

## Memo from ERS on the SEC - Fiduciary Duty to Monitor Client Assets

March 29, 2024

*Disclaimer: This document is not legal advice. It is intended to stimulate fiduciaries to look more carefully at the risks of the assets they purchase and hold for clients.*

In the realm of financial management and investment advisory, the role of a fiduciary stands as a cornerstone of trust and ethical responsibility. As outlined by the U.S. Securities and Exchange Commission (SEC) and other regulatory bodies, investment advisors are legally and ethically obligated to act in the best interests of their clients. This fiduciary duty encompasses a range of responsibilities, **chief among them being the vigilant monitoring** and management of client holdings.

The following quotes outline the nature of these requirements:

- 1) “Although all investment advisers owe each of their clients a fiduciary duty under the Advisers Act, that fiduciary duty must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client. [...] For example, **the obligations of an adviser providing comprehensive, discretionary advice** in an ongoing relationship with a retail client (e.g., **monitoring and periodically adjusting a portfolio of equity and fixed income investments with limited restrictions on allocation**) will be significantly different from the obligations of an adviser to a registered investment company or private fund where the contract defines the scope of the adviser’s services and limitations on its authority with substantial specificity.”<sup>1</sup>
- 2) “In other words, **an adviser’s federal fiduciary duty may not be waived**, though it will apply in a manner that reflects the agreed-upon scope of the relationship.”<sup>2</sup>

This unyielding nature of the fiduciary obligation highlights **the seriousness with which monitoring duties must be approached**. The laxity exhibited by some advisers in fulfilling these monitoring duties not only undermines the trust inherent in the client-adviser relationship but also contravenes the non-negotiable standards set forth by federal regulations.

- 3) “The duty of care includes, among other things: [...] (iii) **the duty to provide advice and monitoring over the course of the relationship**.”<sup>3</sup>

This line explicitly sets out monitoring as one of the fundamental duties associated with the fiduciary relationship.

- 4) “A reasonable belief that investment advice is in the best interest of a client also requires that an adviser conduct a reasonable investigation into the investment sufficient not to base its advice on materially inaccurate or incomplete information. **We have taken enforcement action where an**

<sup>1</sup> Source: <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>, starting page 9

<sup>2</sup> Source: <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>, page 10

<sup>3</sup> Source: <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>, page 12

**investment adviser did not independently or reasonably investigate securities before recommending them to clients.”<sup>4</sup>**

**The SEC's stance on the necessity for investment advisers to conduct thorough and independent research into investments is unambiguous.** This requirement is not merely a guideline but a **fundamental aspect** of the adviser's fiduciary duty to act in the best interest of their clients. The emphasis on avoiding reliance on materially inaccurate or incomplete information underscores the depth and quality of investigation expected. The SEC has a history of enforcement actions against advisers who fail to meet this standard, demonstrating the serious penalties associated with inadequate research.

- 5) “An investment adviser’s duty of care also encompasses the duty to provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship. For example, **when the adviser has an ongoing relationship with a client and is compensated with a periodic asset-based fee, the adviser’s duty to provide advice and monitoring will be relatively extensive** as is consistent with the nature of the relationship.”<sup>5</sup>

Advisers earning a percentage of Assets Under Management (AUM) are implicitly expected to offer a more consistent and active management approach. Daily monitoring in these situations becomes essential, not just as a best practice, but as a fundamental aspect of the adviser's fiduciary responsibility.

- 6) “The duty of care includes a duty to provide investment advice that is in the best interest of the client, including **a duty to provide advice that is suitable for the client**. In order to provide such advice, an adviser must have a reasonable understanding of the client’s objectives.”<sup>6</sup>

**Advisors frequently subject their clients to “buy-and-hold” strategies** – i.e., where the objective is to stay fully invested in the market long-term. **There are risks associated with these strategies: not only could the market crash during your hold, wiping out years’ worth of prior or future gains**, but the strategy is particularly unsuited for older clients, who may only have an investment horizon of a few years and thus have no time to recover from any such large losses.

## 7) “Deficiency 3: Failure to Perform Conduct Due Diligence on Investments

Performing due diligence on investment products is essential to providing advice that is in the best interest of a client. The Commission cites the Larry Grossman case as a not-so-subtle reminder of **the consequences of failing to investigate securities before recommending them to clients** (disgorgement and an industry bar). [...] The SEC discusses **the factors that should be considered**, including costs associated with the product, which involves its ‘**investment objectives, characteristics** (including any special or unusual features), **liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon and cost of exit.**’<sup>7</sup>

<sup>4</sup> Source: <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>, page 16

<sup>5</sup> Source: <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>, page 20

<sup>6</sup> Source: <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>, pages 12-13

<sup>7</sup> Source: <https://www.jdsupra.com/legalnews/what-your-next-deficiency-letter-is-58048/>

- 8) “The Commission provides its view on an adviser’s fiduciary obligations. It is a clear message that **advisers failing to address these duties with process, policies, and procedures will face the consequences** [...]”<sup>8</sup>
- 9) “Many retail advisers schedule an annual review with their clients to review their portfolios. The Interpretation requires more from advisers who agree to provide continuous discretionary advice and charge an ongoing fee. **The SEC expects ongoing account monitoring**. Many advisers perform periodic monitoring and rebalancing throughout the year (even if they don’t discuss this with clients), but **without the documentation to prove it, as far as the SEC is concerned, it didn’t happen.**”<sup>9</sup>

Given these realities, the integration of advanced analytical tools and services, like those offered by Equity Risk Sciences, becomes crucial. These tools can provide advisers with more accurate, comprehensive, and up-to-date information, thereby enhancing the quality of their investment research and decision-making processes. This, in turn, helps advisers to fulfill their fiduciary duties more effectively and avoid the significant risks and penalties associated with inadequate research.

## How ERS Helps Fiduciaries and Asset Managers

Identifying changes and new trends in a company’s financial condition is crucial for risk management.

- 1) **Early Warning:** Monitoring financial statements can reveal risks early on, such as excessive debt signaling potential stock price drops and negative rating agency assessments.
- 2) **Informed Decisions:** Recognizing financial patterns allows for smarter investment decisions.
- 3) **Valuation Precision:** A stock’s value reflects a company’s fiscal well-being. Identifying financial risks can refine stock valuations.
- 4) **Market Edge:** Correct analysis of financial patterns provides investment advantages, leading to higher returns.
- 5) **Risk Control:** Identifying changes in risk profiles enables investors to adjust portfolios to suit their risk tolerance.

In short, timely and rigorous tracking of changes in the financial conditions of one’s holdings is vital for accurate risk assessments, proactive decision making, improved financial performance, reducing investment losses, and complying with SEC regulations.

### **SECURITIES AND EXCHANGE COMMISSION** 17 CFR Part 276 – July 12, 2019

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Commission Interpretation Regarding Standard of Conduct for Investment Advisers

“We have taken enforcement action where an investment adviser did not independently or reasonably investigate securities before recommending them to clients.” *page 18*

“when the adviser has an ongoing relationship with a client and is compensated with a periodic asset-based fee, the adviser’s duty to provide advice and monitoring will be relatively extensive...” *page 23*

<sup>8</sup> Source: <https://www.jdsupra.com/legalnews/what-your-next-deficiency-letter-is-58048/>

<sup>9</sup> Source: <https://www.jdsupra.com/legalnews/what-your-next-deficiency-letter-is-58048/>