

# The 12 Most Critical Duties for Investment Fiduciaries

(SEC/FINRA)

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The following document details the specific duties mandated by the SEC's "**Commission Interpretation Regarding Standard of Conduct for Investment Advisers**" (Release No. IA-5248), which became effective on **July 12, 2019**, as well as additional duties that flow logically from the fundamental principles of fiduciary responsibility.

While "fiduciary" is a broad concept, the 2019 Interpretation clarified exactly what the SEC expects from Registered Investment Advisers (RIAs) regarding their Federal Fiduciary Duty. This document distills these requirements—and their practical implications—into 12 actionable duties necessary to protect client assets and comply with the rigorous **Duty of Care** and **Duty of Loyalty**.

These duties are ordered roughly by the frequency and severity of their violation in current industry practice.

## 1. Disclose the Risks Specifically Associated with Your Recommended Strategy

Generic warnings (e.g., "investments may lose value") are insufficient. The advisor must disclose the *specific magnitude of potential loss* associated with the strategy being recommended.

- **The Action:** If recommending a long-term buy-and-hold strategy in equities, the advisor must disclose in writing that investors using this strategy have historically suffered losses of 30%, 50%, or even 75% during market declines. They must disclose that "blue chip" companies frequently fail entirely (General Motors, Kodak) or come close to failure (General Electric). Recovery times from major drawdowns have historically exceeded a decade.
- **The Standard:** The client must understand, before investing, the realistic worst-case scenarios for the recommended strategy—not sanitized language about "corrections," but the actual historical record of drawdowns and failures.

## 2. Disclose Back-Tested Evidence of Strategy Efficacy (Or Its Absence)

An advisor who charges ongoing fees implicitly promises to add value. If the advisor cannot demonstrate—with data—that their strategy has historically outperformed a passive benchmark, they must disclose this fact.

- **The Action:** The advisor must disclose whether they have back-tested evidence that their strategy can beat the S&P 500. If they have no such evidence, they must say so explicitly. They must further disclose that the client may be better served by low-cost index funds if the advisor cannot demonstrate a track record of outperformance.
- **The Math:** If the S&P 500 returns nothing over a 10-year period and the client is paying 1% annually in advisory fees, the client has lost 10% of their assets to fees alone with zero return. The advisor must make this risk concrete.

### 3. Disclose the Compensation Conflict Between Equities and Debt

This is a primary conflict of interest that has never been adequately addressed: advisors are compensated approximately **100% more** for managing equities and ETFs than for managing debt instruments (bonds, notes, Treasury bills). No self-respecting advisor would charge 1% to buy Treasury bills—so they don't recommend them, even when such instruments might objectively serve the client's interests better.

- **The Action:** The advisor must disclose that their compensation is substantially higher when recommending equities versus fixed-income instruments. This creates an inherent conflict when advising clients—particularly those concerned with capital preservation—about asset allocation.
- **The Duty of Loyalty Implication:** The 2019 Interpretation reinforces that you must not place your own interest ahead of the client's. If you cannot fairly and fully disclose a conflict such that a client can understand it and give informed consent, you must eliminate the conflict entirely.

### 4. Disclose That Alternative Strategies (Including Bonds) May Better Serve the Client

Many clients—particularly those concerned with capital preservation—may be objectively better served by a significant allocation to high-quality, short-duration laddered bond portfolios rather than equities. Advisors should be required to disclose this alternative.

- **The Action:** The advisor must explain that a laddered portfolio of investment-grade bonds with durations of 5-15 years offers: (a) minimal capital risk; (b) increasing income as bonds mature and can be reinvested at higher coupon rates during inflationary periods; and (c) potential capital gains when inflation subsides and higher-coupon bonds sell at premiums.
- **The Historical Record:** During inflationary periods, the stock market has historically underperformed significantly. Equity portfolios may lose 30-40% or more and may never return to their previous highs. A laddered bond portfolio provides insulation from almost any market occurrence while generating predictable income.

### 5. Disclose the Relationship Between Price Paid and Minimum Value

The most material measure of investment risk is the relationship between the *price paid* for a security and its *minimum value* (essentially, the company's book value or equity). An advisor cannot claim to have disclosed the risk of a security without explaining this relationship.

- **The Action:** The advisor must evaluate and disclose the relationship between the price paid for a company and a reasonable estimate of its minimum value in a distressed sale. Only then can the potential loss from an investment be properly assessed.
- **Example:** A company trading at a \$10 billion market cap with only \$500 million in equity has far greater downside risk than a company with a \$10 billion market cap and \$9 billion in equity. The first company could theoretically lose 95% of its value; the second has substantial asset backing. Failing to disclose this distinction is *prima facie* evidence of violating the duty to disclose risk.
- **The 2019 Standard:** The Interpretation warns against basing advice on materially inaccurate or incomplete data. Using outdated risk metrics or failing to analyze the price-to-value relationship is a breach of the Duty of Care.

## 6. Disclose Your Loss Mitigation Strategy (Or Its Absence)

An advisor must disclose what specific strategies, if any, they will employ to reduce losses during a severe market drawdown.

- **The Action:** If the advisor has a loss mitigation strategy, they must describe it and acknowledge that its effectiveness is uncertain: "We have a strategy. We don't know how well it will work, but here it is."
- **If No Strategy Exists:** The advisor must state plainly: "We do not have a strategy to prevent losses of 50% or more. We do not know of anything we can do to mitigate that risk." Silence on this point is a failure of disclosure.

## 7. Perform "Reasonable Investigation" into Every Investment (Due Diligence)

The 2019 Interpretation explicitly states that you cannot recommend an investment unless you have a **reasonable independent basis** for believing it is in the client's best interest. You must essentially "audit" the product before buying.

- **The Action:** You must understand the investment's liquidity, risks, volatility, and costs. You cannot rely solely on the issuer's marketing materials.
- **The Risk Focus:** You must evaluate if the investment creates "risks that the client cannot afford to take."

## 8. Establish and Maintain a Dynamic "Investment Profile" for Each Client

It is a violation of the Duty of Care to assume an investment is safe without matching it to a specific client profile. You must update this profile regularly, not just at account opening.

- **The Action:** You must document the client's financial situation, level of financial sophistication, investment experience, and financial goals.
- **The 2019 Update:** The SEC clarified that for retail clients, you must continually inquire about changes to this profile.

## 9. Conduct Proactive Portfolio Monitoring

The Duty of Care explicitly includes a duty to monitor. If you charge an ongoing asset-based fee, the SEC generally expects ongoing monitoring. But the nature of that monitoring matters: *proactive, activist monitoring* is fundamentally different from *reactive, post-decline investigation*.

- **The Action:** You must have systems in place that alert you when a portfolio drifts from its risk mandate or when a specific holding's risk profile changes. You must read and analyze quarterly financial statements within days of their release, monitoring liquidity ratios, equity-to-debt ratios, and leverage trends. If liquidity is decreasing, if equity relative to debt is declining, if leverage is increasing—these are signals that must trigger review.
- **The Disclosure Requirement:** If automation or computer programs exist that could more safely monitor risk, and the advisor chooses not to use them, they should disclose: "We do not use any form of automation to update the risk of your portfolio. What we do is: after a stock falls, we then find out why." Clients deserve to know if their advisor's monitoring is proactive or reactive.

## 10. Evaluate "Account Type" Recommendations

The 2019 guidance expanded fiduciary duty to include the advice to open a specific *type* of account (e.g., IRA vs. taxable, Advisory vs. Brokerage).

- **The Action:** You must calculate and document why a fee-based advisory account is better for the client than a commission-based brokerage account (or vice versa) based on their trading frequency and asset level.

## 11. Conduct "Look-Through" Analysis on Complex Products

For complex products (like inverse ETFs, structured notes, or private REITs), the "reasonable investigation" standard is heightened.

- **The Action:** You must understand the underlying derivatives and leverage. If you cannot explain mathematically how the product will behave in a market crash, you cannot purchase it for a client.

## 12. Maintain Recordkeeping of the "Reasonable Basis"

FINRA and the SEC require you to prove *why* you made a decision.

- **The Action:** You must maintain records that reconstruct the analysis performed. If an investment declines severely, you need the "receipts" showing that—at the time of purchase—it was a prudent decision based on the data available. This includes documentation of the risk disclosures made to the client, the price-to-value analysis performed, and the monitoring protocols in place.

## Objective Analysis: Is Risk Evaluation Possible Without Data Science?

**Short Answer:** For simple assets, yes. For the modern diversified portfolio, **no, it is rapidly becoming impossible.**

Here is the objective breakdown:

### 1. Where Data Science is Not Required (The "Fundamental" Era)

If an RIA invests solely in transparent, linear assets—such as U.S. Treasury bonds or blue-chip stocks held for 20 years—they can "know" the risk using traditional fundamental analysis (reading balance sheets, understanding cash flow). This satisfies the "Reasonable Investigation" standard because the risks (interest rate risk, default risk) are visible to the naked eye and basic arithmetic.

### 2. Where Lack of Data Science is a Fiduciary Risk

However, most fiduciaries invest in ETFs, mutual funds, or portfolios that interact with each other. Here, traditional analysis fails:

- **Correlation Blindness:** Without data science (correlation matrices and regression analysis), a human cannot see that three seemingly different funds in a portfolio all crash simultaneously during a specific type of liquidity event.

- **Hidden Leverage:** Many modern products contain embedded derivatives. "Knowing" the risk requires Monte Carlo simulations or VaR (Value at Risk) modeling to predict how that asset behaves in the "tail" (a 3-standard deviation market crash). You cannot calculate this with a calculator; you need algorithmic modeling.
- **Price-to-Value Analysis at Scale:** Evaluating the relationship between price paid and minimum value across hundreds of securities—and monitoring changes quarterly—requires systematic data processing that exceeds human capacity.
- **The "Reasonable Basis" Drift:** As data science tools become standard, the regulatory definition of "reasonable" shifts. If a tool exists that could have predicted a risk, and the fiduciary chose not to use it, they may be found negligent.

## Conclusion

While the SEC does not explicitly mandate "Data Science" by name, the requirement to have a **"reasonable belief"** in a product's safety essentially mandates it for any portfolio more complex than cash and bonds. In the modern market, **you cannot fulfill the Duty of Care on complex portfolios without quantitative risk analytics.**

## A Current Example

Consider Microsoft (MSFT), widely regarded as one of the safest "blue chip" holdings. The stock traded near \$468 in July 2024 and declined to approximately \$388 by early 2025—a drawdown of approximately 17% in a matter of months. Advisors who told clients that Microsoft was "safe" without quantifying the potential for such declines, without analyzing the price-to-value relationship, and without having a monitoring system that could flag changing risk conditions, arguably failed multiple duties outlined in this document. The question every advisor should ask: Did I disclose this risk? Did I have a system to detect it? Did I have a strategy to mitigate it?