Fiduciary Corner Compliance

Can investment advisers disclose away all conflicts? Can brokers?

There's still disagreement over whether disclosure and informed client consent are enough to satisfy a fiduciary's obligation to act in the client's best interest.

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By Bloomberg

With the release of its regulatory package on April 18, the Securities and Exchange Commission drew an important distinction between disclosure obligations for investment advisers versus those for brokers.

Even as the greater fiduciary debate drags out, the SEC is clear that disclosure is effective in addressing conflicts only when advice is absent from the relationship.

In its 1963 decision in SEC v. Capital Gains, the Supreme Court affirmed an adviser's fiduciary duties and held that the Investment Advisers Act of 1940 requires advisers to eliminate, or at least expose, conflicts of interest between advisers and their clients and to act in the best interest of clients at all times.

Despite nearly eight decades of experience under the Act, various interested parties are still at odds over the fundamental question of whether disclosure and informed client consent are enough to satisfy a fiduciary's obligation to act in the client's best interest.

As a matter of established law (and as affirmed in the SEC's April guidance), the fiduciary duty of loyalty requires that investment advisers "make full and fair disclosure of all material facts relating to the advisory relationship" and that informed consent be obtained from the client. The onus is on advisers to provide disclosures that are sufficiently specific and clear "that a client is able to decide whether to provide informed consent."

As important new guidance, the SEC notes that some complex or extensive conflicts may defy adequate disclosure, thereby depriving clients of the ability to provide truly informed consent.

The SEC goes on to assert: "In all of these cases where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed."

Even more significantly, the SEC tackles head-on the question of whether investment advisers can disclose away all conflicts, even conflicts that would effectively violate the fiduciary adviser's duty of loyalty.

Citing the congressional intent behind the Advisers Act and case law precedent, the SEC declares that the adviser/client relationship "in all cases remains that of a fiduciary to a client … the investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty."

(More: When it comes to the proposed SEC advice rule, words matter)

Consumer groups, certifying organizations (such as the CFP Board and CFA Institute), and financial planning and investment membership associations have generally backed the SEC's stance that disclosure of conflicts is always necessary but rarely sufficient to fulfill fiduciary obligations. They have called on the SEC to provide greater clarity regarding the differences between the fiduciary standard that applies to investment advisers and the proposed new non-fiduciary "best interest" standard for brokers in the proposed new standard disclosure form called the "customer relationship summary," or CRS.

The disclosure obligations of broker-dealers are more limited than those of investment advisers. According to the SEC, "whether a broker-dealer has a duty to disclose material information to its customer depends upon the scope of the relationship with the customer, which is fact-intensive." Furthermore, "where a broker-dealer processes its customer's orders, but does not recommend securities or solicit customers, then the material information that the broker-dealer is required to disclose to its customer is narrow, encompassing only the information related to the consummation of the transaction."

The disclosure obligations of investment advisers and broker-dealers are different because the underlying premise of each type of the client relationship is distinct. As famously described by Supreme Court Justice Benjamin Cardozo, a fiduciary providing advice is "held to something stricter than the morals of the market place" and the fiduciary's conduct is to be "kept at a level higher than that trodden by the crowd."

In advisory relationships, conflicts that are not avoided must be disclosed and managed through strict adherence to the fiduciary duties of loyalty and care throughout the relationship, duties that cannot be waived.

Disclosure is a requisite part, not the method, of managing unavoidable conflicts in advisory relationships. Conversely, sales relationships operate according to marketplace rules in which disclosure is the primary means of dealing with conflicts that are inherent to sales relationships.

(More: Why you should still take the fiduciary high ground on 401(k) rollovers)

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