Hedge Fund Monthly

Mixing Investment Adviser and Brokerage Services

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Trendy money managers and brokers take on the role of chief cook and bottle washer when they opt to be all things to all clients. In the context of this article, we are interested in those situations when they opt to be their client's broker (or introducing broker) and investment adviser (either to a fund or private client). By becoming a broker, the money manager can significantly increase his bottom line as he is now entitled to sales commissions, third-party selling fees and in some cases increased access to margin (a key point if the manager runs a hedge fund or a proprietary trading firm). As his client's investment adviser, the money manager can earn those hefty tax-advantaged advisory fees we have all been reading about in the mainstream press for months. Purveyors of both advisory and brokerage services need to be aware of the mix of statutes and judicial doctrines that affect them. The purpose of this article is to flag the concerns of the investment adviser and the weightier concerns of the broker.

Overview

Brokers (B) typically set up as an investment adviser in one of two ways. He may either register his brokerage as an investment adviser or establish an affiliated investment advisory business. Investment advisors (IA) transition to the brokerage business either by registering his investment adviser business as a broker or by establishing an affiliated brokerage firm. When a service provider offers both investment adviser and brokerage services to his clients, the broker/investment adviser (B/IA) will execute client transactions through its affiliated brokerage firm. Endemic to this kitchen table arrangement are economic conflicts that trigger regulatory and client concerns, if not headaches.

The primary concerns are as follows:

- Is the adviser departing from its duty of best execution by causing its advisory clients to pay too high a price for securities execution?
- Is the adviser churning accounts in order to generate sales commissions?

A B/IA must "test for integrity" all his sales and advisory activities under the following statutes and judicial doctrines.

Investment Advisers Act of 1940

The Investment Advisers Act of 1940 (IA Act) does not impose any specific restrictions on the B/IA with respect to an affiliated brokerage. In play is the general

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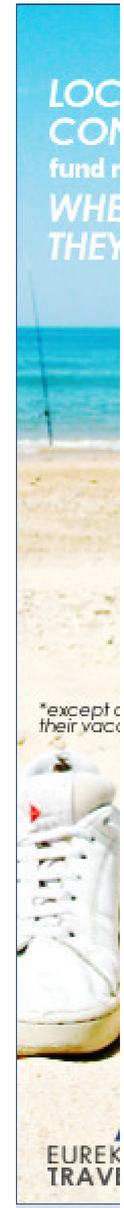

fiduciary duty imposed on investment advisers by Section 206 of the IA Act. A B/IA should use an affiliated broker only if he can satisfy the duty of best execution. The B/IA’s use of an affiliated broker must be fully and clearly disclosed in the B/IA’s Form ADV Part II (Schedule F). Appropriate disclosure may include a clause in the advisory contract allowing the client to acknowledge that the B/IA is affiliated with the B/IA’s brokerage or that the B/IA is also a broker. The client must explicitly authorise the B/IA to execute transactions consistent with the B/IA's duty of best execution. The B/IA’s Form ADV Part II (Schedule F) should explain the B/IA's practice of engaging in affiliated brokerage transactions.

Planning: Review Schedule F of Form ADV Part F to make sure your disclosures are up to date as well as accurate.

Affiliated brokerage transactions are of interest to an SEC (or state SEC) inspection team. When (not if, but when) the B/IA is audited, the inspection team will review the B/IA's disclosures with respect to affiliated brokerage transactions and review whether the commissions paid to an affiliated brokerage are in accordance with industry standards.

Affiliated Broker-Dealers

Three other statutes and a handful of judicial doctrines impose specific regulatory restrictions on the provider of affiliated brokerage services. Those statutes are the Securities Exchange Act of 1934, the Investment Company Act of 1940, and Employee Retirement Income Security Act (ERISA) of 1974.

Securities Exchange Act of 1934. The IA covers those situations where an IA is itself a member of a national securities exchange or affiliated with a member. Section 11(a) of Securities Exchange Act of 1934 (SEA) prohibits an exchange member from engaging in transactions on the exchange floor for an account in which it or an affiliated IA has investment discretion unless the advisory client gives authorisation and the client is provided with an annual statement of the compensation paid to the exchange member in connection with those transactions.

Investment Company Act of 1940. The Investment Company Act of 1940 (IC Act), at Section 17(e)(2), limits the sales (and other) commissions paid to an affiliated broker-dealer. Payments have to be “usual and customary.” The limits imposed on affiliated broker payments by Section 17(e)(2) of the IC Act vary depending on the transaction. Rule 17e-1 of the IC Act establishes guidelines as to when commissions are deemed to fall within the usual and customary standard. Commission must be reasonable and fair compared to the commission received by other brokers in connection with comparable transactions involving similar securities being purchased or sold on a securities exchange during a comparable period of time. The rule also requires that a fund's board of directors (in the case of a mutual fund) adopt procedures designed to achieve compliance with the rule. They also have to make sure (at least quarterly) that any affiliated broker transactions comply with the rule. A mutual fund must disclose its business practices involving affiliated brokers.

Caveat**:** Proprietary trading firms make a lot of money marking up broker commissions. Those firms truly attempting it all: providing investment adviser, broker, and proprietary trading services need to be very cautious in its billing practices.

Employee Retirement Income Security Act (ERISA) of 1974. Employee public and private pension plans are the largest single category of institutional holders of corporate stocks. It is common to find pension plans being handled by a B/IA. In such cases, when the fiduciary duties of the B/IA to the plan are prescribed by ERISA. ERISA permits a fiduciary to use an affiliated broker for plan transactions under limited circumstances. The transactions must be executed pursuant to a written authorisation executed by a plan fiduciary who is independent of the investment adviser or broker. Such authorisation is made by the plan sponsor (typically the employer). The written authorisation must be terminable at will by the plan without penalty. The affiliated broker must make annual disclosures concerning (among other things) the total of all charges incurred by the plan that relate to securities transactions.

The scope of ERISA is broad. The applicability of ERISA will depend on whether the plan is covered by the statute and on whether the broker falls within the ERISA's definition of the term "fiduciary." Under ERISA, a fiduciary is a person who (1) exercises any discretionary authority or control regarding the management of a plan or the management or disposition of its assets; (2) renders investment advice for a fee or other compensation (direct or indirect) or has authority or responsibility to do so; or (3) has any discretionary authority or discretionary responsibility in the administration of the plan. A broker is a fiduciary if it exercises discretionary authority as to the investments of a plan or if it provides the plan with investment advice for a fee (beyond the normal compensation of a broker). In addition, if a broker is named as a trustee of a plan, it will fall within the definition of fiduciary.

Department of Labor regulations provide, however, a person will be deemed to be giving investment advice only if (1) the person has discretionary authority or control; and (2) there is an understanding between the plan and the fiduciary that the advice will serve as a primary basis for the plan's investment decisions, and that the person will render individualised investment advice based on the particular needs of the plan. For a brokerage firm to be an ERISA fiduciary, it must have discretionary authority over management of the plan or discretionary authority or control over the assets. If an employee of a broker is the investment adviser to a plan (meaning that he is responsible for making investment decisions for the plan's account), both the employee and the firm employing him are fiduciaries under ERISA.

ERISA requires fiduciaries to discharge their duties solely in the interest of the participants and beneficiaries of the plan. They must also act with skill, prudence and diligence. They must diversify the investments of the plan so as to minimise the risk of large losses, unless under the circumstances it is clearly prudent not to do so. That is quite a large burden.

Caution*:* A fiduciary of a plan is personally liable for any losses resulting from a breach of his duties. The fiduciary may be required to restore to the plan any profits that the fiduciary has made through his breach of duty, and may also be subject to other equitable or remedial relief.

While affiliated broker fees paid on behalf of a plan generally constitute prohibited self dealing, the Department of Labor established an exemption. Affiliated brokers can charge fees under certain conditions. Affiliated broker transactions cannot be excessive either in amount or frequency.

Hindsight: A pension plan fund claimed that E F Hutton Co, a fiduciary and investment adviser of the plan, had breached its fiduciary duty by charging the fund excessive commissions and by paying a portion of these commissions to investment managers (who also were fiduciaries of the fund). The fund also made a claim against a director of Hutton and the registered representative who handled the fund's account for making intentional misrepresentations about Hutton's fees. The court denied the director's motion for summary judgment on grounds that even if he was not himself a fiduciary, he knowingly participated in the fiduciaries' activities.

Judicial Doctrines

Courts impose common law duties on the B/IA which serve as an additional restraint on behaviour, much like the statutes cited in this article.

Duty of Care. A broker owes his customer the legal duties of reasonable care, utmost good faith, integrity, and loyalty. A broker must disclose to his customer all material facts within his knowledge that in any way affect the transaction or the relationship. A broker's exact duties depend on the scope of his agency. A broker who has authority to make and manage investments or who effectively controls his customer's account (even though he does not have formal discretionary authority over the account) owes his customer duties of faithful service. This is a standard similar to that imposed on the trustee of a formal trust.

The fiduciary duties of a broker include the duty to use the skill and diligence necessary to protect his customer's interests. Negligent conduct may be a breach of fiduciary duty. A broker must employ such care, skill, prudence, diligence and judgment as might reasonably be expected of a person skilled in his calling.

A client does not have to prove wrongful intent in order to establish a breach of fiduciary claim. Neither constructive fraud nor breach of fiduciary duty requires actual dishonesty or actual intent to deceive.

Caveat: There is some limited authority holding that a breach of a broker's duty of loyalty requires a showing that the broker acted with intent to deceive. In determining the applicable standard of care in a particular situation, a court may take into consideration a variety of authorities, including the rules of self-regulatory organisations, the internal rules and practices that the brokerage firm adopted to govern the conduct of its employees, industry customs and professional practices. The content of these rules and practices will shed some light on the broker's knowledge of the risks involved and the precautions taken to prevent the risks.

Caveat: None of these 'authoritative' sources automatically establishes the proper standard of care. A court could very well go off on a tangent and create a new or higher standard of care.

Duty of Loyalty; Prohibition against Self-Dealing. Among the duties imposed on every broker (including a broker handling a non-discretionary account) is the duty to avoid self-dealing. A broker cannot refuse to disclose any personal interest he has in a particular recommended security. Brokerage firms simultaneously engage in a variety of activities for clients and for their own account. Brokers are supposed to act in a customer's best interest and refrain from self-dealing unless the customer consents (after full disclosure). A broker can be held accountable for breaching his duty of loyalty whenever the broker has a direct economic interest in the transaction.

***Example**:* It is a breach of fiduciary duty for a broker to trade secretly for his own account ahead of an order that a customer has given for execution.

Duty to not to Misrepresent. A broker's duty of good faith to his customer (regardless whether the account is discretionary or non-discretionary) includes a duty not to misrepresent any fact material to the transaction.

Duty to not to Recommend Unsuitable Securities. A broker who recommends a security or investment program that is unsuitable for his customer in light of the customer's financial situation, needs or investment objectives can be held accountable for a breach of fiduciary duty or for negligence.

***Duty to Monitor the Performance of the Account**.* A broker handling a discretionary account owes a duty to his customer to monitor the account's performance. A broker handling a non-discretionary account normally does not have such a duty. If a broker does not have discretionary authority, the agency relationship begins when the customer places an order to buy or sell a security and ends when the transaction ordered is complete. A broker does not automatically assume a continuing obligation to keep abreast of the securities in non-discretionary customer accounts or to advise these customers of any information that might affect the securities.

Duty to Transact Business after Receiving Prior Authorisation from the Customer. A broker handling a non-discretionary account is under a duty to his customer not to buy or sell securities unless the customer gives prior approval for each transaction. An agent owes his principal a duty to act only as authorised.

Conclusion

Providers of B/IA services need to be aware of the "black letter law" and common law doctrines that govern his services. Providers of B/IA services should not only avoid impropriety but also the appearance of such. A good reputation of 20 years can be lost in five minutes. See you in the Soup!

Hannah Terhune is an attorney. Ms Terhune and her staff of professionals, through Capital Management Services Group, provides advice to a wide range of clients, including investment advisers, active traders, hedge funds, forex funds, commodity pools, proprietary trading firms, and brokers. Ms Terhune has written over 100 articles and white papers on hedge funds and tax matters. Ms Terhune holds degrees in law from New York University (LLM in Taxation, 1991) and George Mason University (JD, 1989). She has served as a Lecturer in taxation and business at George Mason University and at Catholic University. Her prior military service includes serving as Judge Advocate in the US Army Special Forces. For more information, please visit www.capitalmanagementservicesgroup.com.

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