This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Fiduciary Duty

For Hedge Fund Managers, How Would a Statutory Definition of "Fiduciary Duty" Affect the Scope of the Duty and the Standard for Breach?

Aug. 27, 2009
By Cara Griffith, *Hedge Fund Law Report*

In its first meeting, the SEC's recently convened Investor Advisory Committee identified defining fiduciary duty as one of its discussion topics. In response, four financial planning and investment advisory industry groups sent a letter to the Investor Advisory Committee opposing a definition of fiduciary duty and supporting the "workability" of the current approach which, according to the letter, involves applying common law principles to specific facts and circumstances. This debate over whether to define fiduciary duty has been given added relevance by the Obama administration's proposal on July 10, 2009 of the Investor Protection Act of 2009 (IPA), which would for the first time define fiduciary duty by statute. See "What Precisely Is 'Fiduciary Duty' in the Hedge Fund Context, and To Whom is it Owed?," Hedge Fund Law Report, Vol. 2, No. 29 (Jul. 23, 2009). For hedge fund managers, there are two primary questions arising out of this debate: (1) to whom is a fiduciary duty owed; and (2) what is the standard for breach of fiduciary duty? The answers to these questions can dramatically alter the legal landscape in which hedge funds operate. Accordingly, this article addresses both questions, both under current law and as the law may evolve following passage of the IPA.

Investor Advisory Committee

On June 3, 2009, SEC Chairman Mary Schapiro announced the formation of an Investor Advisory Committee intended to give investors a greater voice in the SEC's work. The stated purposes and goals of the Investor Advisory Committee are broad, and include advising the SEC on "matters of concern to investors in the securities market"; providing investor perspectives on non-enforcement regulatory issues; and serving as a source of information and recommendations. In a press release, SEC Commissioner Luis A. Aguilar, who will serve as the SEC's primary sponsor of the Committee, noted that "[i]nvestors need a greater voice at the Commission. The Commission's traditional role as the investor's advocate, as well as our deliberations, will be enhanced by the range of views the Advisory Committee will provide."

At its first meeting, on Monday, July 27, 2009, the Investor Advisory Committee identified several discussion topics, one of which was whether "all financial intermediaries who provide investment advice to their customers [should] be subject to the same fiduciary duties, and how should those duties be defined?" In response to the identification of this topic, various financial planning and

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
investment advisory industry groups sent a letter to the Investor Advisory Committee supporting discussion of the fiduciary duty of financial intermediaries as a topic, but expressing concern with the suggestion that fiduciary duty should be defined in order to provide a "workable standard." The groups that signed the letter included the Certified Financial Planner Board of Standards Inc., the Financial Planning Association, the Investment Adviser Association and the National Association of Personal Financial Advisors.

Specifically, the letter stated that what "constitutes a violation of a fiduciary duty . . . is and always has been a matter of the application of common law principles to particular facts and circumstances. Attempting to provide specific definition of all aspects of fiduciary duty, or to enumerate precisely how it applies and what it entails, would have the perverse consequence of diluting protections for investors." The letter suggested that rather than attempting to define fiduciary duty, the Investor Advisory Committee should consider simply extending to brokers that provide investment advice the fiduciary duty that – under the Investment Advisers Act of 1940 (Advisers Act) and common law – investment advisers owe to their clients.

Current "Definition" of Fiduciary Duty

Although fiduciary duty is not currently defined by statute or regulation, courts have held that a fiduciary duty is implicit in the anti-fraud provisions of Section 206 of the Advisers Act. Tamar Frankel, Professor of Law at Boston University School of Law, explained to the Hedge Fund Law Report that the existence of a fiduciary duty depends upon the existence of a fiduciary relationship. A fiduciary relationship, Frankel continued, exists when (1) "the service being provided is one that is unique and one for which society wants to avoid duplication," and (2) "the fiduciary is performing a service for which he needs to be entrusted with property or power." Entrusting a fiduciary with property or power is not an even exchange, Frankel noted. The fiduciary is given the property or power for the purpose of serving the client. The fiduciary is the agent and the client is the principal, but day-to-day monitoring of the agent by the principal is not practicable, and hence the law imposes a duty of loyalty on the fiduciary-principal. In addition, Frankel noted that a fiduciary must exercise expertise and a duty of care.

The most visible current debate regarding fiduciary duty centers on whether broker-dealers, which are currently subject to a less stringent "suitability" standard, should be held to the same fiduciary duties as investment advisers when they perform substantially similar services, namely, giving investment advice. However, for hedge fund managers, the more relevant question is not whether or not a fiduciary duty exists – the existence of the duty for hedge fund managers is effectively beyond cavil – but to whom the duty is owed, the fund or its investors? The U.S. Supreme Court has held that Section 206 of the Advisers Act imposes on an investment adviser a fiduciary duty of loyalty to its "client." See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). From the *Capital Gains* case in 1963 until 2004, the SEC, relying on *Capital Gains*, took the position in inspections and enforcement actions that the "client" to whom the fiduciary duty is owed is the investor, not the fund itself.

But in 2004, the SEC proposed a rule providing that each investor in a hedge fund is a "client" for purposes of the Advisers Act. The purpose of defining client to mean investor, rather than fund, was to narrow the availability of the "private adviser exemption" of Section 203(b)(3) of the Advisers Act, and thereby to require most hedge fund managers to register with the SEC as investment advisers. In *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), the D.C. Circuit struck down the rule, holding that "the [SEC's] interpretation of the word 'client' comes close to violating the plain language of the [Advisers Act]. At best it is counterintuitive to characterize

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
the investors in a hedge fund as 'clients' of the adviser . . . . The adviser owes fiduciary duties only to the fund, not to the fund's investors."

Goldstein Consistent with Commingled Investment Structure

Leading practitioners interviewed by the Hedge Fund Law Report generally view the outcome in *Goldstein* as consistent with the legal and practical realities of managing a hedge fund. According to Stephanie Breslow, a Partner at Schulte Roth & Zabel LLP, *Goldstein* helps resolve a collective action problem inherent in the commingled investment structure. The problem is that interests of individual investors may diverge. For example, some may want cash today while others may want the manager to hold investments until the market improves. *Goldstein* enables managers to reconcile these competing interests by defining the manager's fiduciary duty as owed to the fund as a whole, rather than its investors. In effect, under *Goldstein*, if the manager takes an action that is contrary to the expressed preferences of the minority of investors in a hedge fund – or perhaps the minority of the assets under management, even those assets belong to a majority of fund investors by number – then the manager still may have satisfied its fiduciary duty to the fund so long as the action is in the best interests of the fund. Breslow noted that if the D.C. Circuit had endorsed the SEC's definition of investors as clients of the manager, hedge funds might have become, for fiduciary purposes, in effect a series of managed accounts.

Fiduciary Duty to Fund, But Investors Not Without Remedies

According to Frankel, the result of *Goldstein* is that most practitioners believe "the fund is, in effect, the client of the hedge fund manager," meaning that "the manager owes a fiduciary to the fund first and only secondarily to the beneficiaries of the fund, the investors." However, Frankel noted that even post-*Goldstein*, hedge fund investors retain effective means of ensuring that managers act appropriately. Partnership and corporate law, which prohibit a general partner or corporate director from certain actions that harm limited partners or shareholders, can apply to any entity that employs the partnership or corporate form, as most hedge funds do, Frankel said. In addition, most hedge fund investors have contractual rights under the hedge fund's governing documents, for example, its limited partnership agreement, limited liability company operating agreement, private placement memorandum, etc. Those documents impose certain contractual obligations and limitations on the manager.

Likelihood of Passage of Investor Protection Act

The debate over the beneficiary of a hedge fund manager's fiduciary duty took a new twist with the proposal by the Obama administration on July 10, 2009 of the Investor Protection Act of 2009 (IPA). The aspect of the IPA that has received the most press – and the most vociferous reaction from the broker-dealer community – is a provision that would impose a fiduciary duty on broker-dealers that provide investment advice. Currently, broker-dealers are subject to a less stringent "suitability" standard. Moreover, the IPA would actually define fiduciary duty, a concept that (as the letter from the financial planning and investment advisory industry groups said) heretofore has been the product of caselaw and facts and circumstances analysis. The bill
www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

defines "fiduciary duty" as the duty to act "solely in the interest of the customer or client without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice."

Most importantly for hedge fund managers, the IPA would delegate to the SEC rulemaking authority to define the "client" to whom a fiduciary duty is owed. It's an invitation from the Obama administration and Congress to overturn *Goldstein*, in part, and turn back the clock to the *Capital Gains* understanding of fiduciary duty. George Mazin, a Partner with Dechert LLP, believes the IPA could become law, although it will likely face some opposition and may change in committee.

Likely Effect on Hedge Fund Managers of Defining Fiduciary Duty

According to Mazin, the practical effect on hedge fund managers of defining fiduciary duty by statute or regulation will depend on the standard for breach of fiduciary duty. Currently, the standard for breach of a manager's fiduciary duty to the fund generally is "gross negligence." This is a high standard and thus, for example, a manager found to have been merely negligent in its management of a hedge fund will not have breached its fiduciary duty. However, Mazin predicted that if the IPA were to become law and fiduciary duty were to be defined by statute or regulation, a stricter standard would apply. Specifically, Mazin suggested that one possible outcome would be that the IPA could become law in roughly its current form, including a broad definition of fiduciary duty, and in implementing regulations, the SEC could incorporate the "prudent man" standard of ERISA as the standard for breach of a hedge fund manager's fiduciary duty. The "prudent man" standard of ERISA requires a fiduciary to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

If the SEC were to incorporate this standard as the standard for breach of fiduciary duty, it would be easier for hedge fund managers to breach their fiduciary duties and would expand the range of conduct that may expose managers to liability. On the other hand, if Congress and the SEC merely retained the broad definition of fiduciary duty currently included in the IPA – that is, if the IPA were to become law in its current form and the SEC did not impose by regulation a specific standard for breach of fiduciary duty – the standard for breach likely would remain the current common law standard. In other words, a broad definition of fiduciary duty such as the definition currently included in the IPA would be unlikely to change the game because in applying that broad definition, courts and the SEC would likely incorporate existing common law concepts.

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL