited company.[142] In a Second Circuit decision in the accounting context, Judge Henry Friendly addressed the interaction between detailed rules and generalized standards. The defendants sought jury instructions providing that they could be guilty only if they willfully did not follow GAAP. The trial judge did not agree, stating that the "critical test" was whether the financial statements as a whole "fairly presented" the company's financial position. Proof of GAAP compliance was evidence of good faith, but not conclusive. The rules did not displace the standard, and the court of appeals agreed.[143]

Although I shall not present a comprehensive argument regarding why a detailed rule does not displace a general standard, one can easily see that rules can be under-inclusive and a rule displacing a standard could lead to evasion. A standard, such as the fiduciary obligation, addresses situations where most people agree that conduct should be prohibited, but where the actor has tailored the conduct to avoid the application of a detailed rule.[144] In that case, while a rule may no longer be applicable because conduct falls outside it, the general principle will continue to apply and act as a prophylactic to inhibit the conduct before it causes injury.

C. The case of *Meinhard v. Salmon*

In many cases where courts apply a fiduciary standard, the operative principle can be converted into a detailed rule. This conversion, however, does not eliminate the underlying fiduciary duty. An example is the well-worn case of *Meinhard v. Salmon*.[145] I

---

[140] *See* Thomas Lee Hazen, *Are Existing Stockbroker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 757 ("Even without explicit rules, severe sanctions may be imposed against brokerage firms that engage in . . . improper IPO practices.").

[141] *Id.* at 758.

[142] U.S. v. Simon, 425 F.2d 796 (2d Cir. 1969).

[143] *Id*. at 805-06.

[144] *See* Joseph A. Franco, *Of Complicity and Compliance: A Rules-Based Anti-Complicity Strategy Under Federal Securities Laws*, 14 U. PA. J. BUS. L. 1, 29 (2011).

[145] 164 N.E. 545 (N.Y. 1928).

reference this case because writers often refer to *Meinhard* to support their view of the fiduciary relationship.[146] Professor Bullard maintains that Judge Cardozo's articulation of a "punctilio of honor" standard is a general principle that can be realized only through particular cases.[147] It is true that, where conduct is not addressed by a rule, determining whether one has fulfilled her fiduciary duty takes place after the fact. The existence of a relevant rule, however, does not mean that the fiduciary standard cannot be applied to facts potentially covered by the rule.

Consider *Meinhard*. Once *Meinhard* and similar cases were decided, a principle of law developed providing that a co-adventurer (or partner) cannot, absent disclosure, take advantage of a partnership opportunity during the partnership term. When a future similar case appears, one could safely say, based on *Meinhard*, that a partner has a fiduciary duty, absent disclosure, not to take advantage of a partnership opportunity that arises during the partnership term. Moreover, if this principle were codified in a partnership statute, the statutory obligation not to take advantage of one's partner would not displace the partners' fiduciary duty. Codification in that case would implement the fiduciary duty, not displace it; a codified standard and the fiduciary obligation would continue to live side by side.

Viewing SEC rules and enforcement cases as implementing an investment manager's fiduciary duty is consistent with the SEC's implementation of the Advisers Act, as discussed in Part III. One might argue that the fiduciary obligation is not necessary to regulate conduct that otherwise violates the antifraud provisions of the Advisers Act.[148] In a narrow sense, this is true. As Professor Bullard writes, "[t]he fiduciary duty is not needed to regulate misconduct that otherwise violates anti-fraud rules."[149] If conduct violates an SEC rule, there is no need for regulators to fall back on a general fiduciary obligation to demonstrate liability. The SEC can rely on the particular antifraud rule and ignore an adviser's supervening fiduciary obligation.

This enforcement result, however, does not defeat the claim that the rule instantiates the fiduciary duty. Fiduciary principles support the particular rule at hand and the rule can be viewed as an efficient mechanism for a regulator to enforce the fiduciary standard of conduct. Enforcement of a clear rule is easier and more efficient than repeatedly demonstrating that misconduct occurred and that the misconduct should be considered a breach of fiduciary duty. A rule promotes ease of enforcement; it does not eliminate the background fiduciary obligation.

---

146 Kristina A. Fausti, *A Fiduciary Duty For All?* 12 DUQ. BUS. L.J. 183, 188 (2010); William Sanders, *Resolving the Conflict Between Fiduciary Duties and Socially Responsible Investing*, 35 PACE L. REV. 535, 548-50 (2014); Kenneth M. Rosen, *Financial Intermediaries as Principals and Agents*, 48 WAKE FOREST L. REV. 625, 640-41 (2013); Jay Youngdahl, *The Time Has Come For A Sustainable Theory Of Fiduciary Duty In Investment*, 29 HOFSTRA LAB. & EMP. L.J. 115 (2011).

147 Bullard, *supra* note 7 at 174.

148 *See id*. at 175.

149 *Id*.

Moreover, the fiduciary obligation plays an important role as the supporting structure for the claim. Recall that an investment manager's breach of fiduciary duty is tantamount to committing fraud under section 206 of the Advisers Act. Thus, in determining which antifraud rules to adopt, the SEC, as discussed in Part II, determines which conduct constitutes a breach of fiduciary duty. In any given case, reference to the fiduciary duty might not be necessary to regulate misconduct otherwise addressed by an antifraud rule, once the rule is adopted. Regulators, however, must continually assess when some new form of misconduct results in a breach of fiduciary duty and constitutes a violation of the antifraud provision. Such misconduct might result in an enforcement case today, but the enforcement case might also be codified in a future rule prohibiting the misconduct. In many instances, the SEC will bring a number of enforcement actions in a given area and then codify those cases by adopting a rule.[150] The codification does not make the misconduct any less of a fiduciary breach.

D. The challenge of *Press v. Quick & Reilly, Inc.*

To support the opposing approach, Professor Bullard references the Second Circuit case of *Press v. Quick & Reilly, Inc.*[151] An examination of the *Press* case, however, reveals that it is not applicable in the fiduciary duty context. In *Press*, broker-dealer customers complained that a broker placed their uninvested assets (such as cash resulting from a sale of securities) into poor performing money market funds, which the broker-dealer selected because the funds and their advisers made payments to the broker.[152] The payments represent a classic potential conflict of interest: the defendants' decision where to invest the plaintiffs' assets might be influenced by payments the defendants received from the funds and their advisers. The specific allegation was that the defendants violated Exchange Act Rule 10b-5, a general anti-fraud rule, because the defendants failed to disclose payments they received from third parties. Such disclosures are arguably required by Exchange Act Rule 10b-10, a rule requiring delivery of a confirmation of each securities trade to a customer.[153]

The case might be relevant to the various approaches discussed in this Chapter for the following reason: Although the defendants did not mention the conflict of interest in the context of their Rule 10b-10 disclosures, information about the payments was available to investors in the money market fund prospectuses and Statements of Additional Information.[154] The district court dismissed the Rule 10b-5 claim because the

---

[150] *See* Financial and Disciplinary Information that Investment Advisers Must Disclose to Clients, Investment Advisers Act Release No. 1035 (Sept. 19, 1986) (explaining that disclosure rule codified investment managers' fiduciary obligation to disclose certain information to clients); Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings, Securities Act Release 8511 (Dec. 9, 2004) (explaining that the proposed rule would prohibit by rule certain conduct previously addressed through enforcement actions).

[151] 218 F.3d 121 (2d Cir. 2000); *see* Bullard, *supra* note 7 at 181.

[152] *Press*, 218 F.3d at 123.

[153] *Id*. at 123-24.

[154] *Id*. at 124.

fund prospectuses and SAIs provided sufficient information to negate an inference of fraud.[155] The SEC submitted an amicus brief in the case stating that the defendants could, in fact, rely on statements in the fund prospectuses and SAIs to satisfy their obligations under Rule 10b-10.[156] The SEC did not separately opine on the existence of a Rule 10b-5 violation.[157]

The Second Circuit, per then-Judge Sotomayor, disagreed that the defendants did not adequately disclose the conflict of interest under Rule 10b-10. The court looked to the SEC's interpretation stating that general disclosures in fund prospectuses and SAIs satisfied the defendants' duty under Rule 10b-10 to disclose third party payments.[158] Moreover, when analyzing the Rule 10b-5 claim, the court explained that the SEC has decided what disclosure is necessary to address a conflict of interest resulting from third-party payments to broker-dealers. Therefore, the court stated that it would not undermine the SEC by requiring greater disclosure about the conflict in the Rule 10b-5 context.[159] The SEC's detailed disclosure rule, in other words, was the final word on the scope of disclosure required.

Professor Bullard suggests that *Press* demonstrates that the presence of a specific rule means no additional disclosure is required under a generalized standard.[160] The court, according to this view, looked at the SEC rule and determined that its requirements were a ceiling on what must be disclosed. Under this view, once the SEC adopts a specific rule, it displaces a set of generalized disclosure requirements called for under the general anti-fraud provision.

There is a crucial difference, however, between *Press* and the rules and enforcement cases discussed in Part III. *Press* was not a case addressing what is required by a fiduciary. There is no reason to believe that the *Press* brokers were acting as fiduciaries. The general rule is that broker-dealers do not act in a fiduciary capacity with respect to their customers.[161] Moreover, when the SEC adopted Exchange Act Rule 10b-10, it did not state or even imply that the rule was intended to capture fiduciary obligations of broker-dealers.[162]

---

[155] *Id*. at 126.

[156] *Id*. at 127.

[157] *Id*. at 128.

[158] *Id*. at 129.

[159] *Id*. at 131.

[160] Bullard, *supra* note 7 at 181.

[161] *See* SEC. & EXCH. COMM'N STAFF, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 54 (2011).

[162] *See* Securities Confirmations, Securities Exchange Act Release No. 13508 (May 5, 1977), 42 Fed. Reg. 25318 (May 17, 1977).

Thus, the result in *Press* in the Rule 10b-10 context is not relevant to the discussion in Part III, where the SEC clarified that advisers subject to Advisers Act rules continue to owe a fiduciary obligation to clients. It is no surprise that, in the Rule 10b-10 context, a court would examine an SEC rule to understand what is required of market participants. In the *Press* context, there is no background fiduciary obligation. Perhaps *Press* supports the argument that the general antifraud standard of Exchange Act section 10 is limited in scope in the face of specific rules. *Press*, however, does not implicate the application of a fiduciary standard in the face of a specific rule.

V. Conclusion

The underlying structure of investment management regulation is in large part to implement an investment manager's fiduciary obligation – to explain and explicate what is required by the fiduciary duties of loyalty and care. The fiduciary obligation is not clear-cut; it is not easy to say precisely what conduct is prohibited by the fiduciary duty of loyalty nor what conduct is required by the fiduciary duty of care.

To say that an investment manager should act in a client's best interest, or should act prudently under the circumstances, provides little guidance to an investment manager, or her lawyer, trying to follow the law in good faith. Questions are legion: what rises to the level of a material conflict of interest? What level of disclosure is sufficient? How much diligence must be employed consistent with one's duty as an investment manager? These are questions investment managers and their lawyers face every day, on the ground, and invoking a best interest standard provides little help.

Consequently, the SEC provides guidance on what the fiduciary obligation entails through a series of administrative rules and agency enforcement actions. When the agency adopts a rule, however, the investment manager's fiduciary duty, relevant to the subject matter of the rule, does not vanish. At most, the fiduciary obligation recedes slightly into the background as the relevant rule becomes the SEC's weapon of choice to address misconduct covered by the rule.

There is an alternative view that an administrative rule displaces the fiduciary duty addressing similar conduct. In some cases, a detailed rule may constitute the entirety of the relevant law including the substance of various duties imposed. In those cases, as long as one follows the rule, no liability ensues – there is no overarching standard to fall back on to ground liability. In the context of investment management regulation discussed in this Chapter, the exclusivity of specific rules is insufficient for regulation. A fiduciary duty is painted with broad strokes on a larger canvas, which is then dotted with detailed rules. The fiduciary obligation does not disappear in the presence of a detailed rule. Rather rules co-exist with the fiduciary obligation, which can serve as the basis for liability if a rule is inapplicable.

REFERENCES

Air Line Pilots Association International v. O'Neill, 1991, 499 U.S. 65, 75.

Alex Brown Cash Reserve Fund, Inc., et al., 1984, Application for an Order Granting Exemptions, Investment Company Act Release No. 14220 (Oct. 31).

Barnes v. Andrews, 1924, 298 F. 614, 615 (S.D.N.Y.).

Belmont v. MB Inv. Partners, Inc., 2013, 708 F.3d 470, 502-03 (3d Cir.).

Bines, Harvey E. & Steve Thel, Steve, 2004, Investment Management Law and Regulation 15, 24 (2d ed.).

Black's Law Dictionary, 2009, Fiduciary 702 (9th ed.).

Board of Governors of the Federal Reserve System, 2016, Content of Disclosures, 12 C.F.R. § 1026.18.

Board of Trustees of the Aftra Retirement Fund v. JPMorgan Chase Bank, N.A., 2011, 806 F. Supp. 2d 695 (S.D.N.Y.).

Bok, Sissela, 1999, Lying: Moral Choice in Public and Private Life 4.

Booth, Richard A., 2006, Who Should Recover What for Late Trading and Market Timing?, *Journal of Business and Technology Law* 1, 101, 109.

Brady v. UBS Financial Services, Inc., 2013, 2013 WL 1309250 (N.D. Okla., March 26).

Brehm v. Eisner, 2000, 746 A.2d 244, 264 (Del.).

Brunner, Christopher M., 2013, Is The Corporate Director's Duty of Care A "Fiduciary" Duty? Does it Matter?, *Wake Forest Law Review* 48, 1027, 1029, 1030.

Bullard, Mercer, 2011, The Fiduciary Study: A Triumph of Substance over Form?, *Review of Banking & Financial Law* 30, 171, 173-74, 175, 181.

Campbell Harrison & Dagley L.L.P. v. Lisa Blue/Baron and Blue, 2011, 843 F. Supp. 2d 673, 688-89 (N.D. Tex.).

In re Caremark International, Inc., 1996, 698 A.2d 959, 972 (Del. Ch.).

Chevron U.S.A., Inc. v. NRDC, 1984, 467 U.S. 837.

Cooter, Robert & Bradley J. Freedman, 1991, The Fiduciary Relationship: Its Economic Character and Legal Consequences, *New York University Law Review* 66, 1045, 1047 (1991).

Cox, James D. et al., 2013, Securities Regulation: Cases and Materials 834.

DeMott, Deborah A., 2007, Disloyal Agents, *Alabama Law Review* 59, 949, 952.

Easterbrook, Frank H. & Daniel R. Fischel, 1993, Contract and Fiduciary Duty, *Journal of Law and Economics* 36, 425, 427.

Ernst & Ernst v. Hochfelder, 1976, 425 U.S. 185, 202-03.

Fausti, Kristina A., 2010, A Fiduciary Duty For All? *Duquesne Business Law Journal*, 12, 183, 188 (2010).

Financial Planning Association v. SEC, 2007, 482 F.3d 481, 490 (D.C. Cir.).

Flannery, Anne C., 1994, Time for Change: A Re-examination of the Settlement Policies of the Securities and Exchange Commission, *Washington & Lee Law Review* 51, 1015.

In the Matter of Franchard Corp., 1964, 42 SEC 163.

Franco, Joseph A., 2011, Of Complicity and Compliance: A Rules-Based Anti-Complicity Strategy Under Federal Securities Laws, *University of Pennsylvania Journal of Business Law* 14, 1, 29.

Frankel, Tamar, 1995, Fiduciary Duties as Default Rules, *Oregon Law Review* 74, 1209, 1217-18.

Geman v. SEC, 2003, 334 F.3d 1183, 1186-87, 1189, 1190 (10th Cir.).

Harvard College v. Amory, 1831, 26 Mass. 446 (Mass.).

Hazen, Thomas Lee, 2010, Are Existing Stockbroker Standards Sufficient? Principles, Rules, and Fiduciary Duties, *Columbia Business Law Review* 2010, 710, 757, 758.

Herman & MacLean v. Huddleston, 1983, 459 U.S. 375, 388-89.

Howard v. Shay, 1996, 100 F.3d 1484, 1489 (9th Cir.).

Investment Advisers Act of 1940, 2012, § 206, 211(d), 15 U.S.C. § 80b-6, 80b-11(d).

Investment Company Act of 1940, 2012, § 38(c), 15 U.S.C. § 80a-37.

Kaplow, Louis, 1992, Rules Versus Standards: An Economic Analysis, *Duke Law Journal* 42, 557.

Kennedy, Duncan, 1976, Form and Substance in Private Law Adjudication, *Harvard Law Review* 89, 1685.

Kirby, Justin, 2008, Letter to Nancy M. Morris, Secretary, Securities and Exchange Commission (May 16).

Kornman v. SEC, 2010, 592 F.3d 173, 181.

Kraakman, Reinier, et al., 2009, The Anatomy of Corporate Law 39-40, 103.

Laby, Arthur B., 2004, Resolving Conflicts of Duty in Fiduciary Relationships, *American University Law Review* 54, 75, 100-106

Laby, Arthur B., 2008, The Fiduciary Obligation as the Adoption of Ends, *Buffalo Law Review* 56, 99, 129-37.
Laby, Arthur B., 2011, *SEC v. Capital Gains Research Bureau* and the Investment Advisers Act of 1940, *Boston University Law Review* 91, 1051.
Langbein, John H., 1995, The Contractarian Basis of the Law of Trusts, *Yale Law Journal* 105, 625, 629, 642.
Langevoort, Donald C., 2010, Brokers as Fiduciaries, *University of Pittsburgh Law Review* 71, 439, 456.
The Law Commission, 1995, Fiduciary Duties and Regulatory Rules 44-45 (Law Com No. 236).
Lemke, Thomas P., Gerald T. Lins, & Thomas A. Smith, III, 2015, Regulation of Investment Companies § 9.02[2][a][5][A].
Leslie, Melanie, Trusting Trustees: Fiduciary Duties and the Limits of Default Rules, *Georgetown Law Journal* 94, 67, 96, 99 (2005).
Meinhard v. Salmon, 1928, 164 N.E. 545.
Metro Communication Corp. BVI v. Advanced Mobilecomm Tech., Inc., 2004 854 A.2d 121, 157 (Del.Ch.).
In re Moody's Corp. Sec. Litig., 2011, 274 F.R.D. 480, 489 (S.D.N.Y.).
Morris v. Wachovia Sec., Inc., 2003, 277 F. Supp. 2d 622, 644 (E.D. Va.).
New York Attorney General, 2003, Press Release, State Investigation Reveals Mutual Fund Fraud, Sept. 3.
New York State, 2016, NY Vehicle and Traffic Law, Article 30, § 1180.
Osterman, Elizabeth G., 2008, Investment Company Registration and Compliance, ALI-ABA Course of Study, SP019 ALI-ABA 467 (July 16).
Park, James J., 2007, The Competing Paradigms of Securities Regulation, *Duke Law Journal* 57, 625, 640, 661-62.
Plaze, Robert E., 2015, Regulation of Investment Advisers by the U.S. Securities and Exchange Commission, 30, 31.
Press v. Quick & Reilly, Inc., 218 F.3d 121, 123-24, 126-29, 131 (2d Cir. 2000).
Reading v. Regum, 1948, 2 All ER 27.
Restatement (Third) of Agency, 2006, § 8.08.
Restatement (Second) of Trusts, 2012, § 170 cmt. a.
Restatement (Third) of Trusts, 2007, § 90, Prudent Investor Rule, General Note.
Ribstein, Larry E., 1997, Fiduciary Duty Contracts in Unincorporated Firms, *Washington & Lee Law Review* 54, 537, 542 (1997).
Ribstein, Larry E., 2010, Wall Street and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations, Hearings Before the Senate Subcommittee on Crime and Drugs, 111th Cong. 1.
Richards, Lori A., 2006, Fiduciary duty: Return to First Principles, Remarks at Eighth Annual Investment Adviser Compliance Summit (Feb. 27).
Riggs, David, 2000, Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission (June 13).
Ripken, Susanna Kim, 2006, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, *Baylor Law Review* 58, 139, 160.
Rosen, Kenneth M., 2013, Financial Intermediaries as Principals and Agents, *Wake Forest Law Review* 48, 625, 640-41.
Sanders, William, 2014, Resolving the Conflict Between Fiduciary Duties and Socially Responsible Investing, *Pace Law Review* 35, 535, 548-50 (2014).
Santa Fe Industries v. Green, 1977, 430 U.S. 462, 471 n.11.
SEC v. Blavin, 1983, 557 F. Supp. 1304, 1314 (E.D. Mich.).
SEC v. Capital Gains Research Bur., Inc., 1963, 375 U.S. 180, 181, 191-92, 194, 195, 200.
SEC v. Chenery, 1942, 318 U.S. 80, 85-86, 92.
SEC v. Moran, 1996, 922 F. Supp. 867, 896-98 (S.D.N.Y.).
SEC v. Slocum, Gordon, & Co., 2004, 334 F. Supp. 2d 144 (D.R.I.).
SEC v. Steadman, 1992, 967 F.2d 636, 641-43 & n.5 (D.C. Cir.).
SEC v. Treadway, 2006, 430 F. Supp. 2d 293, 338-39 (S.D.N.Y.).
Securities Act of 1933, 2012, § 17(a), 15 U.S.C. § 77q(a).
Securities Exchange Act of 1934, 2012, §§ 3(a)(35), 10(b) 15 U.S.C. § 78c(a)(35), 78j(b).
Shearson Lehman/Coast Savings Housing Partners, Limited, et al., 1984, Application for an Order for Exemption, Investment Company Act Release No. 14185 (Oct. 9).

Smith, D. Gordon, 2002, The Critical Resource Theory of Fiduciary Duty, *Vanderbilt Law Review* 55, 1399, 1406-11.
Sullivan v. Chase Inv. Serv. of Boston, Inc., 1978, 79 F.R.D. 246, 259 (N.D. Cal.).
Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, 1979, 444 U.S. 11, 24.
TSC Industries, Inc. v. Northway, Inc., 1976, 426 U.S. 438, 448-49.
U.S. v. O'Brien, 2014, 18 F. Supp. 3d 25, 32 (D. Mass.).
U.S. v. Simon, 1969, 425 F.2d 796, 805-06 (2d Cir.).
U.S. Securities and Exchange Commission, 1948, Arleen W. Hughes, Exchange Act Release No. 4048, (Feb. 18), *aff'd sub. nom*. Hughes v. SEC, 1949, 174 F.2d 969 (D.C. Cir.).
U.S. Securities and Exchange Commission, 1977, Securities Confirmations, Securities Exchange Act Release No. 13508, 42 Fed. Reg. 25318 (May 17).
U.S. Securities and Exchange Commission, 1983, No-Action Letter, Rocky Mountain Financial Planning, Inc. (Feb. 28).
U.S. Securities and Exchange Commission, 1986, Financial and Disciplinary Information That Investment Advisers Must Disclose to Clients, Investment Advisers Act Release No. 1035, 51 Fed. Reg. 34229 (Sept. 26).
U.S. Securities and Exchange Commission, 2000, Dawson-Samberg Cap. Mgmt., Inc., Investment Advisers Act Release No. 1889 (Aug. 3).
U.S. Securities and Exchange Commission, 2002, Scwendiman Partners, LLC, Investment Advisers Act Release No. 2043, 2002 WL 1484401 (July 11).
U.S. Securities and Exchange Commission, 2002, Proxy Voting by Investment Advisers, 67 Fed. Reg. 60841, 60842-43, 60847 (Sep. 26).
U.S. Securities and Exchange Commission, 2002, F.X.C. Inv. Corp., SEC Release No. 218, 2002 WL 31741561 (Dec. 9).
U.S. Securities and Exchange Commission, 2003, Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, 6586, 6588 n.23, 6589 (Feb. 7).
U.S. Securities and Exchange Commission, 2003, Alliance Capital Management, L.P., Investment Advisers Act Release No. 2205 (Dec. 18).
U.S. Securities and Exchange Commission, 2003, Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 74714, 74715, 74716 (Dec. 24).
U.S. Securities and Exchange Commission, 2004, Press Release, Massachusetts Financial Services Co. Will Pay $225 Million and Make Significant Governance and Compliance Reforms to Settle SEC Fraud Charges Concerning Mutual Fund Market Timing, Feb. 5.
U.S. Securities and Exchange Commission, 2004, Massachusetts Financial Services, Co., Investment Advisers Act Release No. 2213 (Feb. 5).
U.S. Securities and Exchange Commission, 2004, Press Release, SEC Brings Enforcement Action Against Banc of America Securities for Repeated Document Production Failures During a Pending Investigation, March 10.
U.S. Securities and Exchange Commission, 2004, Strong Cap. Mgmt., Inc., Investment Advisers Act Release No. 2239 (May 20).
U.S. Securities and Exchange Commission, 2004, Press Release, Strong Capital Management and Founder Richard Strong Agree to Pay $140 Million to Settle Fraud Charges Concerning Undisclosed Mutual Fund Trading, May 20.
U.S. Securities and Exchange Commission, 2004, Pilgrim Baxter & Associates, LTD., Investment Advisers Act Release No. 2251 (June 21).
U.S. Securities and Exchange Commission, 2004, Banc One Investment Advisors Corp., Investment Advisers Act Release No. 2254 (June 29).
U.S. Securities and Exchange Commission, 2004, No-Action Letter, Institutional Shareholder Services (Sept. 15).
U.S. Securities and Exchange Commission, 2004, Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings, Securities Act Release 8511 (Dec. 9).
U.S. Securities and Exchange Commission, 2005, Banc of America Capital Management, LLC, et al., Advisers Act Release No. 2355 (Feb. 9).
U.S. Securities and Exchange Commission, 2005, In re Columbia Mgt. Advisors, Inc. and Columbia Funds Distributor, Inc., Advisers Act Release No. 2351 (Feb. 9).

U.S. Securities and Exchange Commission, 2008, Medcap Mgmt. & Research LLC, Investment Advisers Act Release No. 2802 (Oct. 16).
U.S. Securities and Exchange Commission, 2009, Hennessee Group LLC, Investment Advisers Act Release No. 2871 (Apr. 22).
U.S. Securities and Exchange Commission, 2010, Political Contributions By Certain Investment Advisers, Advisers Act Release No. 3043, 75 Fed. Reg. 41,018, 41,022 (July 14).
U.S. Securities and Exchange Commission, 2010, Amendments to Form ADV, 75 Fed. Reg. 49234-35, 49236, 49237 n.35, 49240, 49245-46, n. 191, 49250, n. 245, Appendix C (Aug. 12).
U.S. Securities and Exchange Commission, (2011), Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act 54.
U.S. Securities and Exchange Commission, 2011, Barr Rosenberg, Investment Advisers Act Release No. 3285 (Sept. 22).
U.S. Securities and Exchange Commission, 2015, Agency Financial Report, 154-56.
U.S. Securities and Exchange Commission, 2015, Investment Company Reporting Modernization, Investment Company Act Release No. 31610, 80 Fed. Reg. 33590, 33591-92 (June 12).
U.S. Securities and Exchange Commission, 2016, Investment Advisers Act Rule 206(4)-6, 17 C.F.R. § 275.206(4)-6.
U.S. Securities and Exchange Commission, 2016, Securities Exchange Act Rule 15c1-2c, 17 C.F.R. § 240.15c1-2(c).
U.S. Securities and Exchange Commission, 2016, Securities Act Rule 408(a), 17 C.F.R. § 230.408(a).
Velasco, Julian, 2015, A Defense of the Corporate Law Duty of Care, *Journal of Corporate Law* 40, 647, 649, 664, 666, 667, 668.
Wingate Housing Partners, Ltd. II and Continental Wingate Co., Inc., 1983, Filing of Application for an Order Granting Exemption from all Provisions of the Act, Investment Company Act Release No. 13243 (May 13).
In re WorldCom, Inc. Securities Litigation, 2004, 346 F. Supp. 2d 628, 689 (S.D.N.Y.).
Youngdahl, Jay, 2011, The Time Has Come For A Sustainable Theory Of Fiduciary Duty In Investment, *Hofstra Labor & Employment Law Journal* 29, 115.