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Evolving Fiduciary Duties in the Era of Financial Reform

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The crisis in the financial sector has put pressure on both legislatures and courts to increase protections for investors. In response, Congress recently has enacted sweeping financial reform legislation, which has imposed new duties on certain types of advisers and authorizes the SEC to enact new rules imposing additional duties. And recent decisions indicate that courts may be willing to expand the fiduciary duties owed by hedge fund advisers, finding that they owe such duties not only to the funds themselves but, under some circumstances, to the investors in those funds.

In the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] Congress has moved to establish new duties to particular classes of investors. One such class of investors, referred to in the Act as "Special Entities," comprises federal agencies, states, state agencies, cities, counties, municipal or political subdivisions of states, employee benefit or governmental plans as defined in ERISA, and endowments. The Dodd-Frank Act imposes new duties on swap dealers and major swap participants who act as advisers or counterparties to a Special Entity. While arguably distinct from what are traditionally considered fiduciary duties in equity or as codified in state corporation codes, these quasi-fiduciary statutory duties offer significant protection to Special Entities. For example, the Act imposes a duty on a swap dealer or major swap participant acting as an adviser to a Special Entity to make reasonable efforts to determine that the swap is in the Special Entity's best interest. For a swap dealer or major swap participant acting as a swap counterparty, the Act mandates that, before entering the swap, the counterparty must have a reasonable basis for believing the Special Entity has an adviser with a fiduciary duty to act in the best interest of the Entity and who is knowledgeable, not disqualified, independent, has made all necessary disclosures, and makes a written finding regarding fair pricing and appropriateness of the transaction.[2]

Dodd-Frank also requires the SEC to conduct a study to determine whether to impose a fiduciary standard on brokers, dealers and investment advisers with respect to

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[1] Pub. L. No. 111-233 (2010).

[2] *Id.*, §§ 731 & 764.

retail customers. Moreover, it authorizes the agency to issue rules to that effect.[3] The Act sets out some limitations, however. For example, commission–based compensation will not itself constitute a violation of any fiduciary standard adopted under the Act. While the SEC study will not be complete until early next year, and any rules would be proposed only thereafter, the resulting new regulations could profoundly affect the relationships of brokers, dealers and investment advisers with their retail customers.

Courts also appear to be moving, slowly, in the direction of expanding the concept of fiduciary duty. Until recently, courts have often held as a matter of law that hedge fund advisers owe no fiduciary duties to individual investors in a hedge fund, but only to the fund itself. The rule was reflected in the 2006 case *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) in which the D.C. Circuit struck down an SEC rule requiring hedge funds to register with the SEC based on the number of investors in the fund. Analyzing the client-adviser relationship under both prior SEC interpretations and Supreme Court precedent dating back to 1985, it announced that "[t]he adviser owes fiduciary duties only to the fund, not to the fund's investors." *Id.* at 881.

Hedge fund advisors sued by fund investors for breach of fiduciary duties regularly invoke the principle described in *Goldstein* to have such claims dismissed on the pleadings for failure to state a claim recognized by law. Recently, for example, in *West Palm Beach Police Pension Fund v Collins Capital Low Volatility Performance Fund II Ltd*., 2010 WL 2949856 (S.D. Fla. July 26, 2010), the court dismissed fiduciary duty claims against a hedge fund manager on the grounds that "the adviser [to the fund] owes fiduciary duties only to the fund, not to the fund's investors," citing *Goldstein*. *Id.* at *3. And the court in *Barnelli & Cie, S.A. v. Dutch Book Funds, SPC, Ltd.*, 2010 WL 3504780 (N.Y. Sup. Ct. Aug. 9, 2010) dismissed a fiduciary duty claim against hedge fund adviser by fund shareholders on the same grounds.

However, a recent Sixth Circuit case, *U.S. v. Lay*, 612 F.3d 440 (6th Cir. 2010), may signal a softening of the *Goldstein* rule, and an increasing willingness of the courts to impose additional duties on advisers. In that case, an investment by the Ohio Bureau of Workers' Compensation in a hedge fund, the Active Duration Fund, had given rise to a criminal claim of investment adviser fraud. The adviser argued that the jury could not, under *Goldstein*, have concluded that the adviser owed a fiduciary duty to the Bureau because his only duties were to the fund and not to the individual investors. The Sixth Circuit disagreed, holding that "Lay's categorical argument to the contrary is primarily based upon reading too much into the holding of the District of Columbia Circuit in *Goldstein*." *Id.* at 446. "*Goldstein,"* the court held, "did not hold that no hedge fund adviser could create a client relationship with an investor, but rather held only that the SEC had 'not justified treating *all* investors in hedge funds as clients.'" *Id.* at 446-447. The Sixth Circuit concluded that the jury should have been afforded the opportunity to consider various factors that could have resulted in a fiduciary duty being established with the hedge fund investor. The Sixth Circuit cited the fact that the Bureau was the only investor in the fund, that it had meetings with the hedge fund adviser regarding its

[3] *Id.*, § 913.

investment indicating an active role in the investment, and had a previous relationship with the hedge fund manager as a financial adviser. *Id.* at 446. While *Lay* does not announce a full-blown reversal of *Goldstein*, it does indicate an increased willingness to consider a hedge fund manager as a fiduciary to the fund investor in certain circumstances, and tempers the bright-line rule other courts have extracted from that case.

A Connecticut state court faced with a fiduciary duty claim against a Madoff-related feeder fund recently came to a similar conclusion in *Retirement Program for Employees of Town of Fairfield v. Madoff*, 2010 WL 2106654 (Conn. Super. Ct. Apr. 16, 2010). There, the investment adviser for the feeder fund invoked *Goldstein* to argue that the limited partners did not have standing to make a fiduciary duty claim against it. *Id.* at *12. As in *Lay*, the court found the adviser's previous relationship with the investor significant and permitted the limited partners to assert the claim against the adviser. *Id.* at *14-15.

As the effects of the financial crisis percolate through the courts, one can expect further development, and likely expansion, of fiduciary duties owed by advisers to hedge fund and other investors.