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# Fiduciary Duty

Let's Not Forget The "F" Word

During the current, unprecedented turmoil in the corporate cash markets, it is important to take a step back and investigate how today's liquidity issues occurred and what treasurers, CFOs and other corporate cash investors can do to prevent a relapse in the future.

The key to solving this problem over the long-term does not revolve around auction rate securities, SIVs, CDOs, or any other asset type. Instead, corporate cash investors need to focus on the level of *fiduciary duty* associated with their investment person.

## WHAT IS IT?

The website [www.uslegal.com](http://www.uslegal.com) defines "fiduciary duty" as "an obligation to act in the best interest of another party." Simply put, registered investment advisors have it and brokers don't.

More specifically, advisors have a general duty to place the interests of their clients ahead of the interests of themselves and their personnel. An investment advisor owes its clients a "fiduciary duty" to act on their behalf—in good faith, with honesty, with trust, with care, with candor and solely in clients' best interests—unlike a contractual duty which allows a party relatively broad discretion to pursue their own self-interest, subject to a loose good-faith constraint.

In addition, a firm with a fiduciary duty has the following obligations:

- A duty of loyalty to clients
- A duty to treat all clients fairly
- A duty to have a reasonable and independent basis for investment advice
- A duty to disclose actual and potential conflicts of interest
- A duty to seek best execution
- A duty to prevent personal transactions inconsistent with a client's interest
- A duty to ensure investment advice is appropriate/suitable for client's objectives

## HOW DOES IT WORK IN PRACTICE?

When working with a broker, every purchase transaction is viewed as a "sale" of the security to the client. In general, brokers can present disclosure information at the point of sale, implying every transaction is independent and creating the potential for overall portfolio strategy to remain nonexistent. This is how treasurers found themselves with up to 100 percent of their investments in high-commission auction rate securities as opposed to holding a diversified portfolio representing an overall investment strategy.

On the other hand, investment advisors are directed to execute portfolio strategy that is determined in consultation with the client regarding their investment policy, liquidity and risk preferences. Not only does the advisor have to follow the policy to the letter, but must

also endeavor to follow the spirit of the policy. This is encouraged by the fact investment advisors are typically paid the same fee without regard to the specific strategy or individual investments included in the clients' account. In order to ensure this approach, we include our clients' investment policy as part of our management contract.

In short, the disclosure information a broker must present is product-related, while investment advisors must present disclosure information about their business, principals, potential and actual conflicts of interest with the interest of clients.

While there are Financial Industry Regulatory Authority (FINRA) conduct rules that apply to brokers, they do not include a code of ethics. On the other hand, investment advisors registered with the SEC are required to establish, maintain and enforce a written code of ethics that, at a minimum, includes:

- Standards of business conduct that are required of supervised persons; the standard must reflect the fiduciary obligations of the adviser and those of its supervised persons;
- Provisions requiring supervised persons to comply with applicable federal securities laws;
- Provisions that require all access persons to report, and the advisor to review, their personal securities transactions and holdings periodically;
- Provisions requiring supervised persons to report any violations of the code of ethics promptly to the chief compliance officer or, provided the chief compliance officer also receives reports of all violations, to other persons designated in the code of ethics; and
- Provisions requiring the advisor to provide each of supervised persons with a copy of the adviser's code of ethics and any amendments, and

requiring supervised persons to provide a written acknowledgment of their receipt of the code and any amendments.

#### HOW CAN I ENSURE I HAVE IT?

Only entities that are specifically registered with the SEC as a "registered investment advisors" are required to provide fiduciary duty.

In contrast, brokers must comply with rule 2110 of the FINRA rulebook which states *in its entirety*, "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." While there are many "interpretive materials" along with this ruling, the multitude of lawsuits regarding the methods brokers used to sell auction rate securities display the looseness with which this rule is interpreted.

When all else fails, follow the money and investigate how your investment person is compensated. Many brokers will charge a fee, operating under the guise of an investment advisor but without the fiduciary duty or other requirements set forth by the SEC. In addition, those brokers may be receiving commissions or other incentives for "placing" client funds in particular assets without proper analysis of the suitability of those investments.

In stark contrast, all compensatory arrangements, whether direct or indirect, for an investment advisor must be disclosed in Part II of their Form ADV, which is required to be delivered to clients promptly after signing a management agreement reserving the right of the client to rescind within five days after receipt. We strongly recommend you obtain this form from your investment advisor on a regular basis and read it thoroughly.

**WHAT NOW?**

Even though the current credit crisis has been ongoing for several months, scrutiny continues to increase on corporate cash investments. Now is the time for reflection about exactly what went wrong to allow corporate treasurers who depend on the liquidity of their investments to get themselves into zero liquidity situations. By managing the relationship with their investment professional, investors could have avoided this situation if they had hired an investment “partner” as bound by the construct of fiduciary duty as opposed to an investment “salesman” in the form of a broker.

It is important for all treasury departments to review the nature of their relationship with their investment persons to ensure both parties are sitting on the same side of the table. Because treasurers do not have time to construct portfolio strategies, read prospectuses and filter through all of the securities offered by the brokerage community, a registered investment advisor can ensure greater peace of mind by aligning the client’s interest with those of their investment professional.

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